5 Risks that Relate to the Statements of the Parties

5.1 Introduction

In all contracts, part of the general legal risk relates to the parties’ statements rather than the legal system as a whole or laws in general. In addition to the risk inherent in the interpretation of contracts (section 5.2), the risks that relate to the statements of the parties include the risk that terms are not binding as intended (section 5.3) and even the risk that some terms may become (section 5.6) or remain binding (section 5.5). Sometimes terms are binding but not enforceable by legal means (section 5.4).

Freedom of contract. The freedom of contract means the freedom of a party to choose to enter into a contract on whatever terms it may consider advantageous to its interests, or to choose not to.

Both mandatory and dispositive law have interfered in the contractual relationship. Where the parties disagree on the existence or contents of contractual obligations, their mutual relationship is less likely to be interpreted according to the will of one or more parties and more likely to be interpreted according to legal background rules.

Interpretation. All parties interpret contracts. In the case of a dispute, contracts will typically be interpreted by outsiders and not by the persons who drafted them. Even if the contract were valid and binding and enforceable according to its terms, the statements made by the parties’ representatives might not always lead to such contractual obligations or terms they had in mind.

Contract not binding. Normally, the firm wants a good contract to be binding according to its terms. For many reasons, contract terms are not always binding. For example, some contract terms might be incompatible with mandatory provisions of law, or a standard form contract might not have been incorporated properly.

Contract binding. In some cases, the firm would be better off if the contract or some of its terms were not binding. For example, the firm may require better information before it is prepared to accept the contract (section 5.6), or changed circumstances may make the contract unprofitable ex post (section 5.5).

For the reader. The following section starts with a rather lengthy account of the interpretation of contracts (sections 5.2.1–5.2.4). The way contracts are interpreted is one of the key issues that influence drafting, and interpretation rules can be seen in a new light when the perspective is that of the firm as their “user”. Some read-
ers might nevertheless prefer to move directly to section 5.2.5 which deals with the mitigation of risk.

5.2 Interpretation of Contracts

5.2.1 Introduction

Contracts are the most important way to regulate the intended cash flow and the exchange of goods, choose the preferred risk level, manage principal-agency relationships, and regulate information by legal means. The flexibility of interpretation increases risk. On the other hand, better management of the interpretation risk can ensure the same cash flow with lower risk. The firm should therefore make the outcome of interpretation more predictable and precise (i.e. reduce its variance ex ante).

A contract term cannot be enforced without interpreting it. The firm should interpret its draft contracts in advance. After contracting, it may become necessary to interpret the contract in order to determine: how to comply with its terms; whether there is a breach of contract; or whether there is a valid and enforceable contract in the first place. The court is the last instance to interpret the contract.

Contract and contract document. The contract is not the same thing as the contract document or its individual clauses. The contract document is regarded as evidence of a contract.

The existence of proper documentation can reduce risk. For example, it is more difficult to fulfil contracts that do not contain clear terms. Such contracts are often disputed ex post, and a third party (such as an arbitrator or judge), following established rules of contract interpretation (normative interpretation rules, canons of interpretation), may then have to decide the contents of the parties’ obligations.

Governing law, substance, procedure, canons of interpretation. The law governing the interpretation of contracts is designated by the applicable choice of law rules (those of lex fori).

The law governing the interpretation of statements made by the parties should be distinguished from the law that governs the interpretation of contracts. For example, there is a distinction between substance and procedure.

In court proceedings, all procedural matters are governed exclusively by the law of the forum. The firm can choose the applicable procedural interpretation rules by choosing a dispute resolution clause which provides for litigation or arbitration in a certain jurisdiction (section 4.4.4).

Normally, the interpretation of contracts is governed by the law applicable to the contract. Interpretation is one of the matters that come within the scope of the law applicable to the contract under the Rome I Regulation. When interpreting the contractual rights and obligations of the parties in the light of the statements of the parties, the court would thus apply the governing law of the contract.

1 Article 12(1)(a) of Regulation 593/2008 (Rome I).