

Contract Interpretation Revisited: The Case of Severability Clauses

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ABSTRACT

The contextualist contract interpretation approach – under which courts consider all the relevant circumstances beyond the written contract – is a major method applied by courts in contract law disputes.

Although the theoretical debate over the desirability of this approach is rich, there are only a few empirical studies aiming to assess the contract parties' opinion about this approach.

Focusing on the interpretation of unenforceable contract terms, this Article empirically investigates the interpretation preferences of sophisticated parties to commercial contracts. By examining 500 commercial contracts that have been recently disclosed to the Securities and Exchange Commission, this Article finds that a majority (71%) of contracts include a “severability clause,” which typically triggers an anti-contextualist rule of contract interpretation. Under this rule, if the contract includes any type of unenforceable term, courts should normally enforce the remainder of the contract. Such rule, in essence, opts-out from the default contextualist method of interpretation typically applied by courts. Under this default method, courts consider all the relevant circumstances surrounding the contract in order to ascertain the intention of the parties regarding the outcome of the specific unenforceable term. This outcome can be either the enforcement of the remainder of the contract or the nullification of the entire agreement, depending on the intention of the parties, as determined via a contextualist interpretation method. This Article however indicates for the first time that contract parties normally object to such contextual default regime by adopting a severability clause.

The results of this study also indicate that the severability clauses adopted by contract parties are not a mere standardized boilerplate that varies marginally, if at all, among different contracts. These clauses vary significantly both in form and substance.

The theoretical and practical implications of these results are discussed.

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INTRODUCTION

Contract interpretation plays an important role in American law.² It has spurred intense debate among contract law scholars.³ It has also been a source of many contractual disputes.⁴

² STEVEN J. BURTON, *ELEMENTS OF CONTRACT INTERPRETATION 1* (2009) (“Issues of contract interpretation are important in American law.”); Avery Wiener Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 COLUM. L. REV. 496, 496 (2004) (“Under the modern American law of contracts, almost all applications of legal doctrine turn on questions of interpretation[.]”); Joshua M. Silverstein, *Using the West Key Number System as a Data Collection and Coding Device for Empirical Legal Scholarship: Demonstrating the Method Via a Study of Contract Interpretation*, 34 J.L. & COM. 203, 204 (2016) (“Contract interpretation is one of the most significant areas of commercial law.”).

³ Steven J. Burton, *A Lesson on Some Limits of Economic Analysis: Schwartz and Scott on Contract Interpretation*, 88 IND. L.J. 339, 340 (2013) (“After decades of relative neglect, contract interpretation became a hot topic of scholarly debate after 2003.”); Ronald J. Gilson et al., *Text and Context: Contract Interpretation as Contract Design*, 100 CORNELL L. REV. 23, 25 (2014) (“Contract interpretation remains . . . the least settled, most contentious area of contemporary contract doctrine and scholarship.”); Katz, *supra* note 2, at 496 (“For over a century, legal commentators have debated the relative merits of formal and substantive approaches to the interpretation of contracts[.]”); Robert E. Scott, *Contract Design and the Shading Problem*, 99 MARQ. L. REV. 1, 3 (2015); Silverstein, *supra* note 2, at 204 (contract interpretation “has received considerable scholarly attention during the last decade”); Robert E. Scott, *Text Versus Context: The Failure of the Unitary Law of Contract Interpretation*, BUCKLEY’S MIX 5, <http://buckleymix.com/wp-content/uploads/2010/10/scott.pdf> (last visited June 4, 2019) [hereinafter Scott, *Text Versus Context*].

⁴ Gilson et al., *supra* note 3, at 25 (“Contract interpretation remains the most important source of commercial litigation . . .”); see also BURTON, *supra* note 2, at 1 (noting that issues of contract interpretation “probably are the most frequently litigated issues on the civil side of the judicial docket”); David A. Dilts, *Of Words and Contracts: Arbitration and Lexicology*, 60 DISP. RESOL. J. 41, 43 (May-June 2005) (“The construction of contract language is the controversy most evident in contract disputes.”); Benjamin E. Hermalin et al., *Contract Law*, in 1 HANDBOOK OF LAW & ECONOMICS 3, 68 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (“Probably the most common source of contractual disputes is differences in interpretation[.]”); Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1582 (2005) (“[S]ignificant interpretive questions often arise in contract litigation.”); Scott, *supra* note 3, at 3; John P. Tomaszewski, *The Pandora’s Box of Cyberspace: State Regulation of Digital Signatures and the Dormant Commerce*

A major method of contract interpretation applied by the courts is the contextualist approach.⁵ According to this method, when courts interpret a contract, they consider *all* relevant contextual evidence beyond the written contractual text, such as the pre-contractual negotiation history or the parties' post-contractual conduct.⁶ One central theoretical argument that underlies the contextualist approach is based on the following hypothesis about the intention of the contract parties: most parties probably prefer courts to examine all the circumstances surrounding the contract while interpreting it, and not to merely adhere to the contract text.⁷

While theoretical debate over the desirability of the contextualist approach is very rich,⁸ there is scant existing empirical literature aiming to assess the parties' true opinion about this approach, as reflected in the language of their contracts.⁹ This study aims to fill this research gap by analyzing the content of real-world contracts, which may shed light on the parties' interpretation preferences.¹⁰ True, from a methodological perspective, it is almost impossible to empirically assess the parties' opinion, as reflected in their contracts, about the contextualist interpretation approach.¹¹ This is mainly because contract interpretation rules are normally mandatory,¹² i.e., the parties are typically prevented from contracting around

Clause, 33 GONZ. L. REV. 417, 432 (1997–1998) (“Most contract litigation involves disputes over construction of the terms in a contract.”).

⁵ See *infra* Part I.A.

⁶ Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 308 (1985) (“[T]he contextualists have assumed that the purpose of interpretation is to uphold the expectations of the particular parties to the agreement by determining from an analysis of all relevant evidence what they ‘really meant.’”); Katz, *supra* note 2, at 498 (“A more ‘substantive’ approach to contract interpretation . . . would attempt to come to a more all-things-considered understanding, based on all of the materials reasonably available.”); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 572 (2003) (“[Contextualists’] theory lets courts consider all material evidence to resolve interpretive issues.”).

⁷ James W. Bowers, *Murphy’s Law and the Elementary Theory of Contract Interpretation: A Response to Schwartz and Scott*, 57 RUTGERS L. REV. 587, 601 (2005) (“[F]irms might in fact prefer Corbin style contextualist contract interpretation rules.”); Scott, *supra* note 3, at 3 (“This contextualist regime of contract interpretation rests on the powerful intuition that most parties . . . would prefer courts to take advantage of hindsight in assisting the parties to achieve their contractual objectives.”).

⁸ See *infra* Part I.A.

⁹ See *infra* Part I.B.

¹⁰ See *infra* Part II.

¹¹ Lisa Bernstein, *Merchant Law in a Modern Economy* 12 (Coase-Sandor Inst. for Law & Econ., Working Paper No. 639, 2013).

¹² See *id.* (“[T]he [U.C.C.’s] contextualist interpretive approach is, in practice, quasi-mandatory.”); Schwartz & Scott, *supra* note 6, at 583, 585 n.84 (“Courts in general . . . treat interpretation rules as mandatory . . . [t]he current interpretive rules are mandatory[.]”); Scott, *Text Versus Context*, *supra* note 3, at 8 (“Contract interpretation rules are . . . mandatory[.]”).

the contextualist interpretation method.¹³ However, the parties can contractually manifest their objection to the contextualist method of interpretation in one narrow exception: when the court is required to interpret an unenforceable contract term.¹⁴ This narrow exception will be empirically examined in this Article in an effort to peek inside the notions that contract parties may have concerning the contextualist method of interpretation.¹⁵

More specifically, contracts may often contain a single clause that is unenforceable, such as an excessively restrictive non-compete provision, an anti-competitive clause on pricing terms, or an invalid liquidated damages clause.¹⁶ In such cases, courts are often required by the parties to decide what should be the legal outcome of the unenforceable clause: should the invalid clause nullify the entire contract, including its lawful terms, or should the unenforceable clause be severed from the contract, enabling the enforcement of the remaining lawful provisions.¹⁷ In order to decide the outcome of the unenforceable term, courts normally interpret the term by applying a contextualist method of interpretation.¹⁸ Specifically, if the court concludes

¹³ Scott, *Text Versus Context*, *supra* note 3, at 8, 21; *see also* Schwartz & Scott, *supra* note 6, at 583 (noting that under a mandatory regime, “courts, not parties, should choose the rules that determine how contracts are read.”).

¹⁴ *See infra* Part II.A.

¹⁵ *See infra* Part II.

¹⁶ For examples of unenforceable terms, *see* Christopher R. Leslie, *The Arbitration Bootstrap*, 94 TEX. L. REV. 265, 282 (2015); Charles A. Sullivan, *The Puzzling Persistence of Unenforceable Contract Terms*, 70 OHIO ST. L.J. 1127, 1130; Paul H. Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237, 241 (1981); Nick Fay, *The Unintended Consequences of a Severability Clause*, 3 THE TRANSACTIONAL LAW. 3, 5 (2013); Eric Fishman & Robert James, *Drafting Better Severability Clause*, CORPORATE COUNSEL (Oct. 1, 2013) at *2, <https://www.pillsburylaw.com/images/content/4/4/v2/4483/Article20131001DraftingaBetterSeverabilityClause.pdf>.

¹⁷ *See* Mark L. Movsesian, *Severability in Statutes and Contracts*, 30 GA. L. REV. 41, 47 (1995).

¹⁸ *Id.* at 44 (“Because severability turns on the intent of the parties, a court may examine extrinsic evidence, including the contract’s negotiation history, to discover whether the parties in fact believed the illegal term to be essential.”); *Lutz v. Chesapeake Appalachia, L.L.C.*, 717 F.3d 459, 466-67 (6th Cir. 2013) (“Whether a contract is entire or divisible depends generally upon the intention of the parties, and this must be ascertained by the ordinary rules of construction, considering not only the language of the contract, but also, in cases of uncertainty, the subject-matter, the situation of the parties, and circumstances surrounding the transaction, and the construction placed upon the contract by the parties themselves.”); *In re Balfour MacLaine Int’l Ltd.*, 85 F.3d 68, 81 (2d Cir. 1996) (“[T]he severability of a contract is a question of the parties’ intent, to be determined from the language employed by the parties, viewed in the light of the circumstances surrounding them at the time they contracted.”) (citation omitted); *Jacobs v. CNG Transmission Corp.*, 772 A.2d 445, 452 (Pa. 2001) (“[A]bsent express language that a contract is entire, a [Pennsylvania court] may look to the contract as a whole, including the character of the consideration, to determine the intent of the parties as to severability and may also consider

that the parties intended for said term to serve as an “essential” part of their contract, it will normally declare the entire contract void.¹⁹ Conversely, if the courts conclude that the parties intended the unenforceable term to be nonessential, the courts will sever this term from the contract and enforce the remainder of the agreement.²⁰ However, the parties also typically have a legal capability to contract around the contextualist method of interpretation applied by courts when interpreting an unenforceable term. They can specifically adopt an anti-contextualist “severability clause,”²¹ which guides courts in refraining from considering any contextual evidence when interpreting an unenforceable term.²² Instead, the clause normally directs courts to sever any unenforceable clause, regardless of its contextual

the circumstances surrounding the execution of the contract, the conduct of the parties, and any other factor pertinent to ascertaining the parties' intent.”).

¹⁹ VICI Racing, LLC v. T-Mobile USA, Inc., 763 F.3d 273, 284–85 (3d Cir. 2014) (“Delaware law is clear that [a]n invalid term of an otherwise valid contract, if severable, will not defeat the contract . . . [t]hus, a court will enforce a contract with an indefinite provision if the provision is not a material or essential term.”) (citations and internal quotations omitted); United States v. Araguz-Briones, 243 Fed. App’x. 64, 67 (5th Cir. 2007) (“Whether the appeal waiver provision is severable turns on whether it is an “essential term” of the bargain.”); Shaffer v. Royal Gate Dodge, Inc., 300 S.W.3d 556, 561 (Mo. Ct. App. 2009) (“If an unenforceable term is essential to the entire agreement, then it may render the remainder of the agreement unenforceable.”); Michael T. Kersten, *Exactions, Severability and Takings: When Courts Should Sever Unconstitutional Conditions from Development Permits*, 27 B.C. ENVTL. AFF. L. REV. 279, 298–99 (2000) (“If the court determines that the parties would not have made the agreement without the provision, then the provision is essential and will not be severed from the rest of the contract. In this case the entire contract fails and is unenforceable.”); Movsesian, *supra* note 17, at 48 (“If . . . the court believes that the provision is essential, that the parties would not have entered into the agreement without it, the court will declare the provision inseverable and refuse to enforce the contract in its entirety.”).

²⁰ RESTATEMENT (SECOND) OF CONTRACTS § 184 (AM. LAW INST. 1981) (“If less than all of an agreement is unenforceable . . . a court may nevertheless enforce the rest of the agreement in favor of a party who did not engage in serious misconduct if the performance as to which the agreement is unenforceable is not an essential part of the agreed exchange.”); Stewart v. GGNCS-Canonsburg, L.P., 9 A.3d 215, 217 (Pa. Super. Ct. 2010) (“Pennsylvania law holds that if less than an entire agreement is invalid, and the invalid provision is not an essential part or the primary purpose of the agreement, then the remaining portions of the agreement are fully enforceable.”); Movsesian, *supra* note 17, at 43 (“A court will sever an illegal term and enforce the remainder of an otherwise valid contract where the court concludes the term was not an essential part of the agreed exchange, that is, where the court concludes that the parties would have made the agreement even without the illegal term.”) (internal quotations omitted); Kersten, *supra* note 19, at 298 (“If the parties would have made the agreement without the illegal provision, the provision is not essential to the contract. In this case the term can be severed and the remaining contract enforced.”); Fay, *supra* note 16, at 4 (““Courts have long severed an unenforceable provision of an otherwise valid agreement, leaving the remainder in effect, provided the unenforceable portion is not an essential part of the agreed exchange.”).

²¹ See *infra* Part II.A.

²² *Id.*

interpretation, and to enforce the remainder of the contract.²³ This unusual ability to contract around the contextualist method of interpretation, via a severability clause, provides a unique opportunity to empirically investigate what may be the opinion of the contract parties about this method of interpretation. Specifically, if the majority of real-world contracts adopt an anti-contextualist severability clause, it may indicate that contract parties normally object to the contextualist method of interpretation of unenforceable terms.

Focusing on the preferences of sophisticated parties to commercial contracts, this paper analyzes 500 commercial contracts that have been recently disclosed to the U.S. Securities and Exchange Commission (“SEC”) in an effort to reveal the opinion these parties have about the contextual interpretation of unenforceable terms.²⁴ This Article will proceed as follows: Part I provides the theoretical context by reviewing the theoretical debate over the contextualist method of contract interpretation. Part I also presents the major existing empirical research on parties’ preferences for contract interpretation rules, typically relied on by anti-contextualist scholars. It also explains the potential contribution of this Article to the existing empirical research. Part II presents the empirical test of this study. It reviews the data and discusses the methodology for empirically testing the frequency with which an anti-contextualist severability clause is included in commercial contracts between sophisticated parties. Part III discusses the normative implications of the empirical results.

I. THEORETICAL BACKGROUND

A. *The Debate Over Contextual Interpretation*

Under the contextualist method of interpretation, courts consider all relevant contextual evidence beyond the written contractual text to interpret a contract.²⁵ As generally reflected in the Supreme Court decision in *Sand Filtration Corp. v. Cowardin*, “[w]hen the contract is in writing the language used should be interpreted in the light of the circumstances surrounding the

²³ *Id.*

²⁴ *See infra* Part II.C.

²⁵ Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 308 (1985) (“[T]he contextualists have assumed that the purpose of interpretation is to uphold the expectations of the particular parties to the agreement by determining from an analysis of all relevant evidence what they ‘really meant.’”); Katz, *supra* note 2, at 498 (“A more ‘substantive’ approach to contract interpretation . . . would attempt to come to a more all-things-considered understanding, based on all of the materials reasonably available.”); Schwartz & Scott, *supra* note 6, at 572 (“[Contextualists’] theory lets courts consider all material evidence to resolve interpretive issues . . .”).

parties at the time the contract was made” (emphasis added).²⁶ According to the contextualist method, the written contractual language is regarded only as “prima facie terms,” which courts can override by considering contextual evidence to understand the parties’ true intentions.²⁷ Additionally, under this method, courts consider context, even if the contract seems unambiguous.²⁸ As Chief Justice Traynor explained in *Pacific Gas & Electric Co. v. G.W. Thomas Drayage & Rigging Co.*:

The test of admissibility of extrinsic evidence to explain the meaning of a written instrument is not whether it appears to the court to be plain and unambiguous on its face, but whether the offered evidence is relevant to prove a meaning to which the language of the instrument is reasonably susceptible.²⁹

The context that may be considered during the interpretation process includes: (1) the subject matter of the contract, (2) the objective of the contract, (3) statements made by the parties in preliminary negotiations, (4) the subsequent conduct of the parties to the contract, (5) usages of trade, (6) the course of dealing between the parties, and (7) the reasonableness of respective interpretations advocated by the parties.³⁰

A central theoretical argument that underlies the contextualist method is that most parties would probably want courts to apply this method in their case given its benefits.³¹ These benefits include the following:

1. By considering all relevant contextual evidence, courts can reveal

²⁶ *Sand Filtration Corp. v. Cowardin*, 213 U.S. 360, 364 (1909).

²⁷ See Scott, *supra* note 3, at 4–5.

²⁸ Ronald J. Gilson et al., *Contract and Innovation: The Limited Role of Generalist Courts in the Evolution of Novel Contractual Forms*, 88 N.Y.U. L. REV. 170, 171 n.1 (2013) (“In a textualist regime, and absent ambiguity, generalist courts cannot choose to consider context; in a contextualist regime, these courts must consider it.”); Gilson et al., *supra* note 3, at 25–26.

²⁹ *Pacific Gas & Elec. Co. v. G.W. Thomas Drayage & Rigging Co.*, 69 Cal. 2d 33, 37 (1968).

³⁰ See, e.g., the decision of the Supreme Court of Washington in *Berg v. Hudesman*, 115 P.2d 222, 229 (Wash. 1990); see also *Spectrum Glass v. PUD of Snohomish*, 119 P.3d 854, 858 (Wash. Ct. App. 2005); *DP Aviation v. Smiths Indus. Aero. & Def. Sys. Ltd.*, 268 F.3d 829, 838 (9th Cir. 2001).

³¹ James W. Bowers, *Murphy’s Law and the Elementary Theory of Contract Interpretation: A Response to Schwartz and Scott*, 57 RUTGERS L. REV. 587, 601 (2005) (“[F]irms might in fact prefer Corbin style contextualist contract interpretation rules”); Scott, *Text Versus Context*, *supra* note 3, at 3 (“This contextualist regime of contract interpretation rests on the powerful intuition that most parties . . . would prefer courts to take advantage of hindsight in assisting the parties to achieve their contractual objectives.”).

the true subjective intention of the parties.³² Conversely, if courts ignore contextual evidence during the interpretation process, such as the parties' pre-contractual negotiations or post-contractual conduct, they may interpret the contract contrary to the parties' true intentions.³³

2. The contextualist method allows the parties to economize transaction costs.³⁴ Under this method, the parties can write short and simple agreements, leaving it to courts to interpret these agreements via rich and broad contextual evidence.³⁵
3. The contextualist method decreases post-contractual rent-seeking by contract parties. It may specifically deter a party from opportunistically seeking an economic benefit by relying on the formal language of the contract while knowing that it does not reflect the parties' actual mutual intention, which is witnessed by the contract context.³⁶

The contextualist method has been the object of fierce criticism by anti-contextualist scholars.³⁷ The critique suggests that the contextual approach has several major disadvantages for the parties:

1. A contextualist approach creates substantial litigation costs. First, courts must thoroughly examine all relevant contextual evidence beyond the written contract.³⁸ This task may require the expensive

³² Robert E. Scott, *The Death of Contract Law*, 54 U. TORONTO L.J. 369, 375–76 (2004) (“[F]ollowing the lead of Arthur Corbin, courts interpreting the new contract law were advised to use context evidence . . . so as to ascertain the subjective meaning of the parties agreement.”).

³³ Scott, *Text Versus Context*, *supra* note 3, at 16 (“Excluding evidence of these parties’ prior negotiations or practices under their contract risks interpreting the contracts in opposition to the parties’ actual intentions.”).

³⁴ CATHERINE MITCHELL, *INTERPRETATION OF CONTRACTS* 108–09 (2007) (“One of the arguments in favour of contextualism over literalism is that it lowers transaction costs . . .”); George Cohen, *Interpretation and Implied Terms in Contract Law*, in *ENCYCLOPEDIA OF CONTRACT LAW AND ECONOMICS* 125, 132 (Gerrit de Geest ed., 2d ed. 2011) (“A key economic argument for an expansive court role in interpreting and implying terms is that court willingness to engage in these practices enables and encourages parties to write less complete contracts than they otherwise do. Writing less complete contracts saves on drafting and negotiating costs so long as the court-supplied interpretations and terms sufficiently approximate the parties’ intentions.”).

³⁵ MITCHELL, *supra* note 34, at 109 (“Parties can write a simpler document, leaving it to the courts to fill gaps through the process of contextual interpretation.”).

³⁶ *Id.* at 113 (“[A] party may strategically seek an advantage by relying on the strict words of a contract while knowing that the documents did not reflect the parties’ joint understanding”).

³⁷ See, e.g., Schwartz & Scott, *Contract Interpretation Redux*, *infra* note 45; Bernstein, *supra* note 11.

³⁸ For the contextual elements considered by courts under the contextualist method, see *supra* note 30 and accompanying text.

- inquiry of expert and non-expert witnesses.³⁹ Second, the contextualist method can produce disagreements between the parties about the relative weight of each bit of context vis-à-vis the contract text, thereby preventing the parties from reaching a settlement.⁴⁰
2. The contextualist method might give rise to two judicial errors. First, by considering numerous components of context, including oral, behavioral and textual ones, courts might interpret the contract incorrectly, i.e., contrary to the parties' actual intentions.⁴¹ Second, the parties may have intended that the text of their contract be the only source of contract interpretation, whereas the contextual method may wrongly presume that the parties prefer courts to interpret the contract via its context.⁴²
 3. The contextualist method might allow a party to opportunistically escape a contract that has simply proved to be a bad bargain, by disagreeing as to the clear meaning of the contract text and relying manipulatively on its context.⁴³

³⁹ MITCHELL, *supra* note 34, at 110 (under a contextualist regime, “[e]xpert testimony may have to be adduced, preliminary hearings may be required on matters of evidence and procedure and so on.”).

⁴⁰ Cf. MITCHELL, *supra* note 34, at 112 (“[L]itigation over terms and obligations is actually encouraged . . . by courts adopting a contextual approach . . . in relation to terms[.]”). Relatedly, a contextualist approach reduces certainty thereby making settlement less likely. See Cohen, *supra* note 34, at 133 (“[A]llowing contextual evidence may undermine certainty and therefore make settlement less likely.”).

⁴¹ MITCHELL, *supra* note 34, at 110 (“[T]he greater the amount of contextual material, the greater the possibility for error. Decision-makers may easily become ‘bewildered by a large set of conflicting evidence.’”); *id.* at 115 (“The contextual approach arguably increases the chances for error by increasing the amount of information deemed relevant to the interpretation exercise.”); Schwartz & Scott, *supra* note 6, at 587 (“[A] disappointed party may plausibly claim that the parties’ course of dealing or their oral negotiations showed that, in the parties’ language, ‘all’ meant ‘some’ . . . [w]hen such a claim is false but found to be true, the court necessarily will misinterpret the contract.”).

⁴² Scott, *Text Versus Context*, *supra* note 3, at 16 n.40 (“But sometimes the parties may actually have intended that their clear language should be read in the standard (plain meaning) way despite the fact that the language itself conflicts with the prior practices and negotiations of the parties. In such a case, a court that relies too heavily on context risks misinterpreting the parties’ actual intentions.”).

⁴³ MITCHELL, *supra* note 34, at 113 (“One may use the ‘context’ to seek an unbargained for advantage in imposing terms after the parties are in a contractual relationship, even in circumstances where the written terms appear relatively complete.”); Scott, *supra* note 32, at 377 n.18 (“Here the risk is that, unless the court privileges the written agreement by excluding the contextual evidence, parties . . . will be motivated to dispute the meaning of perfectly communicative contract terms as a strategic response to a now disfavoured contract.”).

B. Existing Empirical Studies

Only a small number of empirical studies have thus far examined the parties' preferences for the contextual method of interpretation.⁴⁴ Anti-contextualist scholars often rely on these studies, conducted mainly by Professors Lisa Bernstein, Theodore Eisenberg, and Geoffrey Miller.⁴⁵ In one empirical research study, Professor Lisa Bernstein examined the private legal system created by the National Grain and Feed Association ("NGFA") to settle contractual conflicts among its members.⁴⁶ The study indicated that NGFA arbitrators tend to apply an anti-contextualist method to adjudication.⁴⁷ They particularly did not allow course of performance, trade usage, or course of dealing to alter either the contract text or trade rules.⁴⁸ In another study, Bernstein investigated the contractual relations in the cotton industry.⁴⁹ According to the study, the conflicts in these relations were normally subject to an institutional cotton arbitration.⁵⁰ The study

⁴⁴ Shawn Bayern, *Contract Meta-Interpretation*, 49 U.C. DAVIS L. REV. 1097, 1121 (2016) ("As commentators on all sides of the debate seem to agree, empirical evidence of parties' meta-interpretive preferences is extremely limited."); Silverstein, *supra* note 2, at 283–84 ("The bulk of the interpretation policy debate focuses on interpretive accuracy, transaction costs, and enforcement costs . . . [T]here are virtually no scholarly sources (or judicial opinions) that even purport to present systematic evidence on these questions."); *Id.* at 204 ("Virtually all academic work in this field [contract interpretation] is doctrinal or theoretical. But numerous contract interpretation issues cry out for empirical investigation.").

⁴⁵ For anti-contextualist scholars who rely on Professor Bernstein's empirical research, see, e.g., Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. REV. 1023, 1102 (2009); Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 YALE L.J. 926, 956 (2010) [hereinafter Schwartz & Scott, *Contract Interpretation Redux*]; Schwartz & Scott, *supra* note 6, at 576 n.66 (referencing Lisa Bernstein's empirical scholarship, Professors Schwartz and Scott argue that "[t]here is considerable evidence that firms prefer a formalist adjudicatory style"); Scott, *supra* note 32, at 378 & n.21; Silverstein, *supra* note 2, at 278–79 ("Textualism is frequently defended on the ground that businesses prefer that method of construction. This view finds support in the work of Lisa Bernstein."); For anti-contextualist scholars who rely on Professors Theodore Eisenberg and Geoffrey Miller's empirical scholarship see Lisa Bernstein, *Custom in the Courts*, 110 NW. U. L. REV. 63, 109 (2015); Kraus & Scott, *supra*, at 1102-03; Geoffrey P. Miller, *Bargains Bicoastal: New Light on Contract Theory*, 31 CARDOZO L. REV. 1475, 1477-78 (2010); Schwartz & Scott, *Contract Interpretation Redux*, *supra*, at 956–57; Bernstein, *supra* note 11, at 15–16.

⁴⁶ Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1769 (1996).

⁴⁷ *Id.* at 1769–70.

⁴⁸ *Id.*

⁴⁹ Lisa Bernstein, *Private Commercial Law in the Cotton Industry: Creating Cooperation Through Rules, Norms and Institutions*, 99 MICH. L. REV. 1724, 1725 (2001).

⁵⁰ *Id.* at 1724 ("[M]ost such contracts are concluded under one of several privately drafted sets of contract default rules and are subject to arbitration in one of several merchant tribunals.").

furthermore showed that cotton arbitrators use an anti-contextualist method that gives little explicit weight to the context of the contract.⁵¹

In another empirical study, quantitative in nature, Professors Theodore Eisenberg and Geoffrey Miller investigate, inter alia, choice-of-law clauses in a data set of contracts reported by public firms to the SEC.⁵² The results of the study showed that the parties examined in the study chose California law in less than 8% of the contracts, while parties selected New York law in approximately 46% of the contracts.⁵³ Since California's contract interpretation law is inclined toward contextualism⁵⁴ and New York's contract interpretation law is inclined toward anti-contextualism,⁵⁵ anti-contextualist scholars argued that Eisenberg and Miller's results indicate that parties to commercial contracts tend to object to the contextualist approach of contract interpretation.⁵⁶

This Article makes two major contributions to the existing empirical legal studies on contract interpretation. First, in order to allow cross-industry generalization, the industries of the contract parties, examined in this Article, are heterogeneous and are not limited to the grain, feed, and cotton industries (Professor Bernstein's studies). These industries include, inter alia, the following: agriculture, automotive, banking, insurance, real estate, and retail.⁵⁷ Second, the existing empirical studies focus on indirect indicators of the parties' opinion about the contextual interpretation rules: (a) the method of adjudication applied by arbitrators (Professor Bernstein's studies); (b) the choice of law clauses selected by public companies (Professors Eisenberg and Miller's study). In order to avoid the drawbacks of indirect inference, this Article examines a database that would provide for more direct evidence of the parties' preference for contextual interpretation rules. Specifically, the next Part of this Article empirically examines the frequency with which anti-contextualist interpretation clauses, known as severability clauses, are

⁵¹ *Id.* at 1735.

⁵² Theodore Eisenberg & Geoffrey P. Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts*, 30 CARDOZO L. REV. 1475, 1475 (2009).

⁵³ *Id.* at 1490.

⁵⁴ Miller, *supra* note 45, at 1478; Schwartz & Scott, *Contract Interpretation Redux*, *supra* note 45, at 956; Bernstein, *supra* note 11, at 15.

⁵⁵ Miller, *supra* note 45, at 1478; Schwartz & Scott, *Contract Interpretation Redux*, *supra* note 45, at 956; Bernstein, *supra* note 11, at 15.

⁵⁶ Miller, *supra* note 45, at 1478; Schwartz & Scott, *Contract Interpretation Redux*, *supra* note 45, at 956; Bernstein, *supra* note 11, at 15–16.

⁵⁷ The companies' industries were located via the EDGAR company search engine. See EDGAR: *Company Filings*, U.S. SEC. & EXCH. COMM'N, <https://www.sec.gov/edgar/searchedgar/companysearch.html> (last visited June 10, 2019).

included in contracts.

II. THE EMPIRICAL TEST

A. *Unenforceable Terms and the Severability Clause — Description and Hypothesis*

Contracts often contain an unenforceable term.⁵⁸ Examples of an unenforceable term include: (1) an excessively restrictive non-compete provision, (2) an anti-competitive clause on pricing terms, (3) a prospective release of any fraud claim, (4) a liquidated damages clause that is deemed as a penalty clause, (5) an unenforceable choice of law clause that has no reasonable connection to the transaction, (6) an invalid forum selection clause, (7) a contractual restriction on limitation periods, (8) an invalid term under the statute of frauds, or (9) an invalid waiver of tort liability.⁵⁹

Such unenforceable terms may exist in contracts for several reasons. First, the legal environment of the contract is dynamic. As a result, an enforceable contractual clause during contract formation might later become unenforceable due to a change in a statute or a new court decision.⁶⁰ Second, the line between an enforceable and unenforceable provision may sometimes be unclear and costly to clarify.⁶¹ The parties may prefer to adopt a provision with questionable validity, rather than invest significant resources in clarifying its legal status. Relatedly, the parties may sometimes predict that the chances of the provision being enforceable are low, but the expected benefit of the provision, once enforced, are high.⁶² In such case, if the costs of including an unenforceable term in the contract are low, the parties may find it beneficial to include the term in their contract.⁶³

When a contract includes an unenforceable term, the following central legal dispute may arise: what should be the legal status of the contract? Under current contract law, such legal dispute normally triggers the

⁵⁸ Sullivan, *supra* note 16, at 1128 (“Contracts frequently contain clauses that are not enforceable[.]”).

⁵⁹ See e.g., Leslie, *supra* note 16, at 282; Sullivan, *supra* note 16, at 1130; Rubin, *supra* note 16, at 241; Fay, *supra* note 16, at 5; Fishman & James, *supra* note 16, at *2.

⁶⁰ *Severability Clauses: To Sever, Modify, or Invalidate?*, WHITMAN LEGAL SOLUTIONS, <https://whitmanlegalsolutions.com/blog/severability-clause> (“The law is dynamic and changing. A contract provision that the parties believed was enforceable might later be changed by statute or court decisions.”).

⁶¹ *Id.* (“[T]he line between an enforceable and unenforceable provision may be blurry.”)

⁶² Sullivan, *supra* note 16, at 1133 (A party that adopts in his contract unenforceable terms “understands that it is very likely that the clause is unenforceable, but believes that the chance of enforceability, while low, is nevertheless worth the gamble.”).

⁶³ Sullivan, *supra* note 16, at 1133-34 (Where the costs of adopting an unenforceable term are low, “this might be a rational strategy even if the odds of having the clause finally enforced are minimal.”).

application of a contextualist method of contract interpretation by courts.⁶⁴ If the court concludes, under the contextual interpretation of the contract, that the parties intended the unenforceable provision to be an essential part of the agreement, then the court is likely to nullify the entire contract.⁶⁵ Conversely, if the court concludes that the parties intended the unenforceable provision to be a nonessential part of their contract, then the court is likely to sever the unenforceable provision and enforce the remainder of the contract.⁶⁶ When employing contextual interpretation, courts may consider extra-contractual evidence, such as declarations submitted to the court⁶⁷ or testimonies during trial.⁶⁸ Furthermore, they may consider any contextual circumstances beyond the written contract text,⁶⁹ such as the contract's negotiation history⁷⁰ or the parties' conduct.⁷¹

To illustrate, assume that a contract for the sale of goods includes, inter

⁶⁴ See e.g., *Individual Healthcare Specialists Inc., v. Bluecross Blueshield of Tenn., Inc.*, 566 S.W. 3d 671, 676 (Tenn. 2019) (“Tennessee judges have long used extrinsic evidence of the context and circumstances at the time the parties entered into the contract to facilitate interpretation of contractual terms in accord with the parties’ intent.”).

⁶⁵ See generally *Movsesian*, *supra* note 17; *Shaffer*, *supra* note 19; *Kersten*, *supra* note 19.

⁶⁶ See *supra* note 20.

⁶⁷ See, e.g., *Cole-Hoover v. DOCCS*, No. 02-CV-00826-JJM, 2014 WL 1516482, at *3 (W.D.N.Y. Apr. 17, 2014) (noting that a declaration supports the conclusion that the agreement is not severable).

⁶⁸ See, e.g., *In re Am. Home Mortg., Inc.*, 379 B.R. 503, 521 (Bankr. D. Del. 2008) (noting that a testimony at trial supported a finding that the contract is severable).

⁶⁹ *Movsesian*, *supra* note 17, at 44 (“Because severability turns on the intent of the parties, a court may examine extrinsic evidence, including the contract’s negotiation history, to discover whether the parties in fact believed the illegal term to be essential.”); *Jacobs v. CNG Transmission Corp.*, 772 A.2d 445, 452 (Pa. 2001) (“[A]bsent express language that a contract is entire, a [Pennsylvania] court may look to the contract as a whole, including the character of the consideration, to determine the intent of the parties as to severability and may also consider the circumstances surrounding the execution of the contract, the conduct of the parties, and any other factors pertinent to ascertaining the parties’ intent.”); *Lutz v. Chesapeake Appalachia, L.L.C.*, 717 F.3d 459, 466-67 (6th Cir. 2013) (quoting *Freeman Indus. Prods., LLC v. Armor Metal Grp. Acquisitions, Inc.*, 952 N.E.2d 543, 550 (Ohio Ct. App. 2011) (“Whether a contract . . . is entire or divisible depends generally upon the intention of the parties, and this must be ascertained by the ordinary rules of construction, considering not only the language of the contract, but also, in cases of uncertainty, the subject-matter, the situation of the parties, and circumstances surrounding the transaction, and the construction placed upon the contract by the parties themselves.”); *In re Balfour MacLaine Int’l Ltd.*, 85 F.3d 68, 81 (2d Cir. 1996) (“[T]he severability of a contract is a question of the parties’ intent, to be determined from the language employed by the parties, viewed in the light of the circumstances surrounding them at the time they contracted.”).

⁷⁰ *Movsesian*, *supra* note 17, at 44 (“Because severability turns on the intent of the parties, a court may examine extrinsic evidence, including the contract’s negotiation history[.]”); *KCAS, LLC v. Nash-Finch Co.*, No. 8:17CV439, 2019 WL 687885, at *3-4 (D. Neb. Jan. 9, 2019) (noting that the pre-contractual negotiation supports the conclusion that the agreement is not severable).

⁷¹ *Jacobs v. CNG Transmission Corp.*, 772 A.2d at 452.

alia, an agreement that the buyer will not only buy goods from the seller but also lease a property from the seller.⁷² In addition, assume that the lease agreement is unenforceable, since it cannot be evidenced by a written instrument containing the agreement's essential terms, as required by the statute of fraud. Finally, assume that court is required by the seller to nullify the entire sale of goods contract, and that the buyer, in contrast, requires the court to sever the unenforceable lease agreement from the rest of the lawful sale of goods provisions. In such case, the court may normally apply a contextual method of contract interpretation. Accordingly, if the surrounding circumstances of the contract indicate that the parties intended the lease agreement to be an essential part of the agreement, the court may nullify the entire sale of goods contract. For example, if during the parties' pre-contractual negotiations, the parties stated that the buyer will pay net rather than gross rent in exchange for a reduced sale of good price, the court may interpret the lease agreement as an essential part of the contract. Accordingly, the court may conclude, based on the pre-contractual contextual evidence, that the lease agreement is not severable from the sale of goods contract, and nullify the entire agreement.⁷³

Importantly, the parties can contract around the contextualist approach applied by courts. Specifically, they can include an anti-contextualist severability clause. A severability clause typically evinces the parties' intent that all valid provisions of the contract be given effect, even if the contract contains an unenforceable clause.⁷⁴ Accordingly, a typical severability clause may read: "If any provision of this Agreement is held invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions of this Agreement will remain effective."⁷⁵

By including a severability clause, the parties commonly signal their preference that courts should not apply a contextual fact-intensive method of interpretation. In essence, the severability clause normally directs courts to

⁷² For similar facts *see* *KSAC, LLC v. Nash-Finch Co.*, 2019 WL 687885, at *1.

⁷³ *Id.* at *3-4.

⁷⁴ *Jackson v. Cintas Corp.*, 425 F.3d 1313, 1317 (11th Cir. 2005) ("A severability clause indicates the intent of the parties where the remainder of the contract can exist without the void portion."); *Ritchie Capital Mgmt., L.L.C. v. Kermath*, No. 15 C 8021, 2017 U.S. Dist. LEXIS 84501, at *14 (N.D. Ill. June 1, 2017) ("The existence of a severability clause in a contract . . . indicates that the parties intended for the lawful portions of the contract to be enforced in the absence of the unlawful portions."); *County of Ventura v. City of Moorpark*, 234 Cal. Rptr. 3d 242, 255 (Ct. App. 2018) (A severability clause is evidence of the parties' "intent that, to the extent possible, the valid provisions of the [agreement] be given effect, even if some provision is found to be invalid or unlawful." (quoting *Baeza v. Superior Court*, 135 Cal. Rptr. 3d 557, 568 (Ct. App. 2011))).

⁷⁵ *Fay*, *supra* note 16, at 4.

enforce the legal provisions of the contract, notwithstanding the contextual interpretation of the unenforceable term. Specifically, a severability clause usually reveals the parties' preference that courts should not examine whether the unenforceable term should be contextually interpreted as an essential or nonessential part of the contract. Under this clause, any unenforceable clause should normally be severed and the remaining contract be enforced. Importantly, a severability clause is ordinarily enforced by courts,⁷⁶ or at least entitled to great weight,⁷⁷ thereby minimizing the probability that courts will apply a contextualist method of interpretation.

This Article hypothesizes that most commercial contracts between sophisticated parties adopt an anti-contextualist severability clause for several reasons. First, the probability of judicial error in evaluating contextual evidence is likely to be high in these types of contracts. Commercial contracts between sophisticated parties are normally multifaceted and surrounded by many oral and written statements. They are accompanied by many contextual acts and behaviors by the parties.⁷⁸ As a result, it is possible that judges may inaccurately interpret these statements,

⁷⁶ See *Early v. MiMedx Grp., Inc.*, 768 S.E.2d 823, 827 (Ga. Ct. App. 2015) (“[A] severability clause indicates the intent of the parties where the remainder of the contract can exist without the void portion.’ Accordingly, ‘[v]oid restrictive covenants, which cannot be blue-penciled out of the contract, do not void the entire contract when the contract contains a severability clause . . . [T]he other contract terms survive the void terms, provided that the contract is severable.” (citations omitted) (quoting *Capricorn Sys., Inc. v. Pednekar*, 546 S.E.2d 554, 558-59 (Ga. Ct. App. 2001)); *Toledo Police Patrolmen's Ass'n v. City of Toledo*, 641 N.E.2d 799, 804 (Ohio Ct. App. 1994) (“[S]everability clauses are not illegal and are often effective.”); *Zuver v. Airtouch Commc'ns, Inc.*, 103 P.3d 753, 768 (Wash. 2004) (“[W]hen parties have agreed to a severability clause in an arbitration agreement, courts often strike the offending unconscionable provisions to preserve the contract's essential term of arbitration”).

⁷⁷ *Diamond Hotel Co. v. Matsunaga*, 4 N. Mar. I. 213, 219 (1995) (“The existence of a severability clause in a lease agreement certainly strengthens the case for the severance of unenforceable provisions because it indicates that the parties intended for the lawful portions of the contract to be enforced in the absence of the unlawful portions.”); *Walters v. A.A.A. Waterproofing, Inc.*, 211 P.3d 454, 462 (Wash. Ct. App. 2009) (“Severability is particularly likely when the agreement includes a severability clause.”); *In re Paternity of F.T.R.*, 833 N.W.2d 634, 649 (Wis. 2013) (“A severability clause, though not controlling, is entitled to great weight in determining if the remaining portions of a contract are severable.”).

⁷⁸ *Walnut Creek Pipe Distribs., Inc. v. Gates Rubber Co. Sales Div.*, 39 Cal. Rptr. 767, 770 (Dist. Ct. App. 1964) (“[T]he court below was faced with construing the obligations of the parties in a typical commercial transaction where, in addition to the formal written agreements between the parties, there were many oral and unexpressed agreements.”); Eric A. Posner, *The Parol Evidence Rule, The Plain Meaning Rule, and the Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 556 (1998) (“Because of the large number of statements made during preliminary negotiations [of a complex business deal], the number of statements that are outside the contract . . . is likely to be high.”).

understandings, or behaviors.⁷⁹ In addition, most judges are non-business people and have no experience with these types of complex commercial contracts.⁸⁰ Consequently, courts may err in evaluating the context of transactions that they are not familiar with.⁸¹ Second, the cost of a judicial error in the evaluation of contextual evidence is likely to be high in these commercial contracts because their value is normally significant.⁸² Specifically, a contextualist court may mistakenly interpret an unenforceable clause as an essential term of the contract, thereby wrongly nullifying the entire valuable agreement.

B. Data

The sample of this empirical study is based on commercial contracts contained as exhibits to Form 8-K filings with the SEC.⁸³ Companies that file Form 8-K filings include data about the company's entry into a "material definitive agreement."⁸⁴ A material definitive agreement is a

⁷⁹ Michael B. Metzger, *The Parol Evidence Rule: Promissory Estoppel's Next Conquest?*, 36 VAND. L. REV. 1383, 1387–88 (1983) ("Jurors also may lack the sophistication needed to deal effectively with complex commercial transactions involving numerous alleged oral and written contract terms."); Posner, *supra* note 78, at 556.

⁸⁰ Cf. Posner, *supra* note 78, at 553 ("[C]ourts do a better job of enforcing terms they have seen before than terms they have not.").

⁸¹ MITCHELL, *supra* note 34, at 115 ("The contextual approach arguably increases the chances for error by increasing the amount of information deemed relevant to the interpretation exercise. Judges may have to deal with a significant amount of contextual material, some of it connected to particular frameworks of analysis whose conventions will be unfamiliar to them."); Posner, *supra* note 78, at 553.

⁸² Posner, *supra* note 78, at 556 ("[B]ecause of the high value of the transaction, errors in enforcement are costly.").

⁸³ For the same methodological approach of analyzing contracts contained as exhibits to Form 8-K filings with the SEC, see Theodore Eisenberg, Geoffrey P. Miller & Emily Sherwin, *Arbitration's Summer Soldiers: An Empirical Study of Arbitration Clauses in Consumer and Nonconsumer Contracts*, 41 U. MICH. J.L. REFORM 871, 880 (2008); Theodore Eisenberg & Geoffrey P. Miller, *Damages Versus Specific Performance: Lessons from Commercial Contracts*, 12 J. EMPIRICAL LEGAL STUD. 29, 43 (2015) [hereinafter Eisenberg & Miller, *Damages Versus Specific Performance*]; Theodore Eisenberg & Geoffrey P. Miller, *Do Juries Add Value? Evidence from an Empirical Study of Jury Trial Waiver Clauses in Large Corporate Contracts*, 4 J. EMPIRICAL LEGAL STUD. 539, 550 (2007) [hereinafter Eisenberg & Miller, *Do Juries Add Value?*]; Theodore Eisenberg & Geoffrey Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 VAND. L. REV. 1975, 1983 (2006); Theodore Eisenberg & Geoffrey P. Miller, *The English Versus the American Rule on Attorney Fees: An Empirical Study of Public Company Contracts*, 98 CORNELL L. REV. 327, 349 (2013); Theodore Eisenberg & Geoffrey P. Miller, *The Flight from Arbitration: An Empirical Study of Ex Ante Arbitration Clauses in the Contracts of Publicly Held Companies*, 56 DEPAUL L. REV. 335, 348 (2007) [hereinafter Eisenberg & Miller, *The Flight from Arbitration*]; Eisenberg & Miller, *supra* note 52, at 1487.

⁸⁴ Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, 69 Fed. Reg. 15594, 15619 (Mar. 25, 2004).

transaction that is likely to be considered by a reasonable investor as “important in making an investment decision.”⁸⁵

This study covers the latest 500 contracts, governed by U.S. law, that were filed with the SEC by May 1, 2019.⁸⁶ These contracts were located via Westlaw’s commercial law sample-agreement search engine. The Westlaw sample-agreements database has contracts included in all SEC filings during the sample period.⁸⁷ The commercial contracts examined in this study are highly heterogeneous in type, including, for example: cooperation, agency, distribution, consulting, management services, marketing, and administrative services.⁸⁸ The major types of contracts, as reflected in the contracts’ titles, are shown in Table 1.

⁸⁵ U.S. SEC. & EXCH. COMM’N OFFICE OF INV’R EDUC. & ADVOCACY, INVESTOR BULLETIN: HOW TO READ AN 8-K, at 1 (May 22, 2012), <https://www.sec.gov/investor/pubs/readan8k.pdf>.

⁸⁶ The sample period began on February 14, 2017.

⁸⁷ *Sample Agreements*, THOMSON REUTERS, [https://www.westlaw.com/Browse/Home/SampleAgreements?transitionType=Default&contextData=\(sc.Default\)&VR=3.0&RS=cblt1.0](https://www.westlaw.com/Browse/Home/SampleAgreements?transitionType=Default&contextData=(sc.Default)&VR=3.0&RS=cblt1.0) (last visited June 10, 2019). Sample agreements are sourced from EDGAR filings, beginning in 2000.

⁸⁸ A commercial contract is normally an agreement between two or more business entities. See Schwartz & Scott, *supra* note 6, at 543 (“Even a theory of contract law that focuses only on the enforcement of bargains must still consider the entire continuum from standard form contracts between firms and consumers to commercial contracts among businesses.”); Edward A. Zelinsky, *Deregulating Marriage: The Pro-Marriage Case for Abolishing Civil Marriage*, 27 CARDOZO L. REV. 1161, 1198 (2006) (“Consumer contracts differ from commercial contracts between businesses.”); see also Silverstein, *supra* note 2, at 261 (noting that some scholars believe that commercial and consumer contracts require “different interpretative approaches”).

Table 1. Contract type

| Type | Number | Percentage | Type | Number | Percentage |
|-------------------------|--------|------------|------------------------|--------|------------|
| Cooperation | 76 | 15.2 | Independent Contractor | 17 | 3.4 |
| Agency | 65 | 13 | Licensing | 12 | 2.4 |
| Distribution | 51 | 10.2 | Supply | 8 | 1.6 |
| Consulting or Advisory | 51 | 10.2 | Storage | 7 | 1.4 |
| Management Services | 37 | 7.4 | Terminal Services | 7 | 1.4 |
| Marketing | 24 | 4.8 | Transportation | 6 | 1.2 |
| Administrative Services | 20 | 4 | Lease Agreement | 4 | 0.8 |

The industries of the companies that filed the contracts of this study with the SEC are also heterogeneous, including, for example: agriculture, automotive, banking, business services, chemical products, communication services, computers, electronics, insurance, real estate, retail, petroleum, and gas.⁸⁹

C. Results

Out of 500 contracts, 355 (71%) included a severability clause and 145 (29%) did not include a severability clause. This result indicates that most parties to the sample contracts prefer to opt out of a contextual interpretation of unenforceable terms. Otherwise, the parties would not adopt a severability clause in their contract.

In addition, the results of this study indicate that the severability clauses in the sample are not a mere standardized boilerplate that varies marginally, if at all, among different contracts.⁹⁰ First, from a technical perspective, the number of words in the severability clauses varied significantly, ranging from 22 to 230.⁹¹ The variance in the number of words is illustrated in Figure

⁸⁹ The companies' industries were located via the EDGAR company search engine. *See EDGAR: Company Filings, supra* note 57.

⁹⁰ *But see*, Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 680 (2006) ("Complex transactions are often governed by industry-standard boilerplate terms, which vary little, if at all, across contracts.").

⁹¹ *See, e.g.*, Equipment Lease Agreement filed by Magnegas Corp., Article 27, 2017 WL 05507086 (the severability clause includes 22 words); Distribution, Trademark and Technology Agreement filed by AeroGrow International, Inc., Article 12.2, 2018 WL

1, which represents the frequency distribution histogram of the number of words in these severability clauses.⁹²

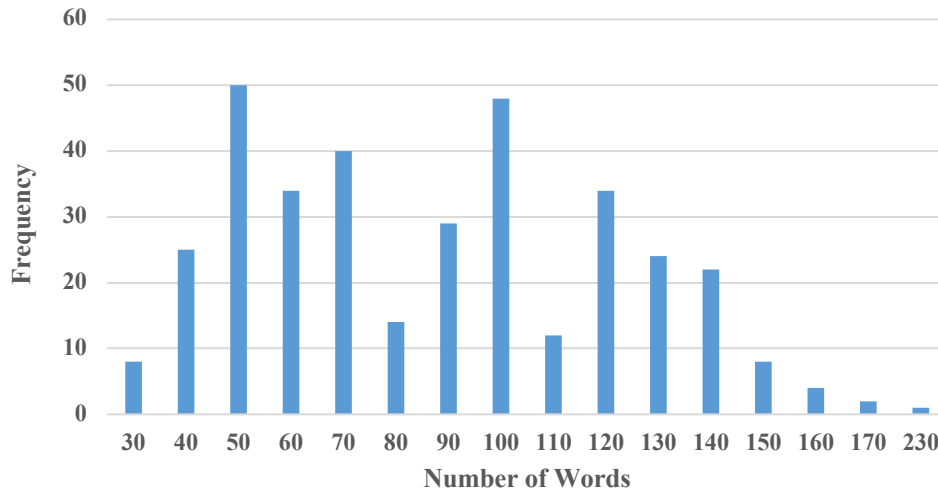


Figure 1. Frequency distribution histogram for the number of words in severability clauses

Second, from a substantive perspective, the content of severability clauses in the sample varied in many aspects. In order to illustrate the difference between the content of severability clauses, this Article focuses on two different demonstrative statements that were added to some of these clauses: (1) if a provision of the contract is unenforceable, the parties shall negotiate to replace that provision with a new provision that is enforceable; (2) if a term of the contract is unenforceable in a certain jurisdiction, such unenforceability shall not render said term unenforceable in any other jurisdiction. The severability clauses differed in their combination of statements (1) and (2). Some severability clauses included only statement (1) or (2). Other clauses, however, cumulatively included statements (1) and (2). Yet, some clauses did not include either of the statements (1) or (2). Table 2 shows the frequency and percentage of all the different combinations for statements (1) and (2) in the severability clauses studied in this Article.

01615018 (the severability clause includes 286 words). In this study, the word count of each severability clause did not include the title of the clause and any content in the clause which did not relate to the severability topic, if such content existed (e.g., content that relates to the agreement's choice of law or forum).

⁹² To clarify, the blue column in Figure 1 above the value '30' represents the number of severability clauses with 30 words or less.

| Statement Combination | Frequency | Percentage |
|------------------------------|-----------|------------|
| Statement (1) only | 121 | 34% |
| Statement (2) only | 40 | 11% |
| Statements (1) & (2) | 7 | 2% |
| Any of statements (1) or (2) | 187 | 53% |

Table 2. Frequency and Percentage of Statements 1 & 2 in severability clauses

Notably, the statements that were added to the severability clauses in the sample varied in several additional aspects, thereby reinforcing the fact that these clauses are not a mere boilerplate that varies marginally, among different contracts. For example, while some clauses stated, *inter alia*, that if part of a contract term is invalid, it will not affect the remaining part of *said specific term*,⁹³ other clauses did not include such a statement.⁹⁴ Similarly, while some clauses stated, among other things, that each provision of this contract shall be interpreted in such manner as to be valid,⁹⁵ other clauses did not include such a statement.⁹⁶ Likewise, some clauses included a statement that if an unenforceable term can be interpreted narrowly so as not to be invalid then it shall be so narrowly interpreted,⁹⁷ but other clauses did not include such a statement.⁹⁸ Finally, some clauses stated that upon a determination that any term is invalid, the parties shall negotiate in good faith to modify the agreement so as to effect the original intent of

⁹³ See, e.g., Cooperation Agreement filed by Safeguard Scientifics Inc., Article 25, 2018 WL 01912439 (“Any provision of this Agreement held invalid or unenforceable only in part or degree shall remain in full force and effect to the extent not held invalid or unenforceable.”).

⁹⁴ See, e.g., Management Consulting Services Agreement filed by Helix TCS, Inc, Article 14, 2019 WL 01721988.

⁹⁵ See, e.g., Transportation Services Agreement (LAR Interconnecting Pipelines) filed by Andeavor Logistics LP, Article 21(f), 2018 WL 03736388 (“Whenever possible, each provision of this Agreement will be interpreted in such manner as to be valid and effective under Applicable Law.”).

⁹⁶ See, e.g., Amended and Restated Exclusive Manufacturing Agreement filed by Natural Alternatives International Inc., Article 27, 2019 WL 01492244.

⁹⁷ See, e.g., Master Services Agreement filed by California Resources Corp, Article 11(d), 2018 WL 00737567 (“[I]f such term or provision could be drawn more narrowly so as not to be illegal, invalid, prohibited or unenforceable in such jurisdiction, it shall be so narrowly drawn[.]”).

⁹⁸ See, e.g., Beverage Manufacture and Supply Agreement filed by Rocky Mountain High Brands, Inc., Article 8.8, 2019 WL 00918115.

the parties as closely as possible in a mutually acceptable manner.⁹⁹ However, some clauses did not include such a statement.¹⁰⁰

III. DISCUSSION AND NORMATIVE IMPLICATIONS

The results of this empirical study indicate that most sophisticated parties to commercial contracts prefer courts not to apply a contextual method during the interpretation of unenforceable contract terms. The study shows that a clear majority (71%) of commercial contracts filed to the SEC have an anti-contextualist severability clause.

Importantly, the adoption of an anti-contextualist severability clause entails a significant economic risk for the parties, which amplifies the parties' concern about the potential error costs of the contextualist method of interpretation. In more detail, the invalidity of a single yet essential contract provision can materially alter the initial contract bargained for by the parties.¹⁰¹ In such case, the enforcement of the remainder of the contract, triggered by a severability clause, may dramatically harm the economic equilibrium of the transaction. For example, assume that a contract for the sale of a business includes, *inter alia*: (a) a severability clause and (b) a non-compete clause, under which the buyer and the seller undertake not to compete with each other. Assume also that the non-compete clause is essential to the contract because the sale price is directly related to the parties' mutual promise not to compete. Under these circumstances, if the non-compete clause is too broad and unenforceable, the economic equilibrium of the remainder of the contract may be harmed. This is because the non-compete clause and the sale price are economically interrelated. Accordingly, the existence of the severability clause puts the parties at risk: it is likely to cause courts to enforce the remainder of the contract, even though it has become unbalanced.¹⁰² This risk, generated by the popular severability clause, highlights how strongly the parties can object to a contextual method of interpretation. By adopting a categorical severability clause, under which any unenforceable term will be severed from the remainder of the contract, the parties are willing to risk that courts will enforce the remainder of the contract, even if it has lost its economic

⁹⁹ See, e.g., Manufacturing and Supply Agreement filed by Cellular Biomedicine Group, Inc., Article 25.10, 2018 WL 06817709 (“Parties shall negotiate in good faith to modify this Agreement so as to effect the original intent of the Parties as closely as possible[.]”).

¹⁰⁰ See, e.g., Master Services Agreement filed by STWC Holdings, Inc., Article 11(b), 2018 WL 03023563.

¹⁰¹ Fishman & James, *supra* note 16, at *2 (“Needless to say, the invalidity of one key provision can result in an exchange materially different from the bargain initially struck.”).

¹⁰² The preceding example is based on Fay, *supra* note 16, at 4.

equilibrium.¹⁰³ The parties presumably prefer taking this risk than allowing courts to broadly apply a contextualist method of interpretation for each potential unenforceable term.

The results of this study may arguably suffer from one central limitation. The severability clauses in the sample may have been added to the contracts arbitrarily without any negotiation and therefore do not represent the true intention of the parties. However, this concern is unlikely for several cumulative reasons. First, the sample of this study includes parties that are legally required to report to the SEC, which are typically companies with more than \$10 million in assets.¹⁰⁴ Given the high screening and qualification standards of these valuable companies, it is reasonable to assume that the other parties to the sample commercial contracts in this study are likely to be relatively sophisticated business entities as well. By that, the sample assures, with a potential slight margin of error, that the severability clauses observed in this data set were freely agreed on and fully understood by both parties.¹⁰⁵ Second, the sample in this empirical study is based on contracts contained as exhibits to Form 8-K filings with the SEC. Form 8-K includes “material definitive agreements,”¹⁰⁶ i.e., agreements that provide for obligations or rights that are material to the SEC filing company.¹⁰⁷ Accordingly, it is reasonable to assume that the sample contract “receive[d] care and attention during negotiation and drafting” from in-house counsel and from well-qualified outside attorneys.¹⁰⁸

The central potential legal implication of the results of this Article, showing that most of the sample contracts opt-out from a contextualist method of interpretation, by adopting a severability clause, is that the default interpretation rules of commercial contracts between sophisticated parties in severability scenarios must be modified. Since most of these contracts include a severability clause, the default rules should mimic the majority’s

¹⁰³ Notably, in 3% of sample contracts (n=15), the parties made an effort to decrease the risk whereby enforcement of the remainder of the contract will harm the economic equilibrium of the contract by stating that the remaining provisions of the agreement shall remain in full force “so long as the economic or legal substance of the transactions contemplated hereby is not affected in any manner materially adverse to either Party.” Toll Manufacturing and Supply Agreement filed by Cellular Biomedicine Group, Inc., Article 25.10, 2018 WL 06817709.

¹⁰⁴ See Securities Exchange Act of 1934 § 12(g), 15 U.S.C. § 78l (2012).

¹⁰⁵ See Eisenberg & Miller, *Damages Versus Specific Performance*, *supra* note 83, at 31.

¹⁰⁶ Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, *supra* note 84.

¹⁰⁷ *Id.*

¹⁰⁸ Eisenberg & Miller, *Do Juries Add Value?*, *supra* note 83, at 582; accord Eisenberg & Miller, *The Flight from Arbitration*, *supra* note 83, at 349; Miller, *supra* note 45, at 1477.

preferences. Specifically, the default interpretation rules of commercial contracts between sophisticated parties should embed the legal rule normally triggered by an anti-contextual severability clause: courts should avoid applying a contextualist method when interpreting an unenforceable term as either essential or nonessential. Furthermore, they should sever any unenforceable term from the agreement and enforce the remainder of the agreement.

By imitating the majority's preferences, the law would reduce the transaction costs of most sophisticated parties to commercial contracts. Only the minority of parties to these contracts, who wish to opt out of the suggested new default anti-contextualist rules, will have to negotiate and draft a contextualist anti-severability clause, stating that "if the contract contains an unenforceable term, courts should consider all the circumstances in order to ascertain the intention of the parties regarding the enforceability of the remaining agreement." This novel legal reality will save transaction costs for the majority of parties who must nowadays negotiate and draft a severability clause.

CONCLUSION

Contract interpretation plays an important role in U.S. law. Despite the extensive theoretical debate over the contextualist contract interpretation method, there has been very little empirical research on this method. This Article, therefore, empirically examines the frequency with which severability clauses are included in commercial contracts between sophisticated parties. Focusing on the interpretation of unenforceable terms, this Article empirically indicates, by analyzing actual commercial contracts, that most sophisticated parties to commercial contracts are likely to prefer anti-contextualist rules of interpretation by adopting a severability clause. The study further indicates that severability clauses adopted by the contract parties are not a mere boilerplate that varies marginally, if at all, among different contracts. These clauses vary significantly both in form and substance.

While this study focused on commercial contracts between sophisticated parties, this Article calls for further empirical research on the parties' preference for contextualist contract interpretation rules. Among other things, the preferences of non-sophisticated parties to non-commercial contracts (e.g., employment or consumer contracts) and commercial contracts should be empirically investigated.