

Winter 2003

Common Sense for Common Stock Options: Inconsistent Interpretation of Anti-Dilution Provisions in Options and Warrants

Miriam R. Albert

Maurice A. Deane School of Law at Hofstra University

Follow this and additional works at: https://scholarlycommons.law.hofstra.edu/faculty_scholarship

Recommended Citation

Miriam R. Albert, *Common Sense for Common Stock Options: Inconsistent Interpretation of Anti-Dilution Provisions in Options and Warrants*, 34 Rutgers L.J. 321 (2003)

Available at: https://scholarlycommons.law.hofstra.edu/faculty_scholarship/424

This Article is brought to you for free and open access by Scholarly Commons at Hofstra Law. It has been accepted for inclusion in Hofstra Law Faculty Scholarship by an authorized administrator of Scholarly Commons at Hofstra Law. For more information, please contact lawcls@hofstra.edu.

COMMON SENSE FOR COMMON STOCK OPTIONS: INCONSISTENT INTERPRETATION OF ANTI-DILUTION PROVISIONS IN OPTIONS AND WARRANTS

Miriam R. Albert*

The press is currently full of stories about stock options, ranging from the changes in accounting treatment being applied to stock options by major corporations to how to distribute options to the issuer's executives in a manner most likely to encourage management to maximize shareholder wealth.¹ Newsworthy as stock options may be at the moment, the drafting of stock option agreements themselves is not often the subject of detailed consideration, which can lead to uneven results when the options are the subject of litigation. Proper drafting of any instrument representing the right to buy a security, including a derivative instrument such as an option or warrant, includes planning for any imaginable contingency that may face the issuer during the life of the instrument.² One typical contingency is the

* Assistant Professor, Legal and Ethical Studies, Fordham University Schools of Business; LLM, New York University, 1997; JD and MBA, Emory University, 1987; BA, Tufts University, 1984. The author would like to thank those who provided valuable assistance: Donna Gitter, Joel Reichart, Joseph Weitzman, and, especially, Dan Berick.

1. A stock option is "an option to buy or sell a specific quantity of stock at a designated price for a specified period regardless of shifts in market value during the period." BLACK'S LAW DICTIONARY 1431 (7th ed. 1999).

A number of major U.S. corporations recently have decided to expense their outstanding options. See FASB's *Plans Regarding the Accounting for Employee Stock Options*, July 31, 2001, available at <http://www.fasb.org/news/nr073102.shtml> (last visited March 4, 2003). Some pundits even hold the growing use of stock options at least partially responsible for the now-burst tech stock bubble and for the misleading accounting practices of firms like Enron and Worldcom. See Gary S. Becker, *Options Are Useful—But Only If They're Used Right*, BUS. WK., Aug. 5, 2002, at 26.

2. A warrant is the right to buy some set number of shares for some set price for some set time period. See WILLIAM MEADE FLETCHER, 19 FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §3:44, at 236 (2001). Once the price of the underlying stock rises above the exercise price for the warrants, the warrants are "in the money" and thus the holders will benefit financially from their exercise. Warrants are a vehicle to offer investors or potential investors the possibility of participating in the good fortunes of the issuer, with no corresponding risk. If the warrants are never in the money, the holders simply never exercise them.

For most of the analysis herein, there is no practical difference between options and warrants. Thus, the article uses the term "option" as a generic term to encompass all agreements representing the right to buy a security. The article uses the specific term when necessary to further the analysis.

possibility of a recapitalization of the stock underlying the instrument. A properly drafted derivative instrument should provide anti-dilution protection in the event of a recapitalization, in the form of a *pro rata* adjustment to the right to acquire shares, so that the recapitalization would trigger a change to the number of shares that can be acquired upon exercise of the option, with no change to the underlying value of the option itself.³ Yet, these instruments are drafted with incomplete or missing anti-dilution provisions more often than one might imagine. Once the interpretation of the instrument is under consideration by a court, common sense may be required to yield to *stare decisis*.

To illustrate the nature of the problem, suppose the holder of an option to buy common stock seeks to exercise the option after the issuer has effected a one-for-five reverse stock split.⁴ If no language in the option itself provides for adjustment in the event of such a change in capitalization, the

3. An example of a typical anti-dilution provision is the language at issue in *Reiss v. Financial Performance Corporation*, 764 N.E.2d 958 (N.Y. 2001), discussed in Parts II and III *infra*:

Change in Class of Shares: If, at any time or from time to time, the Corporation, by stock dividend, stock split, subdivision, reverse split, consolidation, reorganization, reclassification of shares, or otherwise, changes as a whole its outstanding Common Stock into a different class of shares, the class of shares into which the Common Stock has been changed shall replace the Common Stock for purposes of the Warrants so that the Warrant Holders shall be entitled to receive, and shall receive upon exercise of the Warrants, shares of the class of stock into which the Common Stock has been changed.

Warrant Agreement by and between Financial Performance Corp. and Robert S. Trump, Sept. 1, 1993 (on file with author).

4. In the case of a reverse stock split, several shares are automatically converted into one share, and the value of the shares would be expected to increase proportionately. For example, in a one-for-five reverse stock split, each five shares of stock automatically convert into one share. The holder of the warrant to buy 100 shares of such stock at an exercise price of \$1 per share, with no adjustment language in the warrant, would technically still be entitled to purchase the same 100 shares stated in the warrant at the same \$1 exercise price, but would get shares worth five times more, representing a five times greater percentage interest in the issuer than the parties originally contemplated in the warrant. FLETCHER, *supra* note 2, at §3:44, at 246.

In a stock split, one share of stock is automatically converted into some number greater than one, and the value of the shares would be expected to decrease proportionally. For example, in a two-for-one stock split, each share of stock automatically converts into two shares. The holder of the warrant to buy 100 shares of such stock at an exercise price of \$1 per share, with no adjustment language in the warrant, would technically still be entitled to purchase the same 100 shares stated in the warrant at the same \$1 exercise price, but would get shares worth five times less, representing a five times lesser percentage interest in the issuer than the parties originally contemplated in the warrant. *Id.*

option holder will seek to purchase the original number of shares stated in the option, claiming that was the parties' intent when entering into the arrangement. The issuer will contend that the parties' intent was that the number of shares available under the option would automatically adjust downward by a factor of five, to take into account the reverse stock split. If the parties seek judicial interpretation of their arrangement, the courts will balance long-standing common law principles of contract interpretation against modern-day problems created by imperfect drafting. *Stare decisis* mandates that judges follow binding precedents, putting a premium on consistency, so that similarly-situated litigants are treated similarly. However, when courts inappropriately or incorrectly apply precedents, the goal of consistency will not be met.⁵

Courts bound by the same precedents can arrive at inconsistent results when adjudicating similar fact patterns, simply by virtue of the approach they take in applying these precedents and the degree of care and attention they use in such application.⁶ This article is a critique of two competing theories of contract interpretation, the textual approach, focusing exclusively on the parties' words, and the contextual approach, focusing on the circumstances surrounding the contract. Both approaches nominally aim to ascertain and give effect to the parties' original intent, but the means to this same end can differ dramatically. Each approach has strong theoretical and precedential support, and each has merit as an academic theory.⁷ An analysis of cases involving options or warrants drafted with missing or incomplete anti-dilution provisions illustrates the shortcomings of both theories. In practice, some courts are applying the principles of contract interpretation in such an inappropriate or incorrect fashion as to render the principles virtually meaningless. In all but one of the cases discussed herein, the courts used principles of contract interpretation to reach results that cannot be justified under the literal terms of such principles, and that do not further the underlying purpose of such principles. Instead, the courts used the principles primarily as a means to achieve some subjective judicial end, with the judge

5. "Pursuant to *stare decisis*, doing justice was not the job of the court if precedent demanded injustice." Joseph M. Perillo, *The Origins of the Objective Theory of Contract Formation and Interpretation*, 69 *FORDHAM L. REV.* 427, 441 (2000).

6. See Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 *CAL. L. REV.* 261, 301 (1985).

7. *Id.* at 307.

giving lip-service to the principles to justify the desired result.⁸ The inconsistent and insupportable results in this area of the law evidence, in a microcosm, the broader problems with judicial interpretation of contracts in general.

Part I of this article examines both the textual and contextual approaches to contract interpretation, analyzing the "plain meaning rule" indicated by the textual approach and the *Restatement* principles regarding the omission of essential contract terms indicated by the contextual approach. Part II is an analysis of various courts' misapplication of the plain meaning rule and the *Restatement* principles in their respective interpretations of option or warrant agreements that lack, or contain incomplete, anti-dilution provisions. The Part examines six judicial opinions, in five of which the court supplied the missing anti-dilution provision by stretching the principles of contract interpretation beyond the point of reasonableness. The sixth court declined to supply an adjustment provision, but, in so doing, also misapplied the principle of contract interpretation it cited. These unsound decisions may conform to some judicial notion of common sense, but they are not supportable as a matter of *stare decisis* under the principles of contract interpretation relied on therein.

Part III is an analysis of the recent New York Court of Appeals decision in *Reiss v. Financial Performance Corp.*,⁹ in which the court correctly applied a systematic, contextual approach to contract interpretation. The court declined to imply an adjustment provision under the *Restatement* principles of contract interpretation that require the addition by a court of missing "essential" terms, and held that the one-for-five reverse stock split resulted in the warrant holders receiving five times the number of shares shown on the warrant certificates at issue.¹⁰ Reasonable minds can differ on the common sense of this result. But it is precedentially sound under present principles of contract interpretation, and thus is the court's best proxy for the actual intent of the parties.

Ideally, these principles of contract interpretation would be unnecessary, as the parties would spell out their agreement in complete and unambiguous terms. In the real world, however, the application of these principles must be

8. One commentator examined the first twenty cases cited as authorities for the plain meaning rule by *American Jurisprudence 2d*, and found that while all the cases cited to an expression of the rule, only two actually followed the rule. See Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1731 (1997).

9. 764 N.E.2d 958 (N.Y. 2001).

10. *Id.*

applied systematically and correctly to bring about consistent outcomes. The common law developed principles of contract interpretation as a mechanism to assist courts in determining, in hindsight, what the parties intended when they entered into the contract at issue. To the extent that systematic and correct application of these principles still fails to generate results that further that goal, the solution is to change, not disregard, the underlying law. The American judicial system does not change valid and binding legal principles simply because the results may be less than optimal in all cases.¹¹

The article concludes that each of the cases analyzed might have been decided differently, had the judge elected to use a different approach to contract interpretation or used the chosen approach correctly. The benefits of a system of *stare decisis* are compromised by the incorrect application of precedents. This conclusion threatens the stability of our system of freedom of contract and illustrates the need to rein in the inconsistency with which courts interpret all contracts, not just option and warrant agreements. Until judges apply their chosen approach to contract interpretation consistently and correctly, contracting parties must take care to articulate their entire understanding as clearly as possible, to decrease the possibility of subjective judicial interpretation. Each party will also need to give more thought to the choice-of-law and choice-of-forum provisions she seeks to govern any dispute arising under the contract, in the hope that, if litigated, the contract winds up in front of a judge who will apply the principles of contract interpretation appropriately and correctly, using the approach that best serves that party's interest. This contractual forum selection is, in effect, an end run around *stare decisis* and an open invitation to forum shopping.

I. JUDICIAL INTERPRETATION OF CONTRACTS: FURTHERING THE OBJECTIVE INTENT OF THE PARTIES OR THE SUBJECTIVE INTENT OF THE JUDICIARY?

The aim of judicial interpretation of contracts is to ascertain and give effect to what the parties intended when they entered into the contract, a daunting task.¹² Parties litigating a contract presumably have differing

11. Goetz & Scott, *supra* note 6, at 272. The imposition of these principles of contract interpretation is unobjectionable as an academic matter, since parties who do not want their contract to be interpreted thereunder can simply document their understanding in a manner foreclosing their applicability. If they fail to do so, the parties must rely on judicial interpretations of their understanding that can deviate, sometimes dramatically, from their original intent.

12. "Interpretation of a promise or agreement or a term thereof is the ascertainment of its meaning." RESTATEMENT (SECOND) OF CONTRACTS § 200 (1981). *See also* E. Allan Farnsworth, *Disputes Over Omission In Contracts*, 68 COLUM. L. REV. 860, 860 (1968);

opinions as to their collective intent. As litigants, the parties have an incentive to see their particular version of "the parties' intent" endorsed by the court. Over time, principles of contract interpretation have developed to give courts objective tools with which to ascertain the parties' original intent. Different approaches to the application of these principles have been proposed by judges and commentators over the last two hundred years.¹³ These approaches can be placed along a spectrum ranging from purely objective in ideal to purely subjective in ideal, with the caveat that neither endpoint of the spectrum is desirable, or even possible.¹⁴ The debate on the merits of this spectrum of approaches is both long-standing and well-documented.¹⁵

Towards the objective end of the spectrum is a textual approach, holding the parties' words as sacrosanct and dispositive of their original intent. This approach is only applicable to contracts in which the parties' language is clear and unambiguous. In such case, a court can give effect to the parties' intent by enforcing their words, applying a principle of contract interpretation known as the "plain meaning" rule. However, if the parties' words are determined to be ambiguous, the court can consider evidence extrinsic to the parties' words. Towards the subjective end of the spectrum is a contextual approach in which the court looks beyond the parties' words, even absent a finding of ambiguity. The court attempts to ascertain the parties' intent from the surrounding circumstances through the use of other principles of contract interpretation.

The approach taken by the court when interpreting a contract can be outcome-determinative. For example, in the case of a court adjudicating disputes arising from stock option agreement contracts with incomplete or missing anti-dilution provisions, if an option issuer effected a one-for-five reverse stock split, the court interpreting the agreement, if using a textual

Keith A. Rowley, *Contract Construction and Interpretation: From the "Four Corners" to Parol Evidence (and Everything in Between)*, 69 MISS. L.J. 73, 79-80 (1999).

13. See Goetz & Scott, *supra* note 6, at 307; Rowley, *supra* note 12, at 82; Steven W. Feldman & James A. DeLanis, *Resolving Contractual Ambiguity in Tennessee: A Systematic Approach*, 68 TENN. L. REV. 73, 74 (2000).

14. See Melvin Aron Eisenberg, *The Emergence of Dynamic Contract Law*, 88 CAL. L. REV. 1743, 1748 (2000). A purely objective approach is unrealistic as a practical matter, and a purely subjective approach would be so capricious as to undermine the very foundations of *stare decisis*.

15. Goetz & Scott, *supra* note 6, at 306-7. See also James P. Nehf, *Writing Contracts in the Client's Interest*, 51 S.C. L. REV. 153, 170 (1999); Amy H. Kastely, *Out of the Whiteness: On Raced Codes and White Race Consciousness in Some Tort, Criminal, and Contract Law*, 63 U. CIN. L. REV. 269, 294 (1994).

approach, would hold the actual unambiguous wording of the contract [i.e., the incomplete or missing anti-dilution provision] to be controlling. Thus, the court would grant the holder a windfall of five times the number of shares shown on the option, despite the common-sense likelihood that the parties intended that the corresponding right to buy the underlying securities would adjust to match changes in the securities themselves, thereby preserving the grant of value and percentage of ownership given.

If, however, the court interpreting the same agreement were to take a contextual approach, the court would put the agreement in its factual context in an effort to determine the parties' original intent. The wording of the contract would be just one factor in this determination. The court might conclude from its evaluation of the surrounding circumstances that, although the parties failed to provide for adjustment in the literal language of the option, their intent was to provide the holder with the right to buy some given value of stock, representing some specific equity interest in the issuer, not five times that much. The court would then read in an adjustment provision, taking it upon itself to find that the agreed-upon combination of shares and exercise price should be preserved, even in the absence of adjustment language in the option itself. Conversely, the court might conclude from the same circumstances that the parties intentionally omitted an adjustment term, and, accordingly, grant the holder five times the number of shares shown on the option.

The degree of care taken by the court is even more critical to the process of contract interpretation than the decision to apply a textual or contextual approach. When courts apply their chosen approach to contract interpretation incorrectly, they make bad law and, even more troubling, they create bad precedent. The principles of contract interpretation must be applied correctly and under appropriate triggering circumstances in order to generate decisions that are legally supportable thereunder.

A. Textualism: When Words Are Deemed Dispositive

To the textualists, the terms of a written contract are paramount to the determination of the parties' intent. This approach flows from the common law quest for certainty in the contracting process, which is premised on the notion that a complete, integrated, written contract is the best reflection of the parties' intent. The well-settled need for certainty in our contracting process is evidenced by the parol evidence rule which generally forecloses the admission of extrinsic evidence to contradict or supplement the terms of a written contract that is complete on its face, and the Statute of Frauds, with

its bias towards the written contract.¹⁶ Textualists espouse the continued entrenchment and exclusivity of doctrines like these. Any evidence of the parties' intent not memorialized in their written agreement is ignored in an effort to maintain the objective integrity of the parties' written understanding.¹⁷ The textual approach presupposes that a court is capable of determining what constitutes the terms of the agreement in question, and that the court will be capable of confining its interpretation to such terms, which may not always be the case.¹⁸ When a court elects to use evidence beyond the parties' agreement in its interpretation, such interpretation cannot be justified under a textual approach.

A doctrine that has become virtually synonymous with the textual approach is the plain meaning rule, which prohibits courts from any examination of the parties' intent beyond the plain language of their contract. The rule is a vestige of a formalistic period of contract interpretation, with its roots in the primitive view that words were symbols with fixed, objective meanings, and that parties to a writing should be held to those fixed meanings, regardless of their actual intention in executing the writing.¹⁹

The rule presents a significant problem in its application, even if undertaken in a completely consistent fashion. By its terms, the plain meaning rule operates to exclude extrinsic evidence offered to explain the parties' intent, absent a finding of ambiguity.²⁰ Thus, only if a court

16. Goetz & Scott, *supra* note 6, at 273 n.26. See also Farnsworth, *supra* note 12; Stephen J. Lubben, *Chief Justice Traynor's Contract Jurisprudence and The Free Law Dilemma: Nazism, The Judiciary, and California's Contract Law*, 7 S. CAL. INTERDISC. L.J. 81, 103 (1998).

17. "The textualists have implicitly assumed that the purpose of contract interpretation is to maintain the reasonable expectations of contracting parties as a class by upholding the objective integrity of express contractual language." Goetz & Scott, *supra* note 6, at 308.

18. This presupposition was disproved by the trial court opinion in *Reiss v. Financial Performance Corp.* because it relied on filings the defendant made with the Securities and Exchange Commission, and on warrant agreements by and between the defendant and a third party unrelated to the litigation. See *Reiss v. Fin. Performance Corp.*, No. 111385-98, slip op. (N.Y. Sup. Ct. Sept. 22, 1998) (Ramos, J.) [hereinafter *Ramos Sept. Opinion*] (on file with author). See Part II.A. *infra* for a discussion of this opinion.

19. Karla K. Poe, *New Mexico Adopts The Modern Approach to Interpreting Ambiguities: C.R. Anthony Company v. Loretto Mall Partners*, 23 N.M. L. REV. 281, 283 (1993); see also Carlton J. Snow, *Contract Interpretation: The Plain Meaning Rule in Labor Arbitration*, 55 FORDHAM L. REV. 681, 684 (1987).

20. *Lohnes v. Level 3 Communications, Inc.*, 272 F.3d 49, 53 (1st Cir. 2001).

A court's determination that a contract is or is not ambiguous has important implications. If a court holds that a contract is unambiguously worded, it typically

determined that a contract term was ambiguous could it go beyond the parties' words and consider other evidence.²¹ The rigidity of the rule creates the possibility of an inconsistency, as it bars a court from using extrinsic evidence to determine the parties' intent, even though some extrinsic evidence might be relevant to this inquiry.²² Ironically, under the plain meaning rule, such extrinsic evidence is barred unless and until the court finds an ambiguity.²³

Since the plain meaning rule limits the evidence that can be considered, it has the advantages of simplicity, uniformity and predictability.²⁴ But the

will construe the document based upon the plain and natural meaning of the language contained therein. For the most part, a court interpreting an unambiguous agreement need not consult extrinsic evidence to impart the meaning of its terms. A court may, however, consider extrinsic evidence for the limited purpose of evaluating whether a term is ambiguous in the first place, but only if the extrinsic evidence suggests a meaning to which the challenged language is reasonably susceptible.

Id. (internal citations omitted). See Snow, *supra* note 19, at 681-82.

21. If, however, ambiguity looms—that is, if ‘the plain meaning of a contract phrase does not spring unambiguously from the page or from the context’—then the interpretive function involves a question of fact. In such cases, a court may consider extrinsic evidence insofar as it sheds light on what the parties intended.

Lohnes, 272 F.3d at 53-54 (citations omitted).

22. Margaret N. Kniffin, *A New Trend in Contract Interpretation: The Search for Reality as Opposed to Virtual Reality*, 74 OR. L. REV. 643, 648 (1995).

Although courts regularly cite both propositions of the PMR [plain meaning rule]—namely, that when the language is plain there is no room for interpretation, and that in such cases there is no room for considering external facts—the two are somewhat inconsistent, and the first one is intrinsically problematic. They are inconsistent because the second proposition, that unambiguous text should be interpreted without reference to external facts, assumes—contrary to the first proposition—that there is room for interpretation. The first proposition is untenable if interpretation is taken to be the determination of the meaning of a text. One cannot tell whether a text has a plain meaning without knowing what that meaning is, which requires an act of interpretation.

Zamir, *supra* note 8, at 1728-29 (emphasis in original).

23. Snow, *supra* note 19, at 685.

Writings on law and language amply demonstrate that a theoretical weakness inherent in the rule is its assumption that words are capable of having unambiguous meaning. Application of the plain meaning rule requires the preliminary step of characterizing contractual language as either plain or unambiguous. Because the rule does not give courts guidance on how to make this determination, decision-makers are left with the difficult task of determining, as a matter of law, whether a written agreement is clear or ambiguous.

Id.

24. Poe, *supra* note 19, at 285-86.

underlying premise of the plain meaning rule, that words are capable of clear and unambiguous meaning, is questionable. In a perfect world, words in a contract would have one meaning only, and all the parties to the contract would acknowledge this exclusive meaning. The plain meaning rule would work beautifully in that particular and unlikely scenario. But the benefits of the plain meaning rule diminish when the parties' words are not so crystal clear.²⁵

As a result of the plain meaning rule's rigid reliance on the unattainable goal of complete objectivity based on the parties' words, courts may wind up imposing their own understanding of the meaning of the text and may substitute their own experience for that of the parties. Although the rule was designed to give effect to the parties' intent, in practice, it subordinates their intentions to the intrinsic meaning of their chosen words as determined by a court.²⁶ Thus, the court may enforce a different contract than the one the parties actually intended.²⁷

The plain meaning rule is increasingly disfavored, but reports of its death have been greatly exaggerated, given that a majority of the jurisdictions in the United States still adhere, at least nominally, to the rule.²⁸ A detailed criticism and wake for the plain meaning rule is beyond the scope of this article. More relevant for our purposes is that this rule, with its attendant problems, was the nominal basis for the result reached by the

25. As Justice Holmes famously said, a "word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to circumstances and the time in which it is used." *Towne v. Eisner*, 245 U.S. 418, 425 (1918).

According to Judge Learned Hand, "Words are not pebbles in alien juxtaposition; they have only a communal existence; and not only does the meaning of each interpenetrate the other, but all in their aggregate take their purport from the setting in which they are used. . . ." *NLRB v. Federbush Co.*, 121 F.2d 954, 957 (2d Cir. 1941).

26. See Perillo, *supra* note 5, at 431.

27. See Poe, *supra* note 19, at 285.

When their own communication errors cause the parties to understand their agreement in diverse ways, the state's subsequent defining of the disputed terms will necessarily conflict with at least one party's intent. In addition to such errors precipitated by the parties themselves, the state may in effect superimpose new and thus "erroneous" instructions on an original formulation that was well understood between the parties but disputed for strategic motives. Such errors will occur when the court either enforces terms that were almost certainly not contemplated by either party or refuses to enforce terms that were.

Goetz & Scott, *supra* note 6, at 271.

28. Kniffin, *supra* note 22, at 648; Poe, *supra* note 19, at 283; see also Zamir, *supra* note 8, at 1731.

trial courts in *Reiss v. Financial Performance Corporation* and in *Sanders v. Wang*, both unsound decisions. Had these courts correctly applied their chosen textual approach to contract interpretation, the parties' intent might have been served.²⁹

B. Contextualism: When Circumstances Are Deemed Controlling

Over time, the textual approach to contract interpretation has lost favor, as judges and commentators began to seek more fluid and less mechanical approaches to contract interpretation.³⁰ One such approach is a contextual approach, under which relevant contextual evidence is paramount to the determination of the parties' intent.³¹ Contextualists view the textual approach of limiting the court's analysis to the parties' literal words as a disservice to the parties and a slavish adherence to obsolete doctrines that impedes the court's work.³² Instead, in a contextual analysis, extrinsic evidence relating to a contract is admissible to aid the court in determining whether an ambiguity exists. Some contextualist courts have gone further, removing virtually all restraints on the admission of extrinsic evidence.³³

The *Restatement (Second) of Contracts* has contributed to this shift away from a dogmatic and intransigent textual approach. The *Restatement*

29. See *infra* Part II. for a discussion of these cases.

30. Zamir, *supra* note 8, at 1713. According to one set of commentators, the battle is over and the contextualists have won, since the Uniform Commercial Code and the *Restatement (Second) of Contracts* have "abandoned the plain-meaning rule and eviscerated the parol evidence rule" to permit certain extrinsic evidence even if the express terms of the contract are clear. Goetz & Scott, *supra* note 6, at 307.

31. See Snow, *supra* note 19, at 684.

The new trend is an outgrowth of an earlier but continuing trend in which an increasing number of courts have rejected the plain meaning rule and have acknowledged that extrinsic evidence relating to context should always be admissible to determine whether an ambiguity exists. In so doing, these courts hold that it is not possible to know whether there are two or more reasonable interpretations of a disputed contract term without examining the surrounding circumstances.

Kniffin, *supra* note 22, at 643.

"Generally, courts agree that ambiguity in a contractual provision is not established merely because the contracting parties disagree about the meaning of a provision. The prevailing view is that courts should consider objective rather than subjective manifestations of contractual intent." Snow, *supra* note 19, at 686.

"[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.'" Goetz & Scott, *supra* note 6, at 308.

32. *Id.* at 306-07.

33. See Kniffin, *supra* note 22, at 644; see also Poe, *supra* note 19, at 287.

provisions on contract interpretation are not dependent on a judicial finding of ambiguity, but rather "are used in determining what meanings are reasonably possible as well as in choosing among possible meanings."³⁴ Under the *Restatement*, the plain meaning rule has been modified by the caveat "unless a different intention is manifested," moving its approach from textual to contextual with just six words.³⁵ When the parties have reduced their agreement to writing, "interpretation is directed to the meaning of that writing in light of the circumstances."³⁶ Toward that end, a court may supply a contract term not agreed to by the parties.³⁷ This otherwise open invitation for a court to impose its views on the parties is tempered by the caveat that such an omitted term must be "essential" to a determination of the parties' rights and duties. The addition of this "omitted" term does not constitute interpretation under the *Restatement*, thus it cannot be added simply to give effect to the parties' intent.³⁸

Under the *Restatement*, the judicially-supplied term must be "reasonable in the circumstances."³⁹ The *Restatement* details the circumstances under which parties might omit an "essential" term. The first circumstance is when the parties fail to foresee the contingency triggering the dispute. The parties would therefore have no expectations with respect to such contingency, so there would be no point in a court trying to determine what those expectations would have been.⁴⁰ The court should then read in the term that the parties would have drafted had the contingency been brought to their attention, which is easier said than done.⁴¹

34. RESTATEMENT (SECOND) OF CONTRACTS § 202 cmt. a (1981).

35. *Id.* § 202(3)(a); see RESTATEMENT OF CONTRACTS § 235 (1932).

36. RESTATEMENT (SECOND) OF CONTRACTS § 202 cmt. b.

37. *Id.* §204.

38. *Id.* at §204 cmt. c.

Where there is tacit agreement or a common tacit assumption or where a term can be supplied by logical deduction from agreed terms and the circumstances, interpretation may be enough. But interpretation may result in the conclusion that there was in fact no agreement on a particular point, and that conclusion should be accepted even though the omitted term could be supplied by giving agreed language a meaning different from the meaning or meanings given to it by the parties.

Id.

39. *Id.* § 204.

40. *Id.* § 204 cmt. b.

41. "The perceived merit of this approach is that it comes closest to what the parties have actually agreed to, and after all, enforcing the agreement of the parties is what contract law is all about." Dennis Patterson, *The Pseudo-Debate Over Default Rules in Contract Law*, 3 S. CAL. INTERDISC. L.J. 236, 237 (1993). According to the *Restatement*:

The second circumstance under which parties might omit an “essential” term is when the parties have expectations with respect to the contingency that they failed to manifest in their written understanding.⁴² Possible reasons include the expectation resting on an unconscious or partially conscious assumption, the situation seeming unimportant or unlikely, or when a discussion of the contingency might be unpleasant, dilatory, or might result in an impasse in negotiations.⁴³ Unfortunately, the *Restatement* finds no qualitative difference between parties with an expectation about a contingency and parties without such an expectation, allowing courts in either event to supply their own “reasonable” terms, as long as the court determines the omitted term is “essential.” And the *Restatement* misses an opportunity to bring clarity to the rule on adding omitted terms by giving no guidance as to what makes a term essential.⁴⁴ Ironically, the courts are left to apply the plain meaning of the word.

II. JUDICIAL MISINTERPRETATION OF INCOMPLETE OR MISSING ANTI-DILUTION PROVISIONS

The six judicial opinions interpreting common stock options or warrant agreements that omit, or contain incomplete, anti-dilution provisions each misapply the plain meaning rule or the *Restatement* rules, with two of the courts in fact misapplying both rules in their opinions.

A. Judicial Misapplication of the Plain Meaning Rule

The plain meaning rule presents theoretical and doctrinal problems, as discussed above, even if applied in a consistent and correct manner.⁴⁵ When

The process of supplying an omitted term has sometimes been disguised as a literal or a purposive reading of contract language directed to a situation other than the situation that arises. Sometimes it is said that the search is for the term the parties would have agreed to if the question had been brought to their attention. Both the meaning of the words used and the probability that a particular term would have been used if the question had been raised may be factors in determining what term is reasonable in the circumstances. But where there is in fact no agreement, the court should supply a term which comports with community standards of fairness and policy rather than analyze a hypothetical model of the bargaining process.

RESTATEMENT (SECOND) OF CONTRACTS § 204 cmt. d.

42. *Id.* § 204 cmt. b.

43. *Id.*

44. Patterson, *supra* note 41, at 247.

45. See *supra* Part I. for a discussion of the problems inherent in the plain meaning rule.

it is incorrectly applied, the practical results can be even more problematic. A recent judicial opinion interpreting an agreement granting warrants to buy common stock with no anti-dilution provision illustrates the dangers of an incorrect judicial application of the plain meaning rule. In *Reiss v. Financial Performance Corp.*, the trial court nominally relied on the plain meaning rule, but was unable to limit the scope of its interpretation to the actual text of the parties' contract.⁴⁶ Relying on evidence extrinsic to the text, the trial court gave effect to its view of what the parties should have intended, rather than the intention of the parties that was evidenced by the actual language of the agreement.

Marvin Reiss, a director and shareholder of Financial Performance Corporation ("Financial"),⁴⁷ sought to exercise two warrants to purchase Financial common stock after Financial effected a one-for-five reverse stock split.⁴⁸ One of the warrants was issued to Mr. Reiss personally (the "Reiss Warrant")⁴⁹ and the other to Rebot Corporation, a corporation wholly-owned by Mr. Reiss (the "Rebot Warrant").⁵⁰ The certificates evidencing

46. See *Ramos Sept. Opinion*, *supra* note 18.

47. Financial was incorporated in New York in 1984. See *Financial Performance Corporation Annual Report of Form 10-KSB for fiscal year ended Sept. 30, 1996*, at 4 (on file with author) [hereinafter *1996 10-KSB*]. Financial changed its name to BrandPartners Group Inc. and its state of incorporation to Delaware, effective August 20, 2001. See *Verified Amended Complaint*, Jan. 7, 2002, Index No. 11.1385/98, at 2 (on file with author) [hereinafter *Verified Amended Complaint*]. Financial consummated an initial public offering of its common stock in January 1987. See *1996 10-KSB*, *supra*, at 1. The common stock began trading on the Nasdaq over-the-counter market in 1987 and was de-listed in July 1989 because Financial failed to maintain Nasdaq's minimum capital requirements. *Id.* In February 1990, Financial ceased its day-to-day operations and remained inactive through November 1992. *Id.* Financial resumed operations in January 1993, and its common stock resumed trading on the OTC Bulletin Board on November 27, 1996. *Id.*

48. Financial's shareholders approved a one-for-five reverse stock split at the annual meeting on August 26, 1996; as a result, the shareholders each owned one-fifth the number of shares they owned before the split, but maintained their percentage equity ownership interest. See *1996 10-KSB*, *supra* note 47, at F-12. The proxy statement covering the proposed reverse stock split did not mention any adjustment to outstanding warrants. See *Verified Amended Complaint*, *supra* note 47, at 3.

49. On November 11, 1993, Financial's board authorized the issuance of the Reiss Warrant for 500,000 shares at a price of 10 cents per share, issued as an honorarium in recognition of Reiss' services on Financial's board. Mr. Reiss had served as a director of Financial since December 12, 1984, and as treasurer since January 19, 1993. See *Financial Performance Group Annual Report on Form 10-KSB for fiscal year ended Sept. 30, 1993*, at 19 (on file with author) [hereinafter *1993 10-KSB*]. The warrant expired on August 31, 1998. *Id.* at 15.

50. Mr. Reiss made numerous loans to Financial from 1989 through 1993, including a

the Reiss and Rebot Warrants were physically delivered to Mr. Reiss some two years after Financial's board of directors had authorized them.⁵¹ The warrant certificates did not provide for adjustment in the number of shares or in the warrant exercise price under any circumstances, including in the event of a reverse stock split.⁵² Although warrant certificates typically are issued pursuant to warrant agreements, warrant purchase agreements, or other similar contracts that spell out additional terms and conditions governing the warrant, no such corresponding agreements were ever entered into in connection with the Reiss or Rebot Warrants, either contemporaneous with or subsequent to their issuance.⁵³

A few weeks before Financial issued the Reiss and Rebot Warrants, it issued several other warrants, including one to Robert S. Trump, a director and shareholder.⁵⁴ A corresponding warrant agreement was executed contemporaneously with the issuance of Mr. Trump's warrant, containing a

loan in the amount of \$187,328.79. *See Ramos Sept. Opinion, supra* note 18, at 1. Financial's inability to repay this loan led to the issuance on October 8, 1993 of the Rebot Warrant for 1,198,904 shares of Financial's common stock at a price of 10 cents per share. The warrant expired on September 30, 1998. *Id.*

51. *Id.*; *see also Transmittal Letters of Gary S. Friedman, Esq. to Reiss and Rebot Corp.*, Nov. 21, 1995, delivering the Reiss and Rebot Warrants, at 44-45 (on file with author) [hereinafter *Record on Appeal*].

52. Under New York law:

The terms and conditions of such rights or options, including the time or times at or within which and the price or prices at which they may be exercised and any limitations upon transferability, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options.

N.Y. BUS. CORP. LAW § 505(c) (consol. 2002).

53. The letters enclosing the Reiss and Rebot Warrants claimed such warrants were each "subject to the terms and conditions of a warrant agreement dated even date therewith on file at the Company's offices." *Record on Appeal, supra* note 51, at 83. The letters requested that the warrant holders sign and return a copy of such letters to indicate their acknowledgement and agreement. *Id.* Mr. Reiss never did so personally or on behalf of Rebot. *Id.* Instead, Mr. Reiss' counsel sent a letter dated Oct. 9, 1997, asking if there were "any documents in any way impacting upon or adversely affecting the number of warrants and/or the number of shares which can be purchased upon exercise of said warrants." *Id.*

Financial's counsel responded by letter dated Oct. 21, 1997 that Financial's records reflected the number of shares available under the Reiss and Rebot Warrants as adjusted by a factor of five due to the reverse stock split. *Id.* at 84.

Finally, by letter dated May 6, 1998, Financial's counsel furnished Reiss' counsel with the warrant agreements it claimed controlled the Reiss and Rebot Warrants. *Id.* at 87.

54. *See 1993 10-KSB, supra* note 49, at 32.

provision requiring adjustment in the event of any recapitalization (including a stock split) involving Financial's common stock.⁵⁵

In April 1998, Mr. Reiss, personally and on behalf of Rebot, sought to partially exercise the Reiss and Rebot Warrants, and asserted that he was entitled to the number of shares specified in the warrants, without any adjustment for the reverse stock split.⁵⁶ Financial rejected the purported exercise, claiming the number of shares available under both warrants had been adjusted downward by a factor of five as a result of the reverse stock split.⁵⁷ Mr. Reiss filed suit, seeking a judgment declaring his right to purchase the face amount of the warrants at the exercise price.⁵⁸

The trial court dismissed the action in September 1998, and the court's nominally textual approach generated conclusions that are wholly insupportable, both under the theory by which it analyzed the case and in fact.⁵⁹ It found the specific written terms of the Reiss and Rebot Warrants

55. *Id.* The Trump Warrant Agreement contained a comprehensive anti-dilution section and was signed by both parties. The warrant agreement Financial sought during the litigation to introduce as binding on the Reiss and Rebot Warrants is signed only by Financial, with no signature line for the warrant holders. *See Warrant Agreement between Financial Performance Corp. and Robert S. Trump*, *supra* note 3.

56. *See Verified Amended Complaint*, *supra* note 47, at 3; *see also Record on Appeal*, *supra* note 51, at 44-45.

57. Financial documented the reverse split and the corresponding change in the number of shares of issued and outstanding common stock in its books and records and its filings with the Securities and Exchange Commission ("SEC"). In its Annual Report on Form 10-K for 1996, under Item 11: Security Ownership of Certain Beneficial Owners and Management, Financial tacitly indicated its position that all of the outstanding warrants were subject to adjustment by listing Rebot in Financial's books and records as entitled to purchase 239,781 shares of stock (one fifth of the original 1,198,904) and Reiss as entitled to purchase 100,000 shares of stock (one fifth of the original 500,000). *See 1996 10-KSB*, *supra* note 47, at 24. Financial also noted a change in the exercise price of each share of stock to reflect the reverse stock split, with each share now exercisable at 50 cents instead of 10 cents. *Id.*

On May 6, 1998, Financial wrote to Reiss' counsel: "As you and your clients have previously been advised, the September 1993 and November 1993 warrants were issued by the Company subject to the terms and conditions of warrant agreements dated even date therewith on file at the Company's offices, which is customary corporate practice." *Id.* at 38. Yet no warrant agreement was produced to support this position.

58. References to Mr. Reiss as a litigant in this matter are deemed to include him in his personal capacity and as the sole shareholder of Rebot. Mr. Reiss also sought judgment reforming the warrants to provide for extended exercise periods stemming from Financial's delay in physically delivering the warrants, and staying the expiration date while the action was pending. *See Ramos Sept. Opinion*, *supra* note 18, at 2.

59. *Id.* at 4.

required a proportional adjustment due to the reverse stock split.⁶⁰ The trial court further found the Reiss and Rebot Warrants to be unambiguous by their terms, and justified its finding by stating that “there is no basis in law or fact upon which a court may grant declaratory relief which would permit plaintiffs to exercise the warrants without adjusting for the reverse stock split put into effect by the defendants.”⁶¹ This finding is groundless, since the only documents evidencing the agreement of the parties were the Reiss and Rebot Warrants, which contain no adjustment provisions.⁶² The trial court extended its textual analysis to provisions not within the actual text of the warrant certificates, including the warrant agreements between Financial and Mr. Trump, a letter from Financial to Mr. Reiss and certain filings Financial made with the Securities and Exchange Commission (“SEC”) that noted Financial’s view that the Reiss and Rebot Warrants had adjusted by virtue of the reverse stock split.⁶³ The trial court seemed to think that an SEC filing could somehow modify the otherwise complete contractual arrangement between Financial and Mr. Reiss concerning the warrants.⁶⁴ A unilateral assertion in a letter or filing cannot, *ipso facto*, bind the recipient.⁶⁵ If sending a party a letter purportedly binding her to some

60. According to the court, “at the time of issuance, by their written terms the warrants at issue permit and require appropriate adjustments in number and price in the event of a duly authorized reverse split.” *Id.* at 3.

61. *Id.* at 4.

62. No anti-dilution protection is “automatically part of a stock purchase warrant contract. Rather, the precise antidilution protection afforded to a warrant holder will depend on the express terms of the contract itself.” *Anderson v. Somatogen, Inc.*, 940 P.2d 1079, 1082 (Colo. 1996) (internal citations omitted).

63. *Ramos Sept. Opinion*, *supra* note 18, at 3.

64. “Plaintiff Reiss was a director of the defendant at the time that the warrants were authorized for issuance and cannot assert that he was unaware of the precise terms and conditions of the same, inasmuch as his signature appears on an official document filed with the Securities and Exchange Commission, which contain the relevant terms and conditions of the warrants.” *Id.* at 3.

Even if that were true, in this case, the filing the trial court refers to is Financial’s Form 10-KSB for 1996, to which Mr. Reiss is not a signatory. *See 1996 10-KSB*, *supra* note 47, at 36. Mr. Reiss did sign the 1993 10-KSB that was filed before the reverse stock split, and which showed the number of warrants available as the original number on the certificate. *See 1993 10-KSB*, *supra* note 49, at 23-24.

65. Financial’s transmittal letter, dated November 21, 1995, claimed that the Reiss and Rebot Warrants were “subject to the terms and conditions of a warrant agreement dated even date therewith on file at the Company’s offices located at 335 Madison Avenue, New York, New York 10017.” *Reiss v. Fin. Performance Corp.*, 715 N.Y.S.2d 29, 37 (N.Y. App. Div. 2000) (Saxe, J., dissenting in part). The transmittal letter requested that Reiss sign the bottom to acknowledge receipt. *Id.* (Saxe, J., dissenting in part). Reiss did not sign or return the

condition, or making that same statement in a filing with the SEC could actually make the condition binding, freedom of contract would be displaced by a race to the mailbox or to the filing desk at the SEC.⁶⁶ The heart of a binding contract is the mutual assent of the parties, not the unilateral imposition of a term *ex post facto*. And the policy underlying the textual approach to contract interpretation is to use only the clear, unambiguous words of the parties to give effect to their intent. This court undercut this policy with its insupportable rationale.

The trial court affirmed its prior decision in December 1998, finding that Mr. Reiss "relies on the fact that the terms are not contained in the warrants themselves."⁶⁷ This is absolutely true, completely appropriate and outcome-

transmittal letter. *Id.* (Saxe, J., dissenting in part). There is nothing in the record that could be the referenced "warrant agreement of even date." *Id.* (Saxe, J., dissenting in part). Even if Financial could produce the referenced "warrant agreement of even date," such agreement could not be unilaterally imposed on Reiss personally or on behalf of Rebot. *Id.* (Saxe, J., dissenting in part).

66. Nor does the Corporation's assertion, in its 1996 report filed with the SEC, informing its

shareholders and/or prospective shareholders that plaintiffs' warrants were subject to the reverse one-to-five stock split, make that assertion accurate. Indeed, the evidence submitted compels the conclusion that the statement contained in the Corporation's 1996 Form 10-KSB simply lacked any foundation in fact.

Id. at 40 (Saxe, J., dissenting in part).

67. See *Reiss v. Fin. Performance Corp.*, No. 111385-98, slip op. (N.Y. Sup. Ct. Dec. 18, 1998) (Ramos, J.) [hereinafter *Ramos Dec. Opinion*] (on file with author).

The trial court also denied Reiss' request for reformation due to the delay, again an insupportable finding. *Id.* The ruling was issued on September 22, 1998, after the expiration date of the Reiss Warrant on August 31, 1998, and days before the expiration of the Rebot Warrant on September 30, 1998. *Id.* Certainly the delay in delivery of the actual warrant certificates should not, in and of itself, result in equitable reformation of the expiration period unless Reiss could show that he was unaware of the existence of the warrants until their delivery, and thereby incapable of exercising them prior thereto. That the warrant certificates were not physically delivered to Mr. Reiss until November 21, 1995 is of no substance, as Mr. Reiss knew or should have known of the existence of the warrants and thus could have exercised them. The Rebot Warrant was issued in repayment of a debt owed to a corporation he wholly owned; Mr. Reiss or his designated agent presumably participated in the negotiations leading up to the issuance of the warrant. Alternatively, Mr. Reiss would have learned of the existence of the Reiss and Rebot Warrants from the board's authorization thereof, since Mr. Reiss was a director at the time the warrants were authorized. Further, Financial listed the warrants on its books and records and in its SEC filings, including its 1993 Annual Report on Form 10-KSB. See 1993 10-KSB, *supra* note 49. Mr. Reiss had a fiduciary duty to be familiar with the contents of these filings, again because of his status as director and treasurer. For example, he signed the 1993 10-KSB. See 1993 10-KSB, *supra* note 49, at 34.

determinative.⁶⁸ The trial court claims that its failure to “enumerate the exact location of the expression of those terms is irrelevant.”⁶⁹ In fact, such

The issue of whether Mr. Reiss should have known of the existence of the warrants turns out to be a non-issue, and the record clearly indicates he had actual knowledge of same. *Reiss*, 715 N.Y.S.2d at 38 (Saxe, J., dissenting in part). Mr. Reiss’ actual knowledge of the existence of the Reiss and Rebot Warrants is demonstrated by his counsel’s correspondence with Financial’s president, seeking to confirm the Reiss and Rebot Warrants remained in their initial issuance amounts, and requesting “any documents in any way impacting upon or adversely affecting the number of warrants and/or the number of shares which can be purchased upon the exercise of said warrants.” *Id.* (Saxe, J., dissenting in part). While this would have been an appropriate time for Financial to send the warrant agreements that it claimed governed the transaction, Financial responded only that the numbers had been reduced to conform to the reverse split, with no warrant agreements produced in support thereof. *Id.* (Saxe, J., dissenting in part).

Regardless, the lengthy litigation should result in a reformation stemming from Financial’s improper refusal to accept Reiss’ valid exercise; the clock should have stopped then, pending resolution of the litigation. By the time the case reached the Court of Appeals, the warrant period, even if extended by the two years Reiss requested at trial, would have long expired. Thus any interpretation of the warrants by the Court of Appeals (or the Supreme Court on remand) would be a purely academic exercise without a remedy that includes reforming the exercise period beyond the conclusion of the litigation.

The lengthy litigation also raises issues in the calculation of damages. Reiss calculates the damages highest intermediate value of a share of Financial and its successor-in-interest, BrandPartners Group, Inc. on the over-the-counter market, which was \$17.00 per share on February 24, 2000. *See Verified Amended Complaint*, *supra* note 47, at 4-5. Thus, the total damages would be \$17.00 multiplied by 500,000 (that being the number of shares available for purchase under the Reiss Warrant), less the exercise price of 10 cents per share, totaling 8.45 million. *Id.* Likewise, for the Rebot Warrant, the damages total 1,198,904 shares at \$17.00 each, less 10 cents per share for the exercise price, for a total of over \$20 million. *Id.*

68. The defendants’ position is that it is “axiomatic” that:

a stock warrant necessarily converts in exactly the same manner as existing common stock converts upon any sort of adjustment to the form of the stock. However, this is an unfounded assumption. Indeed, the very reason for the standard issuance of warrant agreements simultaneously with stock warrants is to define (and limit) the parties’ rights under the warrants. If stock warrants were deemed automatically adjusted upon consolidations or reclassifications of corporate stock, so that they maintained their proportionate value, there would be no need for the use of warrant agreements to establish the concept of proportional adjustment of stock warrants.

Reiss, 715 N.Y.S. 2d at 40 (Saxe, J., dissenting in part).

69. *See Ramos Dec. Opinion*, *supra* note 67, at 1. Yet the court found:

the terms that provide for adjustment in the case of a reverse stock split are contained [sic] SEC filings and the letters which accompanied the issuance of the warrants at issue. Those letters state that the warrants at issue were subject to the adjustment requirement. Thus the adjustment requirement is a term of each warrant.

Id.

failure is not only relevant, it is dispositive under the textual approach on which the trial court based its finding.

If the trial court had applied correctly its chosen textual approach to interpreting the warrants, Mr. Reiss would have prevailed. Since there were no warrant agreements executed by the parties in connection with the Reiss or Rebot Warrants, the unambiguous warrant certificates themselves represent the only written agreement of these parties and thus the entire legally binding expression of their understanding—which did not provide for adjustment in the event of a reverse stock split. Under a textual analysis, the words of the warrants should have been given their plain and usual meaning, and Mr. Reiss would thus be entitled to the actual number of shares provided in the warrants, with no adjustment. The trial court's inclusion of text beyond the agreement of the parties is not supportable under a textual approach.

B. Judicial Misapplication of the Restatement Principles of Contract Interpretation

The *Restatement* rules on contract interpretation permit courts to apply a contextual approach to contract analysis, thereby arriving at consistent results. For example, the *Restatement* rule on omitted terms permits courts to supply terms that are “essential” to a determination of the parties’ intent. Because the *Restatement* fails to clarify what is meant by “essential,” courts have been able to use this rule to support decisions to add terms they felt the parties should have included, regardless of the parties’ intent. This judicial overstepping is illustrated in the New York Appellate Division’s decision in *Reiss*. The decision nominally relies on the *Restatement* rule for adding “essential” omitted terms, but the court imposes its judgment of the significance of the missing term to give effect to what it thinks the parties should have intended, rather than what the parties actually did intend.

The appellate division used a contextual approach not only to reject the lower court’s reasoning, but also ultimately to affirm its conclusion.⁷⁰ The court reasoned that “in the absence of any evidence that the parties to a warrant contemplated otherwise, the warrant holder, because of the reverse

70. “We note at the outset that, contrary to the conclusion reached by the Supreme Court, the warrants at issue failed to contain any contractual language dealing with the eventuality of a reverse stock split. . . . Nevertheless . . . we agree that plaintiffs’ complaint should be dismissed.” *Reiss*, 715 N.Y.S. 2d at 32. The court found that the lower court considered the Trump warrants, which were not at issue here, just like the possibility of a stock split is not at issue here. *Id.*

stock split, is limited to purchasing shares proportionally adjusted as to both number and price.”⁷¹ The basis for its opinion is purportedly the *Restatement* approach, permitting a court to supply a term that is reasonable under the circumstances if it is “essential to a determination of the rights and duties of the parties.”⁷² The court determined that since an adjustment provision would fundamentally affect both the number of shares available under the warrant and the exercise price, such a provision constituted an essential term.

However, a comment to the *Restatement* section relied on by the court undermines its reasoning. Under the *Restatement*, the supplying of an omitted term does not constitute interpretation.⁷³ Since the *Restatement* defines interpretation as the ascertainment of a contract’s meaning, it follows that an omitted term cannot be added simply to give effect to the judge’s determination of the parties’ intent. Instead, an essential term under the *Restatement* rule is one that is *necessary* to effectuate the contract. Thus, the adjustment term added by the court is not an omitted essential term under the *Restatement* because the Reiss and Rebot Warrants could be enforced solely based on their terms. That literal enforcement of the warrant terms would result in the warrant holders’ entitlement to the actual number of shares listed therein.⁷⁴

The appellate division declined to “disregard common sense and slavishly bow to the written word where to do so would plainly ignore the true intentions of the parties in the making of a contract.”⁷⁵ This condemnation of the textual approach is in keeping with the current judicial trend towards contextualism. The court follows the trend, seeking “the essence of proper contract interpretation, which, of course, is to enforce a contract in accordance with the true expectations of the parties in light of the circumstances existing at the time of the formation of the contract.”⁷⁶ Yet the contextual approach using the *Restatement* rule on essential omitted terms should not be a blank check for a court to impose its view on the parties.⁷⁷ Despite the complete lack of any evidence indicating that the

71. *Id.* at 30.

72. RESTATEMENT (SECOND) OF CONTRACTS § 204 (1981).

73. *Id.* § 204 cmt. c; *see supra* note 37 and accompanying text.

74. “These terms—amount, price, and time frame—constitute the essential elements of the agreement. The term the majority believes to have been accidentally omitted amounts to merely a possible condition or limitation.” *Reiss*, 715 N.Y.S.2d at 40 (Saxe, J., dissenting in part).

75. *Id.* at 34.

76. *Id.*

77. *See id.* at 40 (Saxe, J., dissenting in part).

parties intended automatic adjustment in the event of any recapitalization, the court, in its effort to disregard what it considers common sense, held that an adjustment provision should have been, and thus somehow must have been, the parties' intent.⁷⁸

The court uses the rhetoric of the *Restatement* to reach its desired result, the adding of an adjustment provision, which it somehow determined to be the only reasonable term consistent with what it found to be the "self-evident" expectations of the parties when the warrants were executed.⁷⁹ Yet the parties' expectations are far from self-evident, and the record contains no basis for determining such expectation.⁸⁰ The only support for the court's determination of the parties "true expectation" results from its question to Mr. Reiss about his hypothetical response in the event that Financial had undertaken a stock split instead of a reverse stock split. Mr. Reiss conceded that he would have asserted a contrary position, which is his right.⁸¹ Even though the court acknowledges that Mr. Reiss' position on the hypothetical circumstance of a stock split (as opposed to the reverse stock split actually at issue), is "certainly not dispositive," the court nonetheless uses this inquiry

However, resort by a court to its subjective view of common sense is not a proper basis for a legal conclusion, particularly when it ignores both plaintiff's assertion of what the parties negotiated and intended, as well as '[t]he cardinal rule of contract interpretation . . . that, where the language of the contract is clear and unambiguous, the parties' intent is to be gleaned from the language of the agreement and whatever may be reasonably implied therefrom.'

Id.

78. "In view of the definitive language of the contract, grafting limitations or conditions onto these warrants amounts to rewriting the contracts, and may not be justified as the application of logic or common sense." *Id.* at 41 (Saxe, J., dissenting in part) (citations omitted).

The majority's insertion of a limitation cannot be accurately characterized as a simple construction of the document's terms. Rather, the majority is actually altering a basic, definite term of the contract, as to the price at which plaintiffs were entitled to purchase stock of the corporation. However, the rules of contract construction do not permit an alteration of a clear contract term, based upon a change in circumstances not provided for by the parties at the time of the contract.

Id. (Saxe, J., dissenting in part).

79. *Id.* at 34.

80. The court ignores the extrinsic evidence submitted by Reiss in its determination of the parties' intent, including assertions by Mr. Reiss in an affidavit, elaborated on in his supporting brief, articulating his refusal "to accept the warrants if they were made subject to a warrant agreement which provided for a proportionate change of entitlement in the event of a reverse stock split." *Id.* at 42 (Saxe, J., dissenting in part) (emphasis in original).

81. *Id.* at n.4.

as the centerpiece of its determination of the parties' "true expectation."⁸² There is no legal reason Mr. Reiss should be required to advance the same argument in the event of a stock split that he would advance in the case of a reverse stock split, especially as the circumstances being litigated involved a reverse stock split and not a stock split. It is as inappropriate for a court to decide a matter focusing on the legal position the parties *might* have taken had some other situation occurred, as it was for the trial court to consider the warrants issued to Mr. Trump by Financial in interpreting the Reiss and Rebot Warrants.⁸³ Thus, the court, in its effort to exercise common sense, misapplies the *Restatement* rule to reach a decision that lacks precedential support, and which arguably does not actually reflect the parties' intent.⁸⁴

82. The court concludes that just as plaintiffs should not suffer from the possibility of dilution of their warrants resulting from a stock split, so too Financial should not suffer from the consolidation of its shares resulting from a declaration of a reverse stock split. . . . Any other conclusion would ignore the plain intent of the parties in issuing and receiving the subject warrants.

Id. at 33 (citations omitted). Plain intent is apparently a matter of opinion.

83. In any event, plaintiff would not necessarily have had to take a different position in the event of a stock split; they could have advanced the same position, but simply declined to purchase the shares whose value was lower than the warrant price.

The concern expressed by the defendants, namely, that plaintiffs will unfairly reap a "windfall" if their warrants are not deemed to have been automatically altered by operation of the Corporation's reverse stock split, should not affect the court's analysis of the situation. While an aversion to applying the precise terms of the contract under consideration here is at least facially understandable, the law of contracts offers no relief simply because the contract, as applied, may be unfair. This windfall could have been avoided by inclusion of standard terms and conditions referable to the stock warrants, a precaution which, for whatever reason, the Corporation did not take in this instance.

Id. at 43 (Saxe, J., dissenting in part).

84. *Id.* at 40 (Saxe, J., dissenting in part).

The majority, employing an analysis grounded in "common sense," reasoned that the parties "must have" intended for the stock warrants issued to plaintiffs to be altered in the same proportions as actual shares of stock would be by any stock split occurring during their effective period. However, resort by a court to its subjective view of common sense is not a proper basis for a legal conclusion, particularly when it ignores both plaintiff's assertion of what the parties negotiated and intended, as well as "[t]he cardinal rule of contract interpretation . . . that, where the language of the contract is clear and unambiguous, the parties' intent is to be gleaned from the language of the agreement and whatever may be reasonably implied therefrom.

Id.

C. *Judicial Misapplication of the Plain Meaning Rule, Leading to Judicial Misapplication of the Restatement Rules*

The textual and contextual approaches can co-exist peacefully, if each is applied correctly. The textual approach becomes inapplicable if the text is not clear and unambiguous. The court can then bring in extrinsic evidence to settle the ambiguity. It is a short jump from there to a contextual approach, taking into account extrinsic evidence without a determination of ambiguity. But a court that misapplies the plain meaning rule in its textual approach can then go on to also misapply the *Restatement* rules, generating a legally insupportable holding that does not reflect the parties' intent, but instead reflects what such court *thinks* the parties' intent *should have been*.

Like the *Reiss* trial court, the court in *Sanders v. Wang*⁸⁵ incorrectly applied a textual approach, but the *Sanders* court did so in order to support its decision not to supply an adjustment provision when both a pure textual approach and the *Restatement's* more flexible plain meaning rule would support the addition of such a term. Computer Associates International, Inc. ("CA") adopted a Key Employee Stock Option Plan (the "Plan") in 1995, authorizing the grant of up to six million shares of its common stock to three key executives, who were also directors.⁸⁶ The first two million shares were to be granted outright, upon adoption of the Plan, with additional grants of up to four million shares contingent upon CA's common stock attaining and maintaining certain performance levels.⁸⁷ These performance levels also controlled when the shares granted would vest; if the CA stock traded at \$180 or more for at least 60 trading days, all six million shares would vest.⁸⁸

The Plan was administered by the Compensation Committee of the board, which was vested thereunder with "all discretion and authority as it deems necessary or appropriate to administer the Plan and to interpret the provisions of the Plan."⁸⁹ Unlike the *Reiss* and *Rebot Warrants*, the Plan

85. 25 DEL. J. CORP. L. 1036 (Del. Ch. 2000).

86. *Id.* at 1044. The board approved the Plan on May 25, 1995 and the shareholders approved the Plan at their annual meeting in August 1995. *Id.*

The participants in the Plan were Chairman and CEO Charles Wang at 60%, President Sanjay Kumar at 30%, and Executive Vice President Russell Artzt at 10% of the granted shares. See William M. Bulkeley, *Decompensation: Executives Ordered to Return Millions*, WALL ST. J., Nov. 10, 1999, at A1. Mr. Wang was the most highly compensated executive of 1995, according to Forbes Magazine's annual pay survey. See Mark Harrington, *Wang, the \$650 Million Man*, FORBES, Mar. 21, 2000, at A08.

87. *Sanders*, 25 DEL. J. CORP. L. at 1044.

88. *Id.*

89. *Id.*

contemplated the possibility of a recapitalization, providing an approach (albeit an incomplete one) by which to determine the effect of any such recapitalization on the Plan. The terms of the Plan gave the Compensation Committee discretion, when determining whether the requisite performance levels had been met, to adjust the target stock to account for any stock splits effected after the adoption of the Plan. However, the Plan did not contain a corresponding provision authorizing the Compensation Committee to adjust the number of shares granted to account for any stock split, although this is a standard provision in such an arrangement.⁹⁰ Thus, under the literal terms of the Plan, the number of shares awarded would remain constant even if the target stock price per share were reduced by a stock split, or increased by a reverse stock split. CA subsequently effected three separate three-for-two stock splits in August 1995, June 1996 and November 1997.⁹¹

On May 21, 1998, the Compensation Committee certified that the target prices had been met, as the CA common stock had traded at \$180 or better for at least 60 trading days in a twelve-month period. The actual share price was \$53.33, which exceeded the \$180 threshold when adjusted for the stock splits. In reliance on its discretion under the Plan, the Compensation Committee granted the Plan participants a total of 20.25 million shares worth over \$1.08 billion, the equivalent of the six million shares authorized by the literal language of the Plan, adjusted for the stock splits.⁹²

Shareholders of CA filed suit against CA's seven directors, including the three Plan participants, alleging gross negligence, corporate waste, and breach of fiduciary duties in connection with the grant of shares under the Plan.⁹³ The Delaware Chancery Court found for the plaintiffs. It refused to

90. Matt Krantz, *Computer Associates Execs Must Return \$557 M In Stock*, USA TODAY, Dec. 15, 1999, at 3B.

91. *Sanders*, 25 DEL. J. CORP. L. at 1045.

92. *Id.* "Wang and his board inflamed investors by awarding all 20 million shares on one day, instead of parceling out the stock (and the earnings write-downs) over a period of years." Anthony Bianco, *Software's Tough Guy*, BUS. WK., Mar. 6, 2000, at 132.

93. *Sanders*, 25 DEL. J. CORP. L. at 1036. CA shareholders filed six separate lawsuits in the Eastern District of New York and the Delaware Court of Chancery. The suits ultimately were consolidated after the Eastern District determined that the appropriate forum for the litigation was the Court of Chancery. See *Sanders v. Wang*, No. 16640-NC, 2001 Del. Ch. LEXIS 82, at *4-5 (Del. Ch. May 24, 2001).

The consolidated case involves two plaintiffs from two separate cases: Lisa Sanders and Edward Bickel. The two plaintiffs agree that defendants granted shares without authority under the Plan, but disagree on how many such granted shares were unauthorized. *Sanders*, DEL. J. CORP. L. at 1045.

CA granted the shares just before issuing a public warning that its sales were slowing. Its stock dropped more than 30 per cent and the Plan became a symbol of excessive executive

read in a provision permitting adjustment of the number of shares available under the Plan that would correspond with and give effect to the provision in the Plan permitting the adjustment of the price of the shares. The court ordered the Plan participants to return 9.5 million of the granted shares, one of the largest givebacks of executive compensation ever ordered.⁹⁴ The court's decision is meritless, and fails to give effect to the parties' intent.

In reaching its decision, the court applied a textual approach, relying on the plain meaning rule that when the language is "clear and unequivocal, a party will be bound by its clear meaning."⁹⁵ The court relied exclusively on the text of the Plan, specifically the provision limiting the number of shares to be granted thereunder to a maximum of six million. This provision is clear on its face and unambiguous. Thus, the court determined that the Plan was not ambiguous on its face and therefore should be given effect as written. As a result, the court declined to give effect to the grant of discretion plainly given to the Compensation Committee in its administration of the Plan.⁹⁶

compensation. See R. S. Shankar, *Whose \$550 Million is it Anyway?* REDIFF ON THE NET (Nov. 19, 1999), at <http://www.rediff.com/news/1999/nov/19us5.htm> (last visited Sept. 15, 2002). See also David Crowe, *Court Overturns CA Share Issue*, AUSTLN. FIN. REV., Nov. 11, 1000, at 34.

94. See Ariana Eunjung Cha, *Billion-Dollar Bonus Cut in Half; Judge Backs Shareholders, Tells Executives to Repay Stock*, WASH. POST, Nov. 10, 1999, at A1. Mr. Wang will have to return almost half of the 10 million shares he was granted, worth \$696 million; Mr. Kumar will have to return almost half of the six million shares he got; Mr. Artzt will have to return almost half of the two million shares he got. See Bulkeley, *supra* note 86. While defendants' appeal to the Delaware Supreme Court was pending, the parties settled on the return of 4.5 million shares. John F. Manser, *Computer Associates Executives Settle Shareholder Suits*, N.Y.L.J., Apr. 6, 2000, at 5 (quoting Mr. de Vogel, chairman of CA board's Compensation Committee). CA issued a statement that "even though it continues to believe that the original stock awards were in accordance with both the spirit and intent of the 1995 plan, it is in the interests of the company and its shareholders to put this matter behind us." *Id.* The company agreed to drop its appeal as part of the settlement. *Id.*

The judge approved the settlement on June 22, 2000, and agreed to award the shareholders' lawyers 900,000 shares of CA common to cover their fees and expenses. *Sanders v. Wang and Bickel v. Wang*, 2001 Del. Ch. LEXIS 82, at *4 (May 24, 2001). This award, in turn, generated its own litigation. *Id.* After the Delaware suit was commenced, a New York lawyer filed another derivative suit in New York. *Id.* The New York court consolidated it with the Delaware action, *id.* at *4-5, and when the Delaware court approved the settlement, the New York lawyer filed an application for attorney's fees, *id.* at *7. The judge denied the application, finding that the lawyer's actions "did not contribute in any meaningful way to the efforts of the plaintiffs to create a benefit for the shareholders of Computer Associates or the corporation itself." *Id.* at *2.

95. *Sanders*, 25 DEL. J. CORP. L. at 1051-52 (citation omitted).

96. See *id.* at 1050-52. "Contract interpretation starts with the terms of the contract. If

The court held that the Plan's failure to specifically provide a corresponding adjustment to the number of shares granted in the event of a stock split was subject to the restrictive plain meaning rule.⁹⁷ The court's view completely overlooks the intent of parties evidenced by the inclusion of a provision that explicitly permits the Compensation Committee to adjust the performance targets to reflect any stock splits. This is a glaring example of the limitations inherent in the plain meaning rule, and the need for judicial adoption of the more flexible *Restatement* version that adds the caveat "unless a different intention is manifested."⁹⁸

Whether the corresponding adjustment language for the number of shares after a stock split was omitted intentionally from the Plan is unclear.⁹⁹ What is clear is that the Plan gives the Compensation Committee broad discretion to administer and interpret the Plan, and so the Committee was entitled to supply such a provision. The court focused exclusively on the text of the Plan, relying on precedent for its position that any inquiry "into the subjective unexpressed intent or understanding of the individual parties [to the contract] is neither necessary nor appropriate where words of the contract are sufficiently clear to prevent reasonable persons from

the terms are plain on their face, then the analysis stops there." *Id.* at 1050 (citation omitted). The court finds that the Plan "could not be more clear in limiting the total share grant under the Plan. While §6.2 gives the board authority to interpret and administer the Plan, I can not find that the board could reasonably ignore a clear six million share limit in order to authorized an award of 20.25 million shares." *Id.* at 1052.

97. *Id.* at 1051. The court finds that the terms of the Plan "are not susceptible to varying interpretations under any reasonable analysis that could lead to the conclusion that the board had the authority to award excess shares over the limitation found in [the Plan]." *Id.*

98. RESTATEMENT (SECOND) OF CONTRACTS § 202(3) (1981).

99. The plaintiffs' position was that because CA had included such a provision in at least four other compensation plans written before and after this one, the exclusion must have been intentional. See Ron Insana, *Computer Associates' Top Three Executives Ordered To Pay Back \$1/2 Billion In Lawsuit Over Bonuses And Executive Stock Holdings*, CNBC News Transcript of "Business Center," Nov. 9, 1999.

One must recognize that the board had every opportunity and the ability to insert a similar provision in this KESOP. Past practice showed that where the board wanted such authority and the shareholders have been asked to grant it, that after being fully informed of the consequences, they have approved similar provisions.

Sanders, 25 DEL. J. CORP. L. at 1055.

The defendants disagreed, claiming that "[t]he most fair and logical reading of the plan requires adjusting the number of shares to be awarded to account for any stock splits," according to Willem F.P. de Vogel, a Computer Associates board member and chair of the Compensation Committee. "That is what we intended." David Ward, *Computer Associates to Appeal Executive Stock Return Ruling*, BLOOMBERG NEWS, Nov. 10, 1999.

disagreeing as to their meaning.”¹⁰⁰ While this may be true, in this instance reasonable people could certainly disagree as to the meaning of the Plan.

Despite the court’s statement that the “primary goal of contract interpretation is to satisfy the reasonable expectations of the parties at the time they entered into the contract,” the court ignored the evidence of the parties’ reasonable expectations presented by the language of the Plan itself.¹⁰¹ A likely rationale underlying the adoption of the Plan would be to give the Plan participants an incentive to remain at CA by rewarding them for achieving designated improvements in the common stock price.¹⁰² Presumably, the Plan would inspire them to increase the value of the enterprise as a whole, as reflected in the stock price, and not just to increase the per share stock price alone. Were this not the case, the Plan participants could have attempted to effect a reverse stock split that would have increased the value of each share, presumably causing the stock to hit the market price triggers, without any change in the actual value of the company. Under this court’s analysis, that would have been consistent with the parties’ intent as evidenced only by the text of the Plan, although arguably, it is not what the Plan was designed to accomplish.

Had the parties intended the unusual drafting choice to include a provision in the Plan adjusting the price target to take into account any future stock splits, and yet to exclude a corresponding provision adjusting the number of shares, the prudent course would have been to express this in the text of their agreement. An explicit provision to this effect would have permitted a court using the plain meaning rule to enforce the odd result that the value promised under the Plan could be increased or decreased at will, if CA undertook a stock split or reverse split. It is noteworthy, in this context, that the Plan participants constituted three out of seven board members, just

100. *Sanders*, 25 DEL. J. CORP. L. at 1051 (quoting *Demetree v. Commonwealth Trust Co.*, Del. Ch., C.A. No. 14354, slip op. at 7-8 (1997)).

101. *Id.* at 1050 (citation omitted).

102. See Anthony Bianco, *The Package That Launched a Dozen Lawsuits*, BUS. WK., Apr. 17, 2000, at 108 (“To qualify for the shares under a plan approved by CA shareholders in 1995, top managers were given five years to lift the stock price from \$20 to \$53.33. They did it in three, to de Vogel’s surprise. . . . To cover the cost of the grant, CA took a staggering \$675 million charge against earnings. After the write off, CA’s stock dropped into the 20s but has rebounded strongly of late, to the \$55 range.”).

According to Willem F. P. de Vogel, the chairman of the Compensation Committee, “the plan was designed to retain key executives whose performance is outstanding. . . . [t]he plan was triggered by a \$17.4 billion increase in the market value of CA measured by specific performance milestones, and that the reward would be equal to 3.75 per cent of its equity.” Shankar, *supra* note 93.

one director short of a majority. In the absence of evidence in the text of the Plan that this was a deliberate drafting choice by the parties, the court's attempted application of a textual approach lacks merit.¹⁰³

According to the court, "Interpreting the [P]lan in order to administer it properly is one thing, fundamentally altering its substantive terms is quite another."¹⁰⁴ But the principles of contract interpretation may require a court to do just that, to give effect to the intention of the parties. When a company gives someone the right to buy stock, there is an extrinsically determinable value to that right, made up of two components—the number of shares and the value of the shares. In the event of a recapitalization, the right should either adjust completely, or not adjust, depending on the parties' intent. But it is illogical to think the parties would intend just one of these components to adjust, as if in a vacuum. Here, the parties demonstrated their intent that the right should adjust. To preserve the relative value of the right, both the number and stock price need to be adjusted in parallel in the event of any change in the underlying capitalization. The Plan permitted adjustment of the target share price that triggered the grants, but failed to provide a corresponding adjustment to the number of shares to be granted.¹⁰⁵ This omission is capable of correction under the terms of the Plan itself. The broad discretion given to the Compensation Committee to administer and interpret the Plan permits the Committee to add the missing provision.

The court's application of the plain meaning rule in this case results in a decision that frustrates the parties' intent and instead gives effect to the court's view of what that intent should have been, perhaps reflecting an inherent bias arising out of the enormous sum of money involved.¹⁰⁶ In any

103. Defendants issued a statement in response to the ruling: "Such a decision runs counter to the reasonable expectations that all parties had when the plan was approved by shareholders." Insana, *supra* note 99 (quoting CA's issued statement).

104. *Sanders*, 25 DEL. J. CORP. L. at 1055.

105. *Id.* at 1047.

The strict reading of the share limitation provision frustrates the purpose of the Plan and penalizes its recipients. In particular, defendants say that plaintiffs' strict reading does not make economic sense because if, instead of stock splits, there had been a "reverse stock split" or a share consolidation, then the defendant Participants would get twice as much equity, or over \$2 billion. . . . [I]f this were actually the case that the plaintiffs would then not support their own proposition that a strict reading is required, and would in fact argue just the opposite."

Id.

106. *Id.* at 1052.

As a practical matter, rough calculations indicate that even under the strictest reading of the Plan, the three Participants will together still receive nearly \$320 million. \$320 million is no mere bagatelle. I find it remarkable that the defendants would have me

event, had the court applied a more systematic contextual approach, such as the one used by the New York Court of Appeals in *Reiss*, the result would have been a decision that would be supportable as a matter of law and that would give effect to the likely intent of the parties.¹⁰⁷ The contextual approach suggested by the *Restatement* requires that interpretation of the parties' written agreement be directed to the meaning of the writing, "in light of the circumstances." The circumstances surrounding the Plan show that the parties considered the possible effect of a stock split on the Plan, and made an effort to preserve the grant of the value given thereunder through the adjustment provision and the grant of discretion to the Compensation Committee. A contextual approach to interpreting the Plan would result in the conclusion that the Committee was authorized to make a corresponding adjustment to the number of shares granted after the three stock splits.

The grant of discretion under the terms of the Plan itself furnishes a basis for the addition of the missing adjustment provision. The *Restatement* provision on omitted terms does not support the addition of an adjustment provision in this case. Under the *Restatement*, an omitted term cannot be added simply to give effect to the judge's determination of the parties' intent. Rather, courts are permitted to add only essential terms *necessary* to effectuate the contract. The adjustment term for the number of shares granted under the Plan is not an omitted essential term under the *Restatement*, as the Plan could be enforced solely based on its terms by limiting the shares available to the literal terms of the Plan. However, the terms of the Plan clearly indicate the parties' intent that the shares granted thereunder should retain their value, and provide textual support for adding the missing term through the grant of discretion to the Compensation Committee. Thus the Court's decision not to supply such a provision gives effect to its own view of what the parties' intent was, and not the actual demonstrated intent of the parties.

believe that CA's shareholders would consider that \$320 million for three individuals failed to 'encourage, recognize, and reward sustained outstanding individual performance by certain key employees.'

Id. at 1052; see also Mark J. Loewenstein, *The Conundrum of Executive Compensation*, 35 WAKE FOREST L. REV. 1, 21-22 (2000) (discussing judicial review of executive compensation).

107. See Part III. *infra* for a discussion of the New York Court of Appeals' decision in *Reiss v. Financial Performance Corp.*, 715 N.Y.S.2d 29 (2000).

D. The Dangers of Judicial Misapplication of the Principles of Contract Interpretation

The trial court and appellate division decisions in *Reiss* and the decision in *Sanders* illustrate how a court's approach to contract interpretation can result in a legally insupportable holding that does not reflect the parties' intent, and instead reflects what such court thinks the parties' intent should have been. The holding in *Cofman v. Acton Corp.*¹⁰⁸ illustrates the additional risks of inappropriate or incorrect applications of principles of contract interpretation. This insupportable holding compounds its unsound legal reasoning by creating dangerous precedent, relied on by the Appellate Division in *Reiss*.¹⁰⁹

In *Cofman*, plaintiffs entered into settlement agreements with defendant Acton Corporation, providing each plaintiff with a set sum of money plus an added "sweetener" payable upon demand within the three years following the execution of the settlement agreements.¹¹⁰ The settlement agreements did not contain anti-dilution provisions.¹¹¹ The "sweetener" was a one-time payment equal to the average closing price of one share of Acton's common stock on the American Stock Exchange for any period of 30 consecutive trading days prior to the exercise date selected by plaintiffs, less an exercise price of \$7.00.¹¹² Acton's stock price around the time the settlement agreements were executed fluctuated from \$1.50 to \$3.12 per share.¹¹³ About a year after the settlement agreements were signed, the price of Acton's common stock rose, not because of any change in the financial situation at Acton, but as a result of a one-for-five reverse stock split.¹¹⁴ Plaintiffs each made written demand on Acton, seeking the sweetener based on the share price after the reverse stock split of \$20.54.¹¹⁵ Acton sought

108. 958 F.2d 494 (1st Cir. 1992).

109. *Reiss*, 715 N.Y.S. 2d at 33.

110. *Cofman*, 958 F.2d at 495. In a somewhat ironic twist, Acton included this "sweetener" to avoid issuing stock warrants because "Acton did not wish this complication." *Id.*

111. *Cofman v. Acton Corp.*, 768 F. Supp. 392, 395-96 (D. Mass. 1991) ("Whatever may have been the reasons for the parties' failure to address stock splits and reverse stock splits, the fact that they did fail to do so is manifest. Not a single word or phrase explicitly about stock splits or reverse stock splits appears anywhere in the Agreements.").

112. *Cofman*, 958 F.2d at 495.

113. *Id.*

114. *Id.* at 496. The court notes that the reverse stock split was undertaken because Acton "concluded that there were psychological market advantages in artificially shrinking the number of outstanding shares, and thereby increasing the per share price." *Id.*

115. *Cofman*, 768 F. Supp. at 393.

judicial confirmation that the exercise price of \$7.00 stated in the settlement agreements somehow automatically adjusted upwards by a factor of five because of the reverse stock split.¹¹⁶ The corporation bolstered its contention with a letter to plaintiffs to such effect.¹¹⁷ Like the defendants in *Reiss*, Acton apparently believed it could bind its counterparts to new contractual provisions simply by sending them a letter stating those provisions.

The district court took it upon itself to supply an adjustment provision to the exercise price, and held for Acton. In a misguided effort at consistency, it tried to protect the parties from their careless and incomplete drafting. It determined that it would have been reasonable for stock splits to have no effect, so it held that the price of a share of stock was deemed to mean the form of a share at the time the agreement was signed.¹¹⁸ Thus, the district court held the settlement agreement had to be modified to reflect the reverse stock split.¹¹⁹

116. *Id.* at 394. "Partnerships' position is simple and straightforward. This is precisely the way the agreement reads; it is unambiguous, and integrated, and even were parol evidence admissible, which they deny, there was no prior discussion suggesting exceptions." *Cofman*, 958 F.2d at 496 (footnote omitted). Defendant claims that the share of common stock referred to in the agreements

plainly means the form of common stock in existence when the Agreements were signed. Since that form of common stock is no longer in existence, the argument goes, one share of today's stock must be viewed as equivalent to five old shares. Defendants argue that, in determining defendants' payment obligation under Section 2.2, the trigger price must be adjusted from \$7.00 to \$35.00.

Cofman, 768 F. Supp. at 394.

117. *Cofman*, 958 F.2d at 496.

This is to advise you that the stockholders of Acton Corporation have authorized a one-for-five reverse stock split of Acton Corporation's common shares. . . . The reverse stock split will affect Section 2.2 of the above-referenced Agreement such that the price \$7.00 as referenced in such Section shall become \$35.00.

Id.

118. *Cofman*, 768 F. Supp. at 394.

119. *Id.*

Expressed another way, the substantive effect of the position the defendants took, and now take, is that the trigger price remains \$7.00 and the price to compare it is one-fifth of the May 1989 price of Acton stock, because of the five-for-one combination that occurred after the trigger price was set.

Id.

In searching for the parties' manifested meaning a court is both guided and constrained by the form, structure, sense, and internally manifested design of the contract itself—the *mutual expression of the parties*. The answer the decisionmaker is seeking is not the answer the decisionmaker would think best if left entire freedom of

The district court's holding is without basis under either a textual or contextual approach. Under the plain meaning rule, the unambiguous text is the exclusive source from which the court can ascertain the parties' original intent. Here, the settlement agreements clearly and unambiguously provide no adjustment mechanism. The district court demonstrated its misunderstanding of the plain meaning rule by finding that "the language used by the parties does not explicitly address the question at issue."¹²⁰ Under a correct application of the plain meaning rule, this fact would be dispositive. The clear and unambiguous language of the settlement agreements should be given effect. Under the plain meaning rule, the district court is not permitted to consider any extrinsic evidence, or to add in another term that it thinks reflects the parties' intent.

Likewise, a purely contextual approach applying the *Restatement* rules does not support the addition of an adjustment provision. The *Restatement* permits a court to add only "essential" terms.¹²¹ Because the settlement agreements could be enforced solely based on their terms, with the stated exercise price of \$7.00, the adjustment term added by the district court is not "essential" under the *Restatement*.

Even though its decision is not supportable under any approach to contract interpretation, correctly applied, the district court struggled mightily to fit its decision to violate freedom of contract into some framework of legally supportable analysis. The district court makes new law, finding that "when a document contains no internal indicia that the parties manifested an agreement with each other about an issue, we may need to do some reality testing of litigation positions."¹²² Thus it decides to "wash each party's current contention about meaning in 'cynical acid.'"¹²³ As part of this "wash," the district court considers how each party's assertion would have fared during the negotiation of the settlement agreements. The problem with this line of conjecture, aside from the fact that it is the merest of conjecture, is an inherent logical problem.¹²⁴ It seems unlikely that the parties would

choice. It is fundamental to the integrity of the decisionmaking process that the decisionmaker accept both the guidance and the constraints to be found in the parties' own mutual expression of their agreement.

Id. at 396.

120. *Id.* at 395.

121. RESTATEMENT (SECOND) OF CONTRACTS § 204 (1981).

122. *Cofman*, 768 F. Supp. at 396.

123. *Id.*

124. "Plaintiff also argues that the defendants accepted the risk of such a reverse stock split by not insisting upon or even negotiating for an antidilution clause in the body of the Agreements." *Id.* at 394.

bandy about the possibility of a stock split, or a reverse stock split, pose their irreconcilable views and then decide the prudent course would be to leave the agreement silent on the issue, subject to judicial interpretation at some later date. A more appropriate approach would have been for the district court to correctly apply the binding precedents of contract interpretation, such as the plain meaning rule, saving the acid of its cynicism for a different application.

The First Circuit affirmed the district court decision, noting the "fundamental principle that a contract is to be construed as meaningful and not illusory."¹²⁵ Nonetheless, the court based its decision on what might have happened had Acton effectuated a stock split, instead of a reverse stock split.¹²⁶ In such a case, the value of each share of stock would have decreased by a factor equal to the number of shares into which each share of common stock was split. Absent some remarkable gains on the part of Acton unconnected to the recapitalization, a likely result of such a stock split would be that the \$7.00 exercise price would exceed the price of the common stock, and the sweetener would be valueless to the plaintiffs.¹²⁷ Because this scenario did not occur, it was not an appropriate area for inquiry by the court.¹²⁸

The court permitted the proverbial tail to wag the actual dog by relying on this wholly irrelevant scenario, finding that "it defies common sense" that plaintiffs would have willingly entered into an arrangement with this possible outcome.¹²⁹ There is a fundamental difference between construing a contract in a consistent manner and construing a contract in a reciprocal

125. *Cofman*, 958 F.2d at 497.

126. *Id.*

127. "'It defies common sense' that [the] Partnerships would have agreed that Acton could effectively escape the specified consequences of a rising market price by increasing the number of shares. And if the Partnerships would not suffer from any increasing, it would follow, since a contract must be construed consistently, Acton should not suffer from any decreasing." *Id.* (citations omitted).

128. This approach created an unsound precedent relied on by the appellate division in *Reiss*. According to the New York Court of Appeals in *Reiss*, the appellate division used *Cofman* to reason that "in the event of a forward stock split, supplying a term providing for the proportionate adjustment of the number of shares that could be purchased, and the exercise price, would be necessary to save the warrant holders from having the value of their warrants 'eviscerated.'" *Reiss v. Fin. Performance Corp.*, 764 N.E.2d 958, 962 (N.Y. 2001).

According to the New York Court of Appeals, the appellate division took a second step and reasoned that "just as plaintiffs should not suffer from the possibility of dilution of their warrants resulting from a stock split, so too Financial should not suffer from the consolidation of its shares resulting from a declaration of a reverse stock split." *Reiss*, 764 N.E.2d at 963.

129. *Cofman*, 958 F.2d at 497.

manner. Every contract right and duty need not be fully consistent with its inverse, and the principles of contract interpretation do not require that they be so. Nonetheless, the court observed that the plaintiffs entered into the settlement agreement to capture the possibility of additional funds if Acton's business improved. While this may be true, as a matter of law such a conclusion has no bearing on the interpretation of the provisions of the settlement agreements actually agreed to by the parties.

That the court was reaching for a result is evidenced by its justification "[w]hether we reach that result by implying a provision to meet a circumstance not envisaged by the parties, or by construing the word 'share' as including following the res, is immaterial."¹³⁰ The court applied the *Restatement* rule incorrectly, finding this to be "precisely a case where to read the contract as meaning that Partnerships should not suffer by dilution—and hence Acton by reverse dilution—is a necessity, or 'essential to a determination.'" ¹³¹ The court's misunderstanding of how the *Restatement* rule works is evidenced by its finding that "[t]here is every reason to presume Partnerships did not intend to acquire nothing, and saving from unenforceability ranks as a necessity."¹³² Such a subjective determination undermines the very foundations of contract interpretation and creates unsound precedent. This is not an appropriate application of the *Restatement* rule. The *Restatement* permits the addition of those terms that are "essential." The settlement agreements are capable of being construed without the addition of an anti-dilution clause. That means the plaintiffs get a windfall. And that is the risk created by poor draftsmanship.

III. CONSISTENT AND CORRECT APPLICATION OF PRINCIPLES OF CONTRACT INTERPRETATION LEADING TO SOUND PRECEDENT

Just as the misapplication of the principles of contract interpretation can create bad precedents, the consistent and careful application of these same principles can create sound precedent, and can provide courts with an approach that will generate consistent outcomes more likely to reflect the contracting parties' original intent.

The New York Court of Appeals provided just such a sound precedent in its recent decision in *Reiss*. The court adopted a more systematic contextual approach to interpreting the warrants, and modified the appellate division decision to reinstate the cause of action seeking a declaration that plaintiffs

130. *Id.*

131. *Id.*

132. *Id.*

were entitled to exercise the Reiss and Rebot Warrants in accordance with their literal terms.¹³³ Under its approach, the court started its analysis with the text of the warrants—the actual words that the parties chose. The warrant certificates represented the sum total of their agreement, and the certificates did not provide for anti-dilution. Since the text proved insufficient to ascertain the parties' intent, the court then put the warrants in their context. If the litigating parties do not share the same intent, as in this case, the court must make a determination as to which version of their intent should prevail.¹³⁴

As a result of this analysis, the court determined that the parties' intent was not mutual or readily ascertainable and that the parties' respective intents were, in fact, at odds with each other. Mr. Reiss claimed the lack of anti-dilution protection was intentional, as a response to his objections to signing warrant agreements with such provisions. Financial claimed the anti-dilution provision was unintentionally omitted. The court noted that one month prior to the issuance of the Reiss and Rebot Warrants, Financial issued a warrant certificate to Robert Trump, along with a warrant agreement containing anti-dilution provisions. Mr. Reiss and Financial could have included a similar provision in their arrangement but did not do so, for whatever reason.¹³⁵ The court systematically applied the relevant principles

133. The New York Court of Appeals found these warrants enforceable according to their terms because they have "all the material provisions necessary to make them enforceable contracts, including number of shares, price, and expiration date, and were drafted by sophisticated and counseled business persons." *Reiss*, 764 N.E.2d at 960.

134. It is a fiction to think the court can easily discern and give effect to the parties' intent. If their intent were so mutual and clear that a court could ascertain it, it would likely be reflected in the agreement, obviating the need for judicial determination.

135. However, this inaction may have been unintentional. Whoever drafted the warrant certificates may have simply overlooked the need for such a provision. According to Financial, Alan Swiedler, its counsel, was supposed to prepare Warrant Agreements to control the terms and conditions of all 10 warrants issued by Financial in 1993, but failed to do so. *See Record on Appeal, supra* note 51, at 101. When Financial subsequently fired the lawyer in April 1994, he retained certain papers he was preparing for Financial until they came to a settlement amongst themselves in February 1995. *Reiss*, 715 N.Y.S.2d at 38 (Saxe, J., dissenting in part). Under the terms of the Stipulation of Settlement entered into between Financial and Mr. Swiedler, upon payment of the agreed upon sums, Mr. Swiedler agreed to return all the books and records and other documents of Financial, and Mr. Swiedler withdrew his challenge of the validity of the 1994 proxy and annual meeting. *See Stipulation of Settlement*, Index No. 113927/94, dated Oct. 3, 1994 (on file with author).

While there is no direct evidence that warrant agreements to accompany the Reiss and Rebot Warrants were part of those papers, Financial alludes to at least the possibility. *Reiss*, 715 N.Y.S.2d at 38 (Saxe, J., dissenting in part). Financial's new lawyer reviewed the papers

of contract interpretation, finding evidence in the record that the parties may have intentionally omitted an anti-dilution provision.¹³⁶ It seems unlikely that, during the parties' negotiation, they agreed to intentionally omit an anti-dilution term, putting the risk of a stock split on Mr. Reiss, and the risk of a reverse stock split on Financial. This would seem especially unlikely on the part of Financial, which included such a provision in its arrangements with Mr. Trump. But since the court found that the circumstances surrounding the formation of the warrants indicated that the parties must have foreseen the contingency when the contract was made, and because the warrants can be enforced according to their terms, the court declined to add an adjustment term.¹³⁷ The court remanded the case for a calculation of damages.¹³⁸

for all 10 of the warrants issued by Financial in 1993 including the Trump, Reiss and Rebot warrants, and asserted in a letter of June 20, 1995 that he discovered his predecessor had "failed to prepare and submit to the Board of Directors for approval any form of warrant agreement pursuant to which the warrant certificates were to have been issued." *Reiss*, 715 N.Y.S.2d at 38 (Saxe, J., dissenting in part).

136. According to the plaintiffs' brief:

The Record discloses that during the course of the negotiations, plaintiff Reiss, individually and on behalf of plaintiff Rebot, would not and did not consent to accepting warrants that were subject to the terms of a warrant agreement, such as the agreement the Corporation made with another investor, Robert Trump, only one month earlier.

Brief for Plaintiff- Appellants, dated May 2, 2001; *Record on Appeal*, *supra* note 51, at 140-141. But it seems unlikely that the parties discussed the possibility of recapitalization and intentionally left the matter unresolved. Financial likely assumed its counsel had put anti-dilution provisions in warrant agreements covering the Reiss and Rebot Warrants. Reiss likely assumed that since Financial was in such desperate financial shape, they might agree to give him the upside on any reverse split later on

137. *Reiss*, 764 N.E.2d at 961.

[T]his Court will not imply a term where the circumstances surrounding the formation of the contract indicate that the parties when the contract was made, must have foreseen the contingency at issue and the agreement can be enforced according to its terms. . . . Even where a contingency has been omitted, we will not necessarily imply a term since 'courts may not by construction add or excise terms, nor distort the meaning of those used.'

Id.

138. See *supra* note 67 for a discussion of Mr. Reiss' damages claim.

The plaintiffs did not revive the reformation claim, since even if it were to be granted, it would still leave them with now-expired warrants. *Reiss*, 764 N.E.2d at 962. "Rather, they have argued that their attempt to exercise the warrants, together with their motion for an order to show cause, preserved their right to exercise all the warrants upon the successful conclusion of the litigation." *Id.* The Court punts, stating: "If [the] Supreme Court determines that plaintiffs are entitled to the declaration they seek on the reinstated cause of action, the Court

While the New York Court of Appeals' decision may send shivers up the spine of anyone who drafts options or warrants, the decision is the only possible legally-supportable outcome. The court correctly applied the relevant precedents to reach an appropriate conclusion as a matter of law. The first reaction upon hearing the facts of *Reiss* might be to want the court to read in an adjustment provision to preserve the parties' agreement. But courts need to be very careful in adding provisions, limiting such additions to those terms that are truly essential to a determination of the parties' rights and duties. In *Reiss*, the missing adjustment term was not essential and the court reached the correct, albeit potentially unpopular, decision.

IV. CONCLUSION

The uneven and unpredictable application of the principles of contract interpretation is, to some degree, a function of the very nature of the process of interpretation—and the Anglo-American judicial system's quest for objectivity. The principles of contract interpretation were designed to be objective, so that if a particular case fell within an articulated principle, the principle would be applied, leading to an unbiased determination. But pure objectivity is a fallacy, since even the application of an objective principle has some subjective component, as a judge must make the subjective decision to apply that particular objective principle to that particular case.¹³⁹

should also resolve the remaining remedial issues, including the effect of the plaintiffs' tender." *Id.*

139. For example, a determination that extrinsic evidence should be admitted under the parol evidence rule requires a determination that the contract is not complete on its face, which on its own may require the parties to resort to extrinsic evidence to make such a determination.

Unfortunately, however, parties must communicate express terms through the inherently imperfect mediation of words, actions, and other manifestations that admit of varying interpretations. As arbiter of disputed interpretations, the state determines the meaning of whatever signals the parties exchange. While the state presumably knows what it means by the formulations it implies into every contract, it does not know the intended meaning of terms chosen by the parties. Thus, privately formulated express terms are always subject to an additional dimension of interpretation error.

Goetz & Scott, *supra* note 6, at 283.

According to Professor Perillo:

There is no single subjective or objective theory. Rather, there are a variety of different vantage points from which the formation and interpretation of contracts could conceivably be judged. The legal system could look solely to the intention of the party who used the words or other signs in question, or solely to the

Because of the inherent subjectivity embedded in the interpretive process, neither a purely textual nor a purely contextual approach is likely to generate objective determinations of the parties' intent.¹⁴⁰ The textual approach presupposes the unlikely circumstance that the parties have actually chosen words that both reflect their true intent and are also capable of only one objective, patently-clear-to-all-who-read-them meaning. The more likely scenario is that the meaning of the chosen words cannot be determined without reference to their context.¹⁴¹ The contextual approach has a more obvious subjective component, allowing the judge to interpret the circumstances she feels are significant, substituting her views for the views of the parties.

Courts should acknowledge the specter of subjectivity, yet correctly apply the principles of contract interpretation as objectively as possible to give effect to the parties' intent and not the judge's view of what that intent should have been. To this end, judges should examine the parties' word choice as a good indicator of their intent. In the likely event such language is insufficient to resolve all interpretational issues, courts should then examine the circumstances surrounding the formation of the contract, applying the objective principles of contract interpretation, including the *Restatement* rules, systematically and correctly.¹⁴² Courts must understand under what circumstances each principle is triggered, and the ramifications thereof. The judge should put herself in the circumstances faced by the parties in order to render the decision the parties themselves most likely intended to make, not the decision she herself would have made.

understanding of the party to whom those words or signs were directed. Each of these vantage points is purely subjective; only the subject changes.

Perillo, *supra* note 5, at 429.

140. "The purposes of contract interpretation, properly conceived, are neither to determine a fixed, objective meaning of a written agreement nor to ascertain the true subjective understanding of individual contracting parties." Goetz & Scott, *supra* note 6, at 308.

141. Kniffin, *supra* note 22, at 644.

142. We can borrow a page from the academic discourse on judicial interpretation of treaties, which poses three basic philosophies: a "textual" approach that emphasizes the plain meaning of the terms of the treaty; a "limited textual approach" that gives precedence to the terms of the treaty but permits extrinsic evidence to be considered; and a "policy oriented and configurative" approach, which seeks to discern and give effect to the intention of the parties, wherever such intention may be found. See Philip R. Principe, *Secret Codes, Military Hospitals, and The Law Of Armed Conflict: Could Military Medical Facilities' Use of Encrypted Communications Subject Them to Attack Under International Law?* 24 U. ARK. LITTLE ROCK L. REV. 727, 740 n.79 (2002).

A court should consider extrinsic evidence in evaluating whether a term is ambiguous. And when considering missing "essential" terms, courts should evaluate whether the term is "essential" on as objective a basis as possible. The purpose of adding a term under the *Restatement* is to permit a determination of the parties' rights and duties under the contract. The test for adding a term should be whether a contract is objectively capable of being performed without the addition of such term. If the parties can perform the contract without the term, the term is by definition not essential to a determination of their rights and duties. This is so even if the court thinks the added term makes common sense.

The *Restatement* implicitly supports such an approach, assigning a different purpose to the addition of a term than to the interpretation of a contract. An omitted term cannot be added simply to give effect to the judge's determination of the parties' intent. An essential term under the *Restatement* rule therefore is one that is *necessary* to give effect to the contract. The reasonableness of the added term should take into account the qualitative difference between parties with an expectation regarding the contingency and those with no such expectation. Once the court has determined whether the parties had such an expectation, such determination should be a factor in allocating the risk of such contingency. Parties who have expectations about a contingency but fail to provide for it in their written contract should be held to have assumed more of the risk of the absence of such term.

Cases like *Reiss*, *Sanders* and *Cofman* provide a number of lessons, both practical and conceptual. On a practical level, drafters of option and warrant agreements should be mindful of possible future recapitalizations. Standard provisions in the relevant agreements can render any such recapitalization merely a change in form and not of substance. Also, when a corporation considers a recapitalization, the appropriate parties should examine any outstanding rights to acquire the affected capital stock and determine the effect of such recapitalization on those rights. The corporation can seek to renegotiate with the holders to avoid any results unfavorable to the corporation, restructure the transaction to avoid such results or abandon the recapitalization and pursue other approaches to achieve the corporation's goal in undertaking the proposed recapitalization in the first place.¹⁴³

143. Steven H. Sholk, Recent Decision of New York Court of Appeals Shows Importance of Proper Drafting on Corporate Agreements, at <http://www.gibbonslaw.com/publications/articleuser2.cfm?pubid=713> (last visited Sept. 15, 2002).

On a conceptual level, the cases illustrate the risk of inappropriate or incorrect contract interpretation by the courts. Regardless of whether a court adopts a textual approach or follows the trend towards a more contextual approach, inappropriate judicial interpretation threatens to redefine the very nature of the bargain.¹⁴⁴ Courts will, one hopes, adopt the approach used by the New York Court of Appeals in *Reiss*, which examined the text and context of the contract at issue, and then systematically and correctly applied the appropriate principles of contract interpretation to reach the precedentially-sound result of declining to read in an adjustment provision.¹⁴⁵ This decision is no doubt unpalatable to the defendant issuer and its counsel who drafted the warrants in question.¹⁴⁶ To the extent such results do not comport with some societal notion of common sense, the remedy is to change the underlying principles, and unless and until that happens, to draft contracts more carefully so that the wording reflects the parties' true intent. While the goal of an objective determination of the parties' original intent is not truly feasible, a more systematic contextual approach to contract interpretation will go a long way to alleviating some of the inconsistencies rampant in our current system.¹⁴⁷

144. Goetz & Scott, *supra* note 6, at 272.

145. RESTATEMENT (SECOND) OF CONTRACTS § 204 (1981).

146. The drafters had additional grounds for concern arising from the doctrine of *contra proferentum*. Under the *Restatement*, when choosing among the "reasonable meanings of a promise or agreement or a term thereof, that meaning is generally preferred which operates against the party who supplies the words or from whom a writing otherwise proceeds." RESTATEMENT (SECOND) OF CONTRACTS § 206. The theory behind this rule is that when a party selects the terms of a contract, she is more likely to protect her own interests rather than the interests of her counterpart. *Id.* § 206 cmt. a. While not limited to these situations, this principle of interpretation is frequently applied in cases of standardized contracts, or where one party has a stronger bargaining position. *Id.* The principle was not relied on by the courts in *Reiss*, *Sanders* or *Cofman* and, therefore, a detailed discussion is beyond the scope of this article.

147. Kniffin, *supra* note 22, at 662.

