Essays

Justice, Fault, and Efficiency in Contract Law

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Abstract

This article explores some of the core concepts that underlie contract law. It rejects the feasibility of a uniform theory of contract law including a critique of the economic analysis of contract law. The importance of efficient contract rules and efficient contracts is not disputed, but efficiency's explanatory power is limited due to the breadth of contract law, as well as the complexity and dynamism of modern contracting. Behavioral law and economics is introduced as a method for making law and economics more predictive of real world contracting. The article selects three core principles for analysis – justice, fault, and efficiency that help explain the essence of contract law. It also reflects on the tension between freedom of contract and paternalism.

I. Introduction

On 2 April 2017, I was honored to give the Heremans' lectures on the law and economics of contract law at KU Leuven. My closing speech was entitled: 'Roles of Neoclassical and Behavioral Economics in the Future Analysis of Contract Law'.[1] The speech was the culmination of hundreds of hours of work as I immersed myself in the literature on the economic analysis of contract law or law and economics (LAE). Previously, I had used the terminology of LAE in my writings and ventured into empirical legal studies to test the predictability of tools (heuristics and biases) advanced by behavioral law and economics (BLAE) or behavioral decision theory.[2] But, before being asked to give the lectures I had no solid grounding in hard LAE and was not an advocate of it as a unifying theory of contract law. Early in my career, I wrote an article arguing that the normative infrastructure of contract law made a unitary theory of all of contract law impossible and undesirable. Others had previously and subsequently made

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[1] Dieter Heremans Funds Lectures in Law and Economics 2017 available at https://tinyurl.com/y9b3x2mg (last visited 15 June 2017).

[2] See, eg, L. DiMatteo, 'A Theory of Efficient Penalty: Eliminating the Law of Liquidated Damages' 38 *American Business Law Journal*, 633 (2001); Id, 'Penalties as Rational Response to Bargaining Irrationality' 2006 *Michigan State Law Review*, 883 (2006); L. DiMatteo and B. Rich, 'A Consent Theory of Unconscionability: An Empirical Analysis of Law in Action' 33 *Florida State Law Review*, 1067 (2006).

similar arguments.

The *norms of contracts* have been persistent over the past one hundred years and include: morality of promise, certainty of law, efficiency, fault, and fairness or justice.[3] In fact, these norms, often in tension, are stronger today due to the breadth and complexity of modern day contracting. These norms or goals of contract law have been around for as long as there has been contracts, sometimes used overtly, often used covertly. In different eras of contract law[4] and in different types of contracts this normative composite is rebalanced where some of the norms play a more dominant role in judicial thinking and reasoning.

Formalism sees the key role of contract law as providing certainty and predictability. The story goes that the impact of contract law in the real world of business should be facilitative in nature. Capitalism rests upon two foundational concepts – private property and freedom of contract. These concepts rest on the broader view that economic wealth and growth is most likely when people are allowed to obtain private property in order to improve their quality of life or substantive goals. A person so motivated can increase societal wealth by engaging with others in the transfer of property to those persons that place a higher value on the property. Thus, contracts to transfer property based upon freedom of contract are *Pareto efficient* or optimal since both parties are made better off due to their idiosyncratic preferences and valuations of the subject matter of their contracts. In a perfect world of pure competition, full information, and unbounded rationality there would be little role for government intervention into private contracts. But, such a perfect world does not exist in that most contracts are formed despite the existence of informational and bargaining power asymmetries, and are formed by less than fully rational human beings.

Yet, the legend behind the pure capitalist model of freedom of contract has continued reticence. Formalist contract scholars and judges often state that businesses and businesspersons value certainty and predictability. Certainty and predictability of the law certainly allows for more rational calculations of risk – what does the law require, how is a court likely to apply the law, and what are the consequences if a breach of the law (or a contract) is recognized? The law and economics scholarship includes the Schwartz-Scott Thesis,[5] which poses that due to businesspersons craving for certainty they prefer a four-corner, non-contextual analysis of contracts in business disputes. Thus, even when a party's intent can be proved, through extrinsic evidence (proper dealings, course of

[3] L.A. DiMatteo, 'The Norms of Contracts: The Fairness Inquiry and the "Law of Satisfaction"– A Nonunified Theory' 24 *Hofstra Law Review*, 349 (1995).

[4] American law, especially the common law of contracts, has often been divided into three eras: era of classical contract law or legal formalism in the late nineteenth century and early twentieth century; neoclassical law influenced by legal realism; and modern or relational contract law. See G. Gilmore, *The Ages of American Law* (New Haven: Yale University Press, 1977).

[5] A. Schwartz and R.E. Scott, 'Contract Theory and the Limits of Contract Law' 113 *Yale Law Journal*, 541 (2003).

performance or conduct subsequent to the conclusion of the contract, trade usage, business customs, and commercial practice), to be true to a formal or plain meaning interpretation of the written contract, the party is willing to have the contract interpreted and enforced other than how it was intended. The rationale is that business parties' are willing to accept *ad hoc* injustice in exchange of for systemic certainty in the interpretation of contracts. Based upon this assumption, they argue that contract interpretation should be different in commercial or business transactions, as opposed to consumer or private contracts – business contracts should be formalistically interpreted based upon the apparent meaning of their words.

Professors Alan Schwartz and Robert Scott provide no evidence for their proposition (such as, empirical surveys). I am skeptical of such an assumption. Do businesspersons really want their contracts enforced based on strict interpretation of words against the parties' actual or true intent? Is a businessperson harmed by the bad conduct of the other party willing to lose and pay damages, when in reality the other party was in the wrong? I think not! Some businesspersons or companies seek to deal with future contingencies with long, detailed contracts to reduce uncertainty and allocate all foreseeable risks. In the end, complex contracts (such as a joint venture agreement or intellectual property transfer) are likely to be more detailed then simple contracts such as a sale of goods, but detail doesn't equate to greater clarity or the reduction of the likelihood of dispute, in fact, sometimes they can have the opposite effect. The reason is there is no all-knowing, Uber transactional attorney possessing full information and unlimited cognitive abilities and, hence, no perfectly clear and comprehensive contract. This is not to say that detailed contracts should be avoided in complex business transactions, but the length of a contract is often a function of cultural rather than legal factors. American contracts, especially those negotiated by large law firms, tend to be long and detailed; German contracts tend to be shorter for similar transaction; and internal Chinese transactions may not be based on any written or formal contract at all. Given the domestic context, all three of these types of contracting are equally efficient.

The rest of this article will focus on three concepts that have provided most of the fodder in American debates on contract law – justice, fault, and efficiency. In the early days of the LAE movement, the idea was that the efficiency principle could be the basis of a general theory of contract law, both at the descriptive or positive and normative dimensions. In reviewing the last forty or so years of literature on the economic analysis of contract law in preparation for the Heremans Lecture it is clear to me that such a notion of a unifying theory based upon the efficiency principle has failed. This does not mean that LAE research has not provided valuable insights into the workings of contract law and that the efficiency principle is not important to a full understanding of contract law. It is a realization that contract law is too complex to be captured by a single

principle. For this article I have chosen to examine the role of the principles of justice, fault, and efficiency in the hope of better understanding contract law's complexity.

II. Justice

Grant Gilmore once stated that: 'The values of a reasonably just society will reflect themselves in a reasonably just law'.[6] The key word in this statement is 'reasonably' since it can be interpreted in a number of ways. All guiding principles are relative in some way – there is no absolute justice, absolute morality, or absolute efficiency at least not in contract law. This is because self-interested capitalism is always a trade off between the good and the bad of human behavior; between greed and altruism; and between the exercise of freedom and the need to regulate the abuse of that freedom.

'Reasonably' also provides room for other norms, such as efficiency, to play a role in which the seeking of justice is only one among different goals – this is clearly the case for contract law. Finally, the word justice has different meanings and can be reflected in different ways, such as *ad hoc* justice, systemic justice, procedural justice, and distributive justice. Contract law possesses less than absolute allegiance to these different forms of justice. It is less concerned with *ad hoc* justice than it is with systemic justice. It aims to provide a set of fair rules, which may result in injustice in particular cases. This is rationalized by the fact that parties' private autonomy allows them to use or manipulate the rules to their personal advantage.

Freedom of contract itself is a reflection of procedural justice. Since contract law presumes that parties act voluntarily and there contracts are based upon at least a semblance of freedom then concerns of procedural justice are satisfied. Finally, distributive justice is not considered to be the goal of contract law. Law and economics, for example, focuses on the creation of efficient default rules that result in wealth maximization or net utility gains (Kaldor-Hicks optimality) and not on how those gains are distributed. Nonetheless, contract law has always served a regulatory function – duty of good faith, principle of unconscionability, foreseeability limit on damages, *force majeure*, and hardship – that at least tangentially allows for the reformation or adjustment of contracts to allow for just outcomes.

Some courts believe in legal formalism in which written contracts should be strictly enforced based upon the plain meaning of their words. For them, the protection of the sanctity of the written contract as an expression of private autonomy is not only paramount it is essential to the working of the capitalistic-market economy. The contract is an expression of the free will of the parties,

[6] G. Gilmore, *Ages* n 4 above, 110.

based upon their endogenous preferences and idiosyncratic valuations. Since, parties value the subject matter of the contract or the items being exchanged differently both parties will both better off and thereby society benefits with wealth creation. Under this view, contract law should be purely facilitative in nature – providing rules of formation, default rules to fill in gaps in the contract, and a remedial scheme for the peaceful resolution of disputes. Alternatively stated, there should be little contractual regulation or government intervention into contracts.

The common law's objective theory of contract and legal formalism were the means to exorcise morality from contract law. Great contract scholars at the turn of the twentieth century – Oliver Wendell Holmes, Jr, Christopher Columbus Langdell, and Samuel Williston – saw contract law as a set of external principles that could be objectively applied to real world cases and lead to right answers. Arthur Corbin can be seen as one of the first 'modernist' scholars seeing that the key to case decisions was not general principles, but are found in the 'operative facts' found in the cases. The conflict between general principles-legal formalism and operative facts-contextualism is seen in the *First Restatement of Contracts* in which Williston acted as Reporter and Corbin as Co-Reporter. Section 75 espouses the objective, promissory basis for contractual obligations championed by Williston, while Section 90 (detrimental reliance) advanced the importance of the reasonable expectations of parties as an alternative means to contractual liability, which was championed by Corbin. Grant Gilmore's posed a thesis that the injustice resulting from the strict enforcement of promises or contracts resulted in numerous exceptions – recoverability of reliance damages based upon the reasonable expectations of the promisee or promissory estoppel and the recovery of restitution damages for benefits unjustly bestowed on another party – and thus making contract more tort-like.[7]

British scholar Patrick Atiyah puts forward a somewhat similar argument in his book *The Rise and Fall of Freedom of Contract*.[8] He argues that prior to 1800, liability was based upon reliance or benefits received and not based upon consent. The courts were less concerned with the enforcement of promises or agreements based upon consent and more concerned with the equitable nature or the fairness of the exchange. A paradigm shift occurred in which courts saw the importance of enforcement of promises as products of freedom of contract; this model of contract theory persists into the present. But, Atiyah notes the narrowing of freedom of contract in the twentieth century through greater and greater interventions (regulation) into freedom of contract by governments, such as the rise of consumer protection law.

[7] See G. Gilmore, *The Death of Contract* (Columbus: Ohio State University Press, 1974).

[8] P. Atiyah, *The Rise and Fall of Freedom of Contract* (Oxford: Oxford University Press, 1979). Compare F.H. Buckley, *The Fall and Rise of Freedom of Contract* (Durham: Duke University Press, 1999) (the contract construct has expanded in use and the economic analysis of law shows that consumer protection laws and government regulation of contracts is often counterproductive).

The pure freedom of contract or bargain principle advanced by formalism belies the contextual milieu in which contracts are formed, performed and enforced, and the context in which contract rules have been formed, adjusted, and changed. Society is always in a state of flux, which includes the creation of new types of contracts, new forms of trade usage and business customs emerge, and extra-contractual forces, such as technological change, emergence of the share economy (new methods of doing business that have disruptive impact on traditional ways of doing business), and the effects of globalization on international and domestic transactions. Given rapid change, the model of contract rules as relatively static in order to ensure certainty and predictability in contract law application, and the written contract as embodying the parties' full agreement become untenable.

The formalistic application of contract rules and interpretation of contracts also belie legal history in which the roles of equity, conscience, and fairness have played significant roles.[9] To neglect those influences and the outcomes of cases that can be characterized as reaching a just or fair result, despite the use of the language of formalism, misrepresents what contract law actually does. Formalism whether through the 'mechanical' process of going directly to a grand civil code or by way of strict adherence to the power of precedent in the common law,[10] is more a state of mind or caricature of the realty of the law.[11]

An interesting question is does morality of promise play a larger role in the civil law than it does in the common law? In Continental civil codes the parties are required to display *good faith* (*buona fede; bonne foi; buona fede; treu und glauben*) at every stage of contracting. A duty to act in good faith during the pre-contractual phase is an underlying principle in most civil law countries that reaches from the opening of negotiations, conducting of the negotiations, and to the conclusion of the negotiations. It is a general clause, intended to compensate for the rigidity of highly technical rules or precisely defined concepts found in Continental codifications. These 'safety-valve clauses' work to make the detailed rules more flexible, so that they can be adapted more efficiently to particular cases and just outcomes.

In the area of *remedies*: it is worth highlighting that French law uses the wording *sanction* (and not liability) to identify the consequences of contractual non-performance, which demonstrates the traditional 'moral' approach to non-performance of obligations. Enforced performance is known to be a distinctive

[9] See L.A. DiMatteo, 'Equity's Modification of Contract: An Analysis of the Twentieth Century's Equitable Reformation of Contract' 33 *New England Law Review*, 265 (1999); Id, 'The History of Natural Law Theory: Transforming Embedded Influences into a Fuller Understanding of Modern Contract Law' 60 *University of Pittsburgh Law Review*, 839 (1999); Id, *Equitable Law of Contracts: Standards and Principles* (London: Transatlantic Publishers, 2001).

[10] See N. Duxbury, *The Nature and Authority of Precedent* (Cambridge: Cambridge University Press, 2008).

[11] R. Pound, 'Mechanical Jurisprudence' 8 *Columbia Law Review*, 605 (1908).

feature of the law of contractual remedies in civil law jurisdictions compared to the common law. The one who does not perform his contractual obligations is seen as breaching a moral commitment and is therefore is forced, by the courts, to keep her commitment.[12] This moral dimension of the civil law partially explains the tentativeness of Europe's acceptance of LAE and its rejection of efficient breach theory, which will be discussed below in the section on efficiency.

III. Fault

There has been a longstanding debate in the common law on the role of fault in the law of contracts.[13] Grant Gilmore provocatively claimed the *death of contract* in arguing that tort law was swallowing up contract law.[14] Gilmore saw contract law as a residual category – it is what is left over from the other more specialized areas of the law. The idea that general contract law is partially fault-based is antithetical to the generally held view that the promissorial nature of common law contracts and the compensatory nature of common law contract damages reject the idea that the elements of fault or negligence play any role in contract law. For example, Oliver Wendell Holmes, Jr's famously stated in his 1897 article the *Path of the Law* that a binding contract entitles a non-breaching party to the right to claim damages and nothing more.[15] In that same article he sketched his 'bad man theory' of law in which the lawyer and her client should not view the law from the perspective of a virtuous, law-abiding citizen but, instead from the perspective of the 'bad person'. The bad person perspective is part of Holmes' prediction theory of law, which holds that law is nothing more than a prediction of how a court may decide a case. Thus, a businessperson makes a decision, assisted by its lawyer, on how much it should comply with the law or whether to honor its contractual obligations. This decision is based upon a prediction of the probability of being held accountable and if so, the seriousness of the consequences in being held accountable.

The common law of contract is generally unconcerned with any fault attributed to the parties. A party is seen as strictly liable for damages whether due or not due to fault. For example, whether a party breaches a contract out of necessity, willfully or negligently is not important and does not weigh on the amount of damages to be paid. The *Second Restatement of Contracts* states:

> 'Contract liability is *strict liability*. It is an accepted maxim that *pacta sunt servanda*, contracts are to be kept. The obligor is therefore liable in

[12] B. Passa, 'Pre-Contractual Liability: A Civil Law Perspective', in L. DiMatteo and L. Chen eds, *Chinese Contract Law: Perspectives* (Cambridge: Cambridge University Press, 2017).

[13] See, eg, O. Ben-Shahar and A. Porat, 'Foreword: Fault in American Contract Law' 107 *Michigan Law Review*, 1341 (2009).

[14] G. Gilmore, *The Death* n 7 above.

[15] O. Wendell Holmes Jr, 'The Path of the Law' 10 *Harvard Law Review*, 457 (1897).

> damages for breach of contract even if he is without fault and even if circumstances have made the contract more burdensome or less desirable than he had anticipated'.[16]

Section 261 of the *Second Restatement of Contracts* recognizes the role of fault in the impracticability doctrine:

> 'Where, after a contract is made, a party's performance is made impracticable *without his fault* by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary'.[17]

But, there are concepts and areas of contract law that can be characterized as fault-based, such as the duty of good faith, principle of unconscionability, duty of reasonable efforts, the without fault requirement in excuse doctrines (such as the doctrine of impracticability in American law). Other contract doctrines that are also fault based include misrepresentation, duress, undue influence, and unilateral mistake, along with the foreseeability of damages limitation and the principle of mitigation. The duty of care (fault) can also be seen underlying specific types of contracts, such as bailment, escrow, trust and carriage contracts.

Elsewhere, the fault principle can be seen at work in the breach of professional services contracts where courts determine if a party breached its duty of care based upon professional standards. In agency contracts, the agent may breach the contract by not fulfilling its duties of loyalty and care. In American promissory estoppel (detrimental reliance) a party may be held liable for reliance damages involving a non-contractual promise if an injustice would result if the court did not provide some form of remedy.[18]

In contract interpretation the idea that a party 'should have known' implies that a party is at fault for not knowing a fact. For example, if a party holds itself out as a certain type of businessperson or expert then it is expected to know the trade usage, business customs, and commercial practice known by a reasonable businessperson or expert in that industry or business.[19] Professor George Cohen argues that the fault principle is part of the objective theory of contract that is the basis of Anglo-American contract law. He notes that a party who makes a promise, then subsequently argues an alternative intent or meaning (than that of a reasonable person) is guilty of intentional misrepresentation or negligence because he 'knows or has reason to know that the other party may infer from his

[16] *Restatement (Second) of Contracts*, chapter 11, introductory note (1981) (emphasis added).
[17] ibid, Section 261 (emphasis added).
[18] ibid, Section 90.
[19] See, eg, Uniform Commercial Code §1-303(d) (stating that trade usage of which the parties 'are or should be aware' can be used to interpret the agreement).

conduct that he assents'.[20] Finally, the unilateral mistake doctrine and the duty to disclose in certain contracts are further examples of the influence of fault in contract law. A party that makes a mistake (usually a clerical or calculation error) may terminate a contract if the other party was aware or should have been aware of the mistake at the time of contracting and failed to bring the mistake to the attention of the mistaken party. In certain types of contracts, the modern trend has been an expansion of the duty to disclose facts known to the seller and not discoverable by the buyer through reasonable inspection or due diligence. Thus, a seller of a home is expected to disclose any hidden defects or material facts to prospective homebuyers.

In the civil law, the controversy over the role of fault in contract law is not as pronounced. Along with the relatively vague notion of the duty of good faith, there are a number of specific provisions that are expressly fault based. For example, Art 1175 of the Italian Civil Code states that: 'The debtor and creditor shall behave according to rules of fairness'.[21] The line between justice, fairness and good faith versus fault is a thin one. But, it is not implausible to argue that a party who treats another party unfairly is at fault for causing the other party harm due to its acting unfairly. But, this is a rather abstract analysis. Elsewhere in the Italian Civil Code, the fault principle is easier to discern. Art 1227 states that:

> 'If the creditor's negligence has contributed to cause the damages, the compensation is reduced according to the seriousness of the negligence on the consequences arising from it'.

Negligence is in the common law clearly a synonym for fault, sometimes referred to as contributory fault. Art 1229 of the Italian Civil Code states that:

> 'Any agreement which, in advance, excludes or limits the liability of the debtor for fraud, malice or gross negligence is void'.

This provision illustrates an intersection between contract and tort or delict, namely a party cannot contract out of liability for harm caused by their gross negligence. The rule is the same in the common law.

Other examples of the fault principle in the civil law include Section 276 of the German Civil Code (BGB), which states:

> '(1) The obligor is responsible for intention and *negligence*, if a higher or lower degree of liability is neither laid down nor to be inferred from the other subject matter of the obligation, including but not limited to the

[20] G.M. Cohen, 'The Fault That Lies Within Our Contract Law' 107 *Michigan Law Review*, 1445, 1456 (2009), quoting, *Restatement (Second) of Contracts*, Section 19(2).

[21] M. Beltramo, *The Italian Civil Code* (Dobbs Ferry: Oceana Publications, 1991) (all citations to the Italian Civil Code are as represented in this source).

giving of a guarantee or the assumption of a procurement risk. (2) A person acts *negligently if he fails to exercise reasonable care*'.[22]

In the French Civil Code, a distinction between strict liability and fault is made between the different *obligations de résultat* (promises of result) and *obligations de moyens* (promises of best efforts).[23] The first obligation requires performance as required under the contract, while the second one only requires the use of best efforts in performing on the contract. In the later case, the failure to use best efforts is the fault of the promisor. Another example can be found in German and Italian law where in the sale of goods, a seller is not liable for the fault of a third party it employed to assist in the performance of the contract. Thus, the seller is only liable for damages caused by its negligence, such as failing to arrange substitute goods or supplies, following the breach by the third party.[24]

IV. Efficiency

Historically, minus economic jargon, efficiency has long been an underlying norm of contracts. For example, the *reasonable person principle* is based on the notion of what a reasonably prudent, efficient person would have done in a given situation; something that would satisfy the efficiency norm. In sum, 'everyone (is) held to the standard of the rational, efficient "reasonable" person'.[25] Contracts by there nature serve an economic function; they allow for the creation of markets in a capitalistic system where private property is a fundamental principle. LAE takes the general economic function of contracts to enable the private transfer of property and refines it along economic principles. Thus, contract law functions to enforce efficient contracts, to reduce transaction costs, to deter inefficient conduct, and to deter inefficient performance.[26]

Beginning in the early 1970s the Law and Economic Movement gained strength with the publication of Richard Posner's *The Economic Analysis of Law*.[27] Economic analysis had long played a role in specialized areas of the law, such as antitrust and regulatory law. LAE was different in that its purpose was to explain all areas of law. Soon it began an intense analysis of private law areas including contract law.[28] Since then a deep literature has been developed mapping out a positive or descriptive and a normative theory of contracts based upon the

[22] Bürgerliches Gestzbuch (BGB), § 276 (1) and (2) (2002) (emphasis added).

[23] French Civil Code, Arts 1137 and 1147.

[24] S. Grundmann, 'The Fault Principle as the Chameleon of Contract Law: A Market Function Approach' 107 *Michigan Law Review*, 1583, 1588 (2009).

[25] R.E. Speidel, 'The New Spirit of Contract' 2 *Journal of Law & Commerce*, 193, 197 (1982).

[26] R. Austen-Baker and Q. Zhou, *Contract in Context* (London and New York: Routledge, 2015), 105-107.

[27] R.A. Posner, *Economic Analysis of Law* (New York: Wolters Kluwer Aspen, 1973).

[28] A.T. Kronman and R.A. Posner, *The Economics of Contract Law* (Boston: Little Brown & Co, 1979).

principle of efficiency, which LAE sees as the key to formulating contract law and to the interpretation of contracts. It is hard to argue that contract law and contracts should not be efficient. But, the lingering question is the extent of LAE's explanatory power – has it explained the entire body of contract law and has it provided foundational insights into contract interpretation? The answer, after about forty-years of scholarship is a resounding – no![29] That is not to say that LAE hasn't provided some important insights and that the principle of efficiency, often tied to the norms of predictability and certainty, is not an important part of the normative basis of contract law. A brief review of the basic contributions of LAE to contract scholarship is in order.

First, LAE takes an almost exclusive *ex ante* (at the time of contracting) perspective of contract law and how it is and should be formulated. LAE has much less to say about *ex post* or *post hoc* analyses of contract rules and principles that are applied after contract formation. This is because LAE focuses on the core concept of freedom of contract and the lowering of transaction costs at the time of the conclusion of the contract. It generally disdains *post hoc* regulation or the policing of contracts. However, one must be careful in the use of these terms for temporality of a rules application may seem *ex post*, but its existence is considered *ex ante* if available at the time of contracting. For example, non-mandatory default rules (which make up the bulk of contract law) apply *ex post* to fill in gaps in a contract. But, in LAE the default rules allow for the parties' at the *ex ante* stage to make a more complete contracts.

Second, in incomplete contract theory the completeness of a contract is assessed by a combination of the express terms and default rules. The recognition that contracts are always incomplete and that this incompleteness actually increases the efficiency of contracts if contract law provides efficient default rules. This is why the efficiency of default rules is a major focus of LAE.[30] The use of economics to test the efficiency of existing rules and replacing them with efficient ones, whether attainable or not, is a laudable and legitimate goal.

Third, another function of contract law, according to LAE, is to encourage efficient breach or deter inefficient performance. This idea of efficient breach is one of the most controversial concepts in the LAE of contract law. The idea of efficient breach is often viewed as immoral, especially in Europe. Steven Shavell suggests otherwise – that breach may often be seen as moral, once one appreciates that contracts are incompletely detailed agreements and that breach may be committed due to problematic contingencies that were not explicitly addressed by the governing contracts.[31] In other words, it is a mistake generally to treat a

[29] See, eg, E. Posner, 'Economic Analysis of Contract Law after Three Decades: Success or Failure?' 112 *Yale Law Journal*, 829 (2002).

[30] See I. Ayres and R. Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' 99 *Yale Law Journal*, 87 (1989).

[31] S. Shavell, 'Why Breach of Contract May Not be Immoral Given the Incompleteness of Contracts' 107 *Michigan Law Review*, 1569 (2009).

breach as a violation of a promise that was intended to cover the particular contingency that eventuated. Yet it is manifest that legal systems ordinarily do allow breach – the law usually permits breach if the offending party pays damages – and it is commonplace that breach occurs. Thus, a tension exists between the felt sense that wrong has been done when contracts are broken and the actual operation of the law. Breach may be seen as moral once one appreciates that contracts are incompletely detailed agreements and that breach may be committed when contingencies are not explicitly addressed in the governing contracts.[32]

The problem with Shavell's morality of efficient breach is that breaches cannot be neatly divided between efficient and non-efficient ones. It is premised on the idea that the non-breaching party can be made whole through the payment of damages. However, it does not actually require the non-breaching party be made whole under Kaldor-Hicks criterion but only that the surplus gained from breaching the contract is greater than the loss sustained by the non-breaching party. Also, even if an attempt is made to pay damages to make the other party whole damages are almost always undercompensatory since contract damages fail to capture all of the harm caused by breach, such as loss of productivity, inconvenience, emotional distress, and negative, reputational effects. Also, even if efficient breach makes sense in short-term discrete contracts, it losses its plausibility in long-term relational contracts where efficiency of breach is even more difficult to quantify and where thick relational norms, such as trust, flexibility, and duty to re-negotiate play important roles in holding the contractual relationship together.

Fourth, many of the insights of LAE are tied to the reduction of transaction costs by developing default rules that would efficiently fill in gaps in contracts thus, lowering transactions costs at the front-end (negotiation and drafting of contracts). A classical example is the 1854 case of *Hadley* v *Baxendale*,[33] which established the rule that a person is not entitled to consequential damages when those damages are not reasonably foreseeable. This moved common law damages from strict or absolute liability for damages to recovery for only reasonably foreseeable damages. This is deemed to be the more efficient rule since it incentives one party to share internal information in order to expand recoverable damages. This allows the other party, often the more efficient insurer to take precautions to prevent breach or to minimize its payment of damages. LAE highlights the *insurance function* (intimately related to contracts' planning function) of contract as risk allocation devices, with contract law's default rules assigning unexpressed risk allocations to the most efficient insurers.

There have been numerous critiques of LAE and the explanatory power of the efficiency principle. Professor Ian Macneil, the father of American *relational contract theory*, questioned the explanatory power of LAE across the breadth of

[32] ibid, 1569-1570.
[33] *Hadley* v *Baxendale* [1854] EWHC J70, (1854) 156 ER 145.

transactional-types of contracts, especially regarding relational-types of contracts. Macneil noted that many contractual concepts do not work as efficiently in long-term and relational contracts. For example, at the 'extreme transactional pole', the subject matter is a 'simple, monetizable economic (type of) exchange'.[34]

At the 'extreme relational pole', the subject matter includes 'complex personal non-economic satisfactions'. The increased duration and complexity of many of today's relational contracts makes efficiency valuations more difficult to determine.

The behavioral law and economics (BLAE) school of thought generally is traced to a 1998 article by Christine Jolls, Cass Sunstein, and Richard Thaler that challenges the assumptions of LAE, borrowing from the literature on behavioral decision theory from the field of psychology.[35] It should be noted that the article did not seek to displace LAE but was meant to improve LAE by heightening its ability to predict human actions through the loosening of the assumptions behind the rational choice theory. BLAE shows that human decision-makers are characterized as quasi-rational with bounded rationality, bounded self-interest, and bounded willpower. Cass Sunstein has argued: 'human preferences and values are constructed rather than elicited by social situations'.[36] Just as BLAE seeks to add additional dimensions to the *rational person* to bring the economic model closer to the real *quasi-rational human actor* with her cognitive shortcomings (biases), as well as emotions. In fact, it was inevitable that economic modeling of the human condition would reach a point that it would evolve to include behavioral (psychological) and empirical insights.

A more fundamental critique of LAE is its assumption that contracts are an expression of pure freedom of contract and, therefore, should be strictly enforced. The linchpin of this argument is that the contracting parties are acting rationally with full information, and, as such, are the best evaluators of the value of the exchange and the most able to allocate risks to the most efficient insurer. However, a more realistic assessment of contracting is that contracts are often not the products of pure freedom of contact due to the existence of informational and bargaining power asymmetries. Given this reality, contracting parties' preferences are exogenously influenced and true consent is often a façade given the asymmetries and the parties bounded rationality. One scholar has described contract law as a body of exceptions to freedom of contract.[37] But, this is a false premise since the great bulk of contract law is facilitative and not regulatory.

Contracts are inherently *Pareto efficient* since both parties obtain a net

[34] I.R. Macneil, 'The Many Futures of Contracts' 47 *Southern California Law Review*, 691, 738 (1974).

[35] C. Jolls, C.R. Sunstein and R. Thaler, 'A Behavioral Approach to Law and Economics' 50 *Stanford Law Review*, 1471 (1998).

[36] C. Sunstein ed, *Behavioral Law and Economics* (Cambridge: Cambridge University Press, 2000).

[37] P. Cserne, *Freedom of Contract and Paternalism: Prospects and Limits of an Economic Approach* (New York: Palgrave MacMillian US, 2012), 81.

benefit at least based on their *ex ante* evaluations. That is, parties to contract that is a product of voluntary consent expect the outcome will be benefit enhancing. The issue is what is meant by voluntary? And, what is meant be consent? Is consenting a uniform construct or does it mean different things in different contexts? In the idealized model of the 'horse trade' where the parties negotiate face-to-face and immediately exchange a horse for money true consent is realized. But, in the standard form contract provided by a merchant to a consumer who signs it unread on a take it or leave it basis is this also true consent? The law needs to recognize different levels of consent and determine what level of consent is needed for a given type of contract. For example, in the Internet age, consent means little more than the opportunity to read.[38]

Another flaw in LAE analysis is the assumption that people purely work in their own self-interest. It is more likely that many persons employ a 'bounded self-interest' in that they process and are influenced by perceptions of fairness. In fact, parties often act against their own narrowly defined economic interests, by renegotiation of contracts, not enforcing minor breaches in the contract, and believe that by acting fairly they will benefit from reciprocal fairness in the future. If they are not motivated to act fairly, they generally, at least, want to be viewed as acting fairly. This acting fairly is viewed as self-interested because it may produce positive reputational effects and result in reciprocal responses in the future. Lisa Bernstein also notes the importance of non-legal sanctions like reputational effects.[39] The power of reputational effects is especially strong in the context of a closely-knit industry with a thick relational structure.

The next section will discuss the pseudo-tension between freedom (facilitation) and paternalism (regulation), and how LAE and BLAE may offer insight into resolving this tension.

1. Freedom and Paternalism

Two contract principles underscore free markets – freedom *to* contract and freedom *from* contract. Freedom *to* and *from* contract means that individuals should be allowed to exchange their entitlements *free from government restrictions*. Both forced transfers through required contract terms (*freedom to contract*) and prohibited transfers where certain contract terms are prohibited by public policy (*freedom from contract*) frustrate the price system and erode efficiency. The importance of freedom of contract as protecting the parties *ex ante* preferences is a core tenet of LAE that leads to a presumption against

[38] See O. Ben-Shahar, 'The Myth of the 'Opportunity to Read' in Contract Law' 5 *European Review Contract Law*, 1 (2009).

[39] 'The importance of reputation and the industry's reliance on reputation-based nonlegal sanctions goes back to the early days of the industry'. L. Bernstein, 'Private Commercial Law in the Cotton Industry: Creating Cooperation through Rules, Norms, and Institutions' 99 *Michigan Law Review*, 1724, 1749 (2001).

governmental intervention into the substance of private agreements.

In the often-discussed tension between freedom and paternalism, the question should not be framed as a contest between the two. The question should be what justifies limiting a person's freedom in order to protect that person's interests? This is a question in which an LAE has provided insight. If paternalism is justified, how is it best implemented? However, to answer this question LAE scholars need to better confront the problems of asymmetrical information and distributive justice in different contracting scenarios. For example, if inefficient contracting exists should the law intervene to improve contractual efficiency? How does the core concept of consent as the linchpin of contract enforcement be understood in cases of asymmetrical bargaining power and asymmetrical information? Can efficiency be reconciled with distributive justice in some scenarios? Can the efficiency of distributive justice be recognized when different distributions create lesser or greater net welfare?

In the past, LAE has been deficient in dealing with the existence of values other than efficiency. The LAE literature has supported certain types of interventions based upon justice or paternalism by reframing them in terms of efficiency or simply avoiding the use of words like justice or paternalism, when a more honest approach would be to 'tweak' the normative assumptions of neoclassical economics.[40]

There is not one but numerous LAE approaches, especially in the area of normative economics, with some analysis highly critical of intervention or paternalism and others finding a place for certain types of regulatory intervention. The more that a contract is a product of voluntary consent based upon a broad view of the private autonomy of a rational, fully informed actor, the closer and more predictive the economic person of rational choice theory will be as to the efficiency of contracts, and the greater the argument against regulation internal to contract law or by means of government intervention. However, the further one of the parties is from the above model the stronger the argument for intervention into freedom of contract.

Thus, *paternalism-fairness* is not always an anathema to freedom of contract-efficiency. Interventionism *ex ante* may lead to a more efficient contract or performance outcome. This argument is difficult to make under mainstream economics because the guiding principle is that individuals are the best evaluators of their interests and are best able to protect themselves, given that they are rational actors with purely endogenous, a priori set of preferences. Thus, if allowed they will contract around any paternalistic contract doctrine if they deem it is against their self-interest.

BLAE can help make economic analysis more predictive of real world behavior. An example of this is the realization that self-interest often includes utility calculations related to the interests of the other party – business-linked

[40] P. Cserne, n 37 above, 29.

altruism is often efficient in certain situations – reputation and goodwill, relation building, and deterring opportunistic breach. This is where BLAE can provide insight and where the notions of 'nudge' and 'debiasing' seek to address. But, how can nudging or debiasing be made most efficient? This is where empirical legal studies can provide insight.

The complexity of contracts is not just in their incompleteness, but that their formation and performance are embedded in a context where rationality is bounded; non-legal sanctions,[41] such as reputation effects, may be powerful; and the thickness of some contractual relationships create a normative matrix that includes trust, intra-contract altruism, and the expectation of renegotiation. It may be that different rules are efficient in different contractual settings. BLAE shows that some types of transaction costs are not always foreseeable or calculable because transactional players are irrational by nature. This is what has actually happened in the common law of contracts with a shift from formalism to contextualism and from a general body of contract law to a more nuanced contract law combining general principles with an increased bodes of specialized rules.

Economics yields rich insights into the incentive effects of laws, which society typically enacts to induce desirable behavior. A positive view of the relationship between LAE and BLAE is one that sees EAL as vision and BLAE as method – a way of nudging LAE in the right direction in making law more efficient. Normative LAE can be viewed as a utopian goal or as serving law's expressive function, while BLAE can be seen as a method of moving toward that goal through its descriptive understanding of human behavior. But, in the end, beyond very simple contracting, contracts and contract law is too complex to be explained by a single efficiency principle. Finally, given the array of different contract-types, including thick contractual relationships (joint venture, long-term supply contracts, alliances), efficiency is one of numerous values found in the normative composite that are the foundation of contract law.

In the end, legal scholarship is or needs to evolve using all three approaches – *economic modeling*, *psychological-based decision theory*, and *empirical analysis*. Each approach has their benefits, but, as importantly, the researcher must be fully aware of their shortcomings. Together the different methodologies can be used to replicate each other's insights or to question the findings of a given study within one of the approaches. Together they provide a more holistic accounting of the rationales for contract law rules and a more holistic understanding of human actors working within a market economy.

V. Concluding Remarks

[41] See D. Charny, 'Nonlegal Sanctions in Commercial Relationships' 104 *Harvard Law Review*, 375 (1990).

Steven Smith in his excellent monograph, *Contract Theory*, maps out the minimal requirements in which to measure a theory of contract as being: fit, coherence, morality and transparency.[42] First, any theory of contract law must fit the existing areas of contract law. It must mark out the boundaries of what is contract and what is contract law? A theory of contract fails if it fails to explain major areas of the law. Is what people think of contract law explained by the theory? Second, the theory must show contract as a coherent body of law. Does the theory show contract law as being unified? Can a theory or any single principle, such as promise or efficiency explain all of contract law's different parts?

Third, in the words of Professor Smith, 'a theory of law is better if it portrays the law as morally justified'.[43] From an internal perspective, law must be linked to morality in order to be viewed as a legitimate authority. Legal philosopher Ronald Dworkin, whose interpretive theory of law requires the judge to find interpretations that best fit all of contract law, is an example of the strongest version of the morality criterion.[44] If a rule interpretation fits the overall body of law then it is morally justified. A weaker form of morality and law is functionalism or instrumentalism, which asks: Does a rule, or rule application, serve their intended functions?

Fourth, 'law is transparent to the extent that the reasons legal actors give for doing what they do are there real reasons'.[45] The American legal realists of the 1930s challenged the transparency of law through their rule skepticism and the critical legal theorists of the 1980-1990s saw law as neither objective nor impartial.

Karl Llewellyn, the founder of American realism and the jurisprudence that was able to apply his thinking as the Reporter of the Uniform Commercial Code and the writer of Art 2's sale of goods, rejected the possibility of a uniform theory of contract law. Instead, he advanced the idea of transaction-types.[46] And yet, numerous unified theories of contract law have been posed and should not be disregarded out of hand. In Llewellyn's pragmatism all may have explanatory power for a given transaction-type. It can be assumed that no grand, unified theory exists or can exist.[47] Therefore the coherence requirement is satisfied when any theory explains most of the core elements of the field of contract law. Legal philosopher Brian Bix noted that while no single theory can explain all of contracts, contract law might have a 'unitary essence'.[48] The most

[42] S.A. Smith, *Contract Theory* (Oxford: Oxford University Press, 2004), 7-24.

[43] ibid.

[44] R. Dworkin, 'Hard Cases' 88 *Harvard Law Review*, 1057 (1975).

[45] S.A. Smith, n 42 above.

[46] K.N. Llewellyn, *The Common Law Tradition: Deciding Appeals* (Boston: Little Brown & Co, 1960), 121-157. See also, L.A. DiMatteo, 'Reason and Context: A Dual Track Theory of Interpretation' 109 *Penn State University Law Review*, 397 (2004).

[47] See R. Hillman, *The Richness of Contract Law: An Analysis and Critique of Contemporary Theories of Contract Law* (Dordrecht: Kluwer, 1997).

[48] B. Bix, 'The Promise and Problems of Universal, General Theories of Contract Law'

plausible choice would be contract as promise-based, but that does not get us very far.

For if Llewellyn is right, and I think he is, the explanatory powers of different theories of contract law is rooted in the context in which they are applied. What may be an efficient rule for one transaction-type or in a given context may be inefficient in another. For example, American law has three breaches of performance standards – the *prefect tender rule* or any breach rule in the Uniform Commercial Code, the *substantial performance doctrine* in the common law, and the Convention on Contracts for the International Sale of Goods' *fundamental breach rule*. A strong argument can be made that these diverse breach rules are all efficient given their context.

In the end, role of contracts is relatively simple. It helps enforce cooperation between parties. The role of contract law is to fill in gaps in the contract and regulate impermissible terms. Impermissible terms may be the result of agreements that are not a product of consent (fraud, coercion) or that produce negative externalities or spillover effects (negative effects on non-contracting parties from a contractual agreement), such as illegal contracts.

A key objection to LAE lies in the perceived inconsistency of normative economic analysis and law's traditional focus on justice and fairness. In contract law, default rules should be both fair and efficient. If there is a divergence then it would be best to side with efficiency as fair default rules do no prevent the making of unfair contracts and parties would have to incur transaction costs to avoid inefficient default rules.

The fact that there is no unified theory of contract law, nor should there be, is a testament to its complexity and the complexity of its subject. The different influences that impact the formation and application of contract law makes it, along with other legal concepts, such as agency and trust law, one of the more flexible constructs in law. It is the flexibility of the contract construct, with its myriad of underlying principles – freedom, justice, morality, and efficiency that allows contract law to adjust to a rapidly changing society. The new discoveries for which contract law will need to respond are already upon us in the share economy, digital content regulation, and the continuing commodification of information. Contract law and the application of contract rules – due to their complexity and dynamism – can only be explained by a normative composite including morality, trust, and efficiency, among other norms.

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