Interpreting Choice-of-Law Clauses

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Over the past few decades, the concept of party autonomy has moved to the forefront of private international law scholarship. The question of whether (and to what extent) private actors may choose the law that will govern their relationship has generated extensive commentary and discussion. The result? An ever-expanding literature on the role of party autonomy in private international law.

In this post, I want to call attention to a related issue that has attracted considerably less scholarly attention. This is the issue of how to *interpret* the contractual language by which private actors exercise their autonomy to choose a governing law. (I explored this issue in a recent article.) Over the past several decades, the courts in the United States have developed several interpretive rules of thumb—canons of construction, to use a fancy term—that assign meaning to ambiguous words and phrases that frequently appear in choice-of-law clauses. I discuss several of these interpretive rules—and the various ways in which parties can contract around them—after the jump.

The first, and arguably the least controversial, of these interpretive rules is the *canon in favor of internal law*. When presented with a choice-of-law clause that selects the "laws" of a given jurisdiction, courts in the United States will generally interpret the word "laws" to refer to the internal law of the chosen jurisdiction (excluding its conflicts rules) rather than the whole law of the chosen jurisdiction (including its conflicts rules). This interpretive rule is eminently sensible. Since the entire point of a choice-of-law clause is to reduce legal uncertainty, it would defeat the purpose to interpret the clause to select the conflicts rules of the chosen jurisdiction, which could in turn result in the application of the law of a different jurisdiction.

The second interpretive rule is the *canon in favor of federal inclusion and preemption*. This canon requires a bit of explanation for those not familiar with

the U.S. legal system. Most U.S. choice-of-law clauses select the laws of one of the fifty states (e.g. New York) rather than the nation (i.e. the United States). When a clause selects the "laws" of New York, however, it is not clear whether the parties are selecting the laws of New York *to the exclusion* of any relevant provisions of federal law or whether they are selecting the laws of New York *including* any relevant provisions of federal law. U.S. courts have consistently adopted the latter interpretation. When the parties select the laws of New York, they are presumed to have *also* selected any applicable federal statutes and federal treaties. In the event of a conflict between federal law and state law, moreover, the federal law will prevail.

As a practical matter, this interpretive rule is most often relevant in the context of international sales agreements. The United States is a party to the United Nations Convention on Contracts for the International Sale of Goods (CISG), which covers much of the same ground as Article 2 of the Uniform Commercial Code (UCC). When the parties to an international sales agreement select the "laws" of New York to govern their agreement, they may *think* that they are getting New York's version of the UCC. Instead, they will get the CISG. This is because the "laws" of New York will be deemed to include any relevant provisions of federal law (including the CISG) and that treaty will, in turn, be deemed to preempt UCC Article 2. (I discuss the relationship between choice-of-law clauses and the CISG in greater depth here.)

The third interpretive rule is the *canon of linguistic equivalence*. This canon holds that a choice-of-law clause stating that the contract shall be "interpreted" or "construed" in accordance with the laws of a given state is the linguistic equivalent of a clause stating that the contract shall be "governed" by the laws of that state. This conclusion is by no means inevitable. Indeed, some court in the United States have declined to follow this canon. Most U.S. courts, however, have reasoned that while there may *technically* be a linguistic distinction between the words "interpreted" and "construed," on the one hand, and the word "governed," on the other, most contracting parties are completely unaware of the distinction when it comes to their choice-of-law clauses. Most courts have also reasoned that contracting parties rarely, if ever, intend to select one law to govern *interpretive* issues arising under the contract while leaving unanswered the question of what law will govern the parties' *substantive rights and obligations* under that same contract. Accordingly, they read the words

"interpret" and "construe" to be the linguistic equivalent of "governed."

I refer to the fourth collection of interpretive rules, collectively, as the *canons relating to scope*. These canons help the courts determine whether a choice-of-law clause applies exclusively to *contract claims* brought by one contracting party against the other or whether that clause also selects the law for any *tort and statutory claims* that may be brought alongside the contract claims. The highest court in New York has held that a generic choice-of-law clause—one which states that the agreement "shall be governed by the laws of the State of New York"—only covers contract claims. The highest court in California, by comparison, has interpreted the same language to cover any contract, tort, or statutory claims brought by one party against the other. Courts in Texas and Florida have followed New York's lead on this issue. Courts in Minnesota and Virginia have followed California's lead.

To make things even more complicated, U.S. courts have yet to reach a consensus on how to select the relevant body of interpretive rules. The courts in California have held one should apply the canons followed by *the jurisdiction named in the clause* to interpret the clause. The courts in New York, by contrast, have held that one should apply the canons followed by *the forum state* to interpret the clause. The California courts clearly have the better of the argument—there is absolutely no reason to deny the parties the power to choose the law that will be applied to interpret their choice-of-law clause—but several states have followed New York's lead. The result is a baffling and befuddling jurisprudence relating to the scope of generic choice-of-law clauses.

Sophisticated parties may, of course, contract around each of the interpretive default rules discussed above. To preempt the canon in favor of internal law, they can include the phrase "without regard to conflict of laws" in their choice-of-law clause. To preempt the canon of federal inclusion and preemption, they can state that "the CISG shall not apply" to their agreement. To preempt the canon of linguistic equivalence, they can simply state that the contract shall be "governed" by the laws of the chosen state. And to preempt the canons relating to scope, they can either state that claims "relating to" the contract shall be covered by the clause (if they want a broad scope) or that the clause only applies to "legal suits for breach of contract" (if they want a narrow scope). To date, however, many U.S. parties have failed to update their choice-of-law clauses to account for these judicial decisions.

I recently reviewed the choice-of-law clauses in 351 bond indentures filed with the U.S. Securities and Exchange Commission (SEC) in 2016 that selected New York law. I discovered that (a) only 55% excluded the conflicts rules of the chosen jurisdiction, (b) only 83% contained the phrase "governed by," and (c) only 12% addressed the issue of scope. Chris Drahozal and I also recently reviewed the choice-of-law clauses in 157 international supply agreements filed with the SEC between 2011 and 2015. We discovered that (i) only 78% excluded the conflicts rules of the chosen jurisdiction, (ii) only 90% contained the phrase "governed by," and (iii) only 20% addressed the issue of scope. These findings suggest that the feedback loop between judicial decisions *interpreting* contract language and the lawyers tasked with *drafting* this language does not always function effectively. Contract drafters, it would appear, do not always take the necessary steps to rework their choice-of-law clauses to account for judicial decisions interpreting language that commonly appears in these clauses.

Going forward, it would be fascinating to know whether any *non-U.S. courts* have developed their own interpretive rules that assign meaning to ambiguous words and phrases contained in choice-of-law clauses selecting non-U.S. law. If anyone is aware of any academic papers that have explored this issue from a non-U.S. perspective, I would be very grateful if you could bring that work to my attention and the attention of the broader community in the Comment section below.