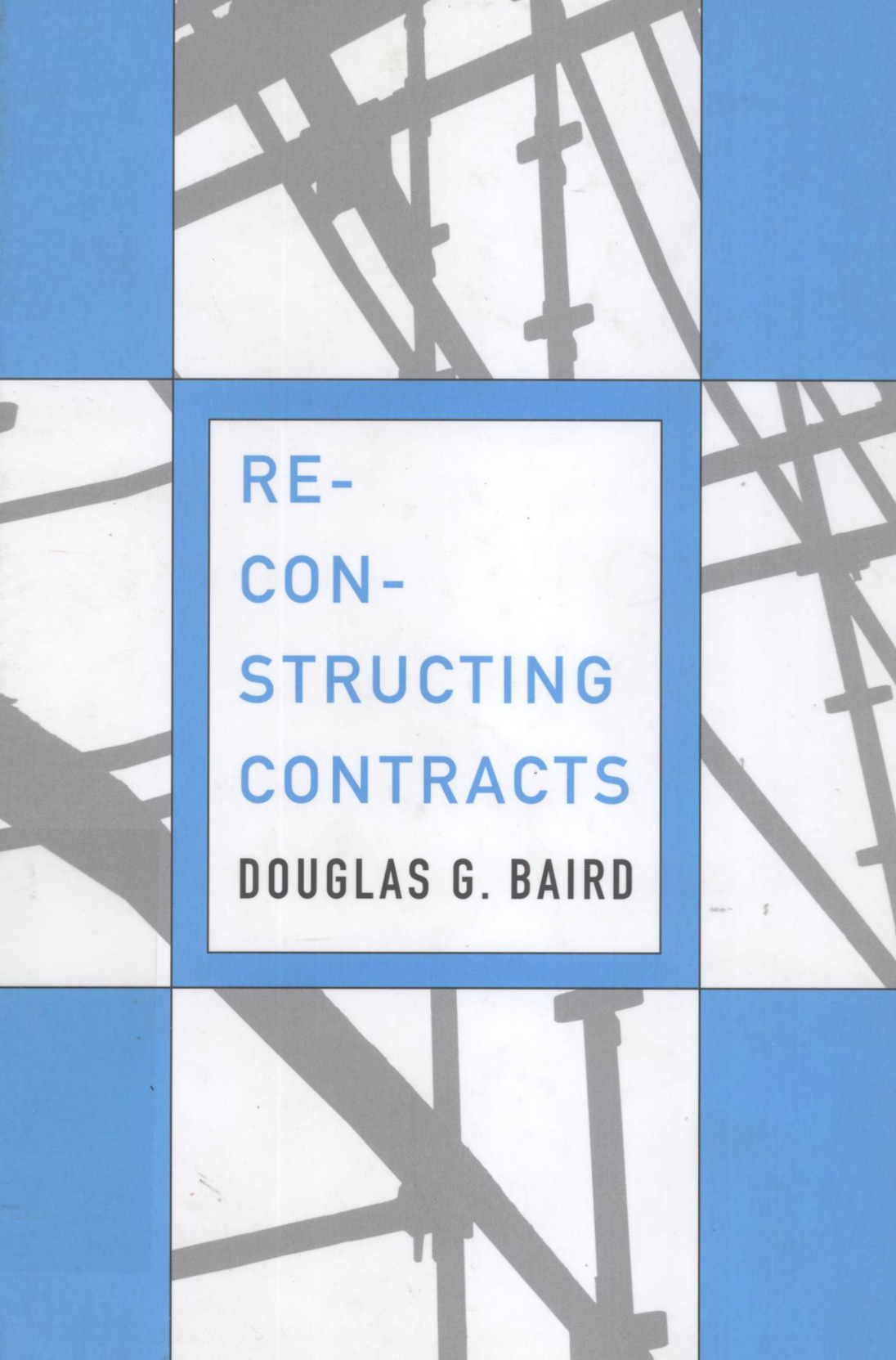

RE-CON-STRUCTING CONTRACTS

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Harvard University Press
Cambridge, Massachusetts
London, England
2013

Printed in the United States of America

Library of Congress Cataloging-in-Publication Data

Baird, Douglas G., 1953–
Reconstructing contracts / Douglas G. Baird.
p. cm.
Includes bibliographical references and index.
ISBN 978-0-674-07248-0 (alk. paper)
1. Contracts—United States. 2. Contracts—Great Britain. I. Title.
KF801.B35 2013
346.7302'2—dc23 2012038116

RECONSTRUCTING CONTRACTS

For Julie and Sam

PREFACE

This volume brings together some of the thinking I have done about contract law over the past two decades. This project began with the 1992 Katz Lecture at the University of Chicago Law School. It was also called "Reconstructing Contracts." That talk contained the seed for what is now the second chapter of this book. Ideas from other work can be found throughout each of the chapters. This book does not set out the essential doctrines of contract law. Marvin Chirelstein, Eric Posner, and others have already done this task far more ably than I could. My attempt has been rather to reflect on the fundamental principles of contracts. In particular, my ambition is to assess where we stand today in an enterprise that Oliver Wendell Holmes began in 1880 when he gave his lectures on the common law and sought, among other things, to set out a few core ideas that unite the law of contracts.

When I was in law school, the conventional wisdom was that Holmes's enterprise was a pipe dream. Contract law itself did not have metes and bounds that could be laid out neatly. If this book has any general theme, it is that this view is fundamentally wrong. The Anglo-American law of contract does organize itself around a handful of straightforward ideas. They are not immutable and universal laws in the fashion of those of Newton or Einstein, but they are useful principles nevertheless.

Far from presenting a view of contract law that is distinctively my own, these essays reflect what I have learned from the extraordinary contracts scholars whose orbits have crossed mine. These begin with Thomas Jackson and Robert Scott. I had the great privilege of working with both while a law student. Later came many others. Most prominent among them is Richard Posner, whose influence permeates every essay. They also include my colleagues Lisa Bernstein, Ronald Coase, Richard Craswell,

Frank Easterbrook, Richard Epstein, Robert Gordon, Stanley Henderson, Cass Sunstein, and the late Brian Simpson. Each uncovered foundational ideas reflected in this book. There are many other scholars whose work I have studied and enjoyed. I am deeply indebted to all of them and hope this book can be understood as a celebration of their work, even when seen through the somewhat imperfect lens I bring to it.

RECONSTRUCTING CONTRACTS

CONTENTS

Introduction
The Young Astronomer

Courts enforce the promises one merchant makes to another according to their terms. This proposition is nearly always true in virtually every country and every legal system in the world. But this leaves much unsettled. Two merchants exchange multiple communications with one another. How do courts decide when and if they have entered into a binding contract? Contingencies can arise that no one thought about. When gaps are left in an agreement, how should courts fill them in? And what exactly does it mean to say that a court will enforce a promise? Will the court order performance, impose a fine, or order the payment of damages? If the court orders the payment of damages, how will these be measured? It is equally true that, in contrast to promises made in the marketplace, courts everywhere refuse to enforce casual promises made in a social setting. How exactly is the line drawn between the two?

The answers to these questions again tend to be the same across legal systems throughout the world. Many disputes, indeed the vast majority of them, are easily resolved and will be decided the same regardless of the legal system. But lawyers, at least the good ones, are not hired to win easy cases, and the hard cases are not always decided identically. Even when they are, the path that brings the judge to a certain outcome is not the same. Each legal system organizes itself differently. The contract law of each is a distinct language. To speak it well, one must understand its unique cadences as well as its vocabulary and grammar.

At the start of the Anglo-American legal tradition, a lawsuit began as a petition to the Crown. A citizen who was the victim of a breach of promise asked the Crown to use the power of the state—including force

if necessary—to put matters right. The Crown did not grant relief as a matter of course. The power of the state would not come to the aid of a citizen merely because a promise had been broken. Using force to compel one citizen to right a wrong allegedly done to another was a serious business. It would not be done without good reason, and it would not be done arbitrarily. The citizen had to explain what it was about the broken promise in question that made it worthy of the Crown's attention. To do this, the citizen's job was to explain why this case was like the others before in which relief had been granted. Authority lay in precedent.

There are other ways of proceeding. Some legal systems—such as those in Europe and Japan—begin with a set of general principles and require judges to reason from them when deciding any particular dispute. But the Anglo-American system did not start in this fashion, and it has not changed. Our legal system still rests on a vast body of decided cases from which general principles must be extracted. Anglo-American lawyers face the challenge of locating a given set of facts among the vast forest of cases that have been decided before. From the tens of thousands of reported decisions, they must find those that are closest. Legal scholars have long sought to identify from all these cases a handful that is representative. By giving lawyers a few landmarks, scholars help them find their bearings.

The modern study of contract law begins properly with Christopher Columbus Langdell's appointment to the deanship of the Harvard Law School in 1871. He instituted the case method of legal instruction, and he set the example for others with his course on contracts. Instead of a book that set forth principles in the abstract, his contracts book provided a representative set of decided cases. Students learned the law by reading them closely. Langdell believed that fundamental principles were embedded in the cases he selected. Just as the immutable laws that governed the natural world could be discovered through close observation of a few phenomena, the essential features of contract law could be found in these judicial opinions.

Oliver Wendell Holmes began his own intense study of the law at about the same time that Langdell brought his revolution to the Harvard Law School. He too looked for the core principles of the common law and more or less replicated Langdell's effort to identify the central principles of contract. A novel written at the time portrays a thinly disguised Holmes as he goes about this task. He is the Young Astronomer, a man obsessed

with fixing his attention to the thousands of stars in the heavens and making sense of them.[1]

In contrast to Langdell, Holmes doubted that immutable laws of science governed the movement of the legal heavens. Laws reflect in some measure the circumstances that brought them into being:

> [W]hile, on the one hand, there are a great many rules which are quite sufficiently accounted for by their manifest good sense, on the other, there are some which can only be understood by reference to the infancy of procedure among the German tribes, or to the social condition of Rome under the Decemvirs.[2]

Legal rules are grounded in history and are path dependent.

> [J]ust as the clavicle in the cat only tells of the existence of some earlier creature to which a collarbone was useful, precedents survive in the law long after the use they once served is at an end, and the reason for them has been forgotten. The result of following them must often be failure and confusion from the merely logical point of view.[3]

Nevertheless, Holmes shared with Langdell the belief that one could identify a relatively simple set of patterns that could explain how judges behaved. He too believed that careful study of a handful of paradigmatic cases could capture the basic principles a lawyer needed in order to understand the peculiar rhythms and harmonies of the common law.

For Holmes, the law of contract revolved around three central ideas. First, objective criteria controlled the formation of a contract. A subjective meeting of the minds was not the benchmark. There is instead an objective test that tells us whether, at any moment, you are contractually bound or not. Second, only those promises that are part of a bargained-for exchange are legally enforceable. A promise is legally enforceable only if it is given in exchange for something else, such as another promise. Third, when you break a legally enforceable promise, you are required to pay compensatory damages—that amount of money that will put the innocent party in the same position that party would have been in had the promise been kept.

Writing some forty years ago, Grant Gilmore surveyed the landscape of decided contract cases and concluded that the coherence that Holmes had

tried to impart with these principles had fallen apart. He called his masterful account of the law of contracts *Death of Contract*. He observed:

> The instinctive hope of the great system-builders was, no doubt, that the future development of the law could be, if not controlled, at least channeled in an orderly and rational fashion. That hope has proved, in our century of war and revolution, delusive. The systems have come unstuck and we see, presently, no way of gluing them back together again.[4]

The idea that contractual liability has a yes/no, on/off character is much more troubling than Holmes and others understood. Consider the following case.[5] A worker goes to her boss a week after her written contract expires. The worker says that if her contract is not going to be renewed, she needs to know. Another firm has offered her a job at the same salary. She would prefer to stay, but if she is not given a contract for the next year, she will leave. Her boss tells her, "You have nothing to worry about. Go back to your job. We like the work you are doing." The boss is encouraging but does not explicitly use any of the ordinary words of contracting.

Someone committed to Holmes's position is in an awkward spot. If you believe this conduct is insufficient to form a contract, then the boss is free to fire the worker several months later after the worker has given up the chance to move elsewhere. But if you think there is a contract, you face another unattractive possibility.

A minute after the exchange, the boss realizes that she might have been misunderstood. She catches up with the worker and says, "Look, it occurs to me that you may have misunderstood. I cannot agree to bind the company to a contract now. You are going to have to hang in limbo. I hope you stay, but if you don't like it, then I'm afraid you will have to take the other job." If you really think that the previous exchange formed a contract, the worker could say, "Sorry, boss. It is too late. You are committed to having me around for another year." The boss is liable, regardless of whether the worker has relied in any way on the conversation that took place a minute before.

For many who thought deeply about contracts in the last half of the twentieth century, it was more sensible to view a contract as merely another species of civil obligation. We assess the conduct of the parties and establish relative culpability as we do with other sorts of injury. If the worker has not relied on the promise, damages should not be awarded.

If she has, then she should be made whole, but only to the extent she has reasonably relied. Justice requires no more.

The classical view of contract, from this perspective, made little sense. The liability of one person to another should not turn sharply on a single, discontinuous moment. There should not be an instantaneous transition from a world of no liability to a world in which you were liable to the extent of the full value of the promise. Nor should promising behavior give rise to legal liability only when it was part of a bargained-for exchange. It makes far more sense to hold people to their words as a general matter to the extent that others reasonably rely on them.

Moreover, one must doubt the positive account that Holmes and Langdell offer. Once we begin to question the classical principles, we start to discover cases that do not fit in the traditional paradigm. There are, for example, many instances in which courts enforce promises reasonably relied upon even when there is no bargained-for exchange. Once one finds enough of these cases, Holmes's principles no longer provide a road map. The classical view of contract falls apart. And once one accepts this general notion that individuals are responsible for their words that are reasonably relied upon, there is little left of Holmes's core principles. Contractual liability is no longer an on/off objective proposition limited to bargained-for exchanges and generating liability for full-expectation damages. Instead, it is merely a species of civil liability. It is subsumed within tort law. We face the death of contract.

In the forty years since *Death of Contract,* contract has yet to morph into a species of tort. The revolutionary doctrines of the first half of the twentieth century, such as promissory estoppel, have had only modest and limited scope in practice. The core principles that Holmes put forward are still very much with us, but their logic and limits are now much better understood.

We share the view of the legal realists that some rules are arbitrary, but we no longer see such formality as a vice. There is a virtue in having a realm of contract, apart from ordinary civil liability, that is demarcated by clear rules. We have concluded that these rules work well enough. The debate is not much over whether formal rules are arbitrary. Instead, it is over whether the formal rules we have work as well as they might or whether others might work better.

The worker would like to know where she stands. In a world in which everything turns on reliance, we shall not know if her job is assured until there has been a jury trial. The boss would like to be in a world where

she does not have to worry about whether she has entered into a contract every time she puts off an employee. The world is a better place if the process of creating a legally enforceable contract is subject to a clear set of conventions.

Consider the following legal rule: no deal unless there is sealing wax. Until the boss signs, seals, and delivers a new contract, the firm can get off the hook. Assume that parties know that this was the legal rule. If parties know the legal rule and if it is the legal rule that largely determines the behavior of the parties, everyone would know where they stand. If the boss is evasive, the worker can respond, "Look, I do not want to be a pest, but our hands are tied by this legal rule. I need to have the certainty of having a job for another year, and I can't have it if you do not get out the sealing wax. You have to make up your mind: Do you want me or not? If you tell me simply that I am all right or that my job is secure, that is just as good as telling me there is no deal. Anything short of sealing wax means that you have not entered into the contract with me."

This sort of formal legal rule tells all the players where they stand. It does not allow for ambiguity. The worker either gets the contract, or she is still an employee at will, someone who can be dismissed for any reason or no reason at all. But there is a dark side of formal rules as well. In a world in which you have to use sealing wax, "Don't worry, it's OK" means the same as "Have a nice day." Formal rules work only to the extent that people know them and pay attention to them, and this will not always happen.

There is no single answer to the question of whether a formal legal rule makes sense in any environment. Often formalities create more trouble than they are worth. But instead of thinking of formal legal rules as being out of step with the underlying reality, we are now inclined to see how they can be tools that parties can fashion for their own purposes. Contract law is essentially an empty vessel that allows parties to organize their affairs in a way that makes them better off.

We no longer think of the specific rules of contract law, such as expectation damages, as capturing some set of values immanent in the grand scheme of things. They make sense because they serve a useful purpose. In the case of expectation damages, for example, the legal rule forces each of the parties to internalize the costs that their breach will impose on the other. It is not the only rule parties might pick, but it is a sensible one. Given that parties cannot spell out all the terms of their contract, it

is useful to have contract law provide terms that work for most parties most of the time.

Much of the work of contract law lies in fleshing out the bargain that parties strike between themselves. As noted at the chapter's opening, courts will enforce the bargains of merchants according to their terms. Problems arise when the terms are not clear or, more often, incomplete. Much of contract law simply fills in gaps that apply when the parties are silent. Contract law, in other words, consists largely of default rules. Parties are free to vary them if they choose, and there is no virtue in requiring parties to adopt one set of contract terms rather than another.

This heuristic, like every other, has its limitations. Parties never have all the time and the money in the world. Asking what bargain parties would strike if bargaining were easy misses fundamental features of our world. Nevertheless, asking what sort of deal two merchants would reach if they could bargain over a term explicitly is nearly always a good starting place. If you press for a rule that is something other than what you think most people would want if they thought about it, you should offer some explanation.

This view of contract law as a set of default rules has become part of the mainstream in recent years, but it is hardly new. It can be seen at work in Holmes's own contract opinions. The law should endeavor to impose on a party those contract terms "which it fairly may be presumed he would have assented to if they had been presented to his mind."[6]

In the first four chapters of this book, I examine the traditional principles that Holmes thought foundational to the law of contract, and then I review the contemporary understanding of them. In Chapter 1, I examine the idea that a contract does not require a subjective meeting of the minds. Instead, we use an objective benchmark to determine whether two parties have reached an agreement with each other. As has been the custom in contract classes for more than a century, the classic case of *Raffles v. Wichelhaus* provides the point of entry. Chapter 2 explores the traditional idea that a legally enforceable contract comes into being only when there is a bargained-for exchange. Another canonical case, *Hamer v. Sidway,* is again the focal point of the discussion. The next two chapters look at the idea that courts enforce promises by requiring the payment of money damages. Chapter 3 focuses on Holmes's idea that one can understand what courts are doing by treating the promisor's obligation as an option to pay money damages in the event she does not perform.

Chapter 4 explores the expectation damages principle, the idea that the damages awarded for breach of contract should equal the amount sufficient to put the promisee in the same position she would have been in had the promise been kept.

The next three chapters examine the rules against which parties negotiate their original bargain or seek to modify it. In Chapter 5, I explore the background understanding the law imparts to commercial dealing between parties, both in the good faith duties they assume and their disclosure obligations to one another. Chapter 6 explores the doctrines of excuse and mistake, while Chapter 7 looks at the doctrine of duress and the challenge of distinguishing mutually beneficial renegotiation in light of changed circumstances from advantage taking. In Chapter 8, I examine how the law of contract operates in the marketplace where standardized terms are the norm, and there is none of the one-on-one bargaining between *A* and *B* that is the stuff of the traditional law school hypothetical. In a brief Epilogue, I take stock of where we stand today in the Holmesian enterprise of demarcating the boundaries of contract law.