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## Convergence by Design: Who Contracts and the Plural Purposes of Contract Law

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## **Convergence by Design: Who Contracts and the Plural Purposes of Contract Law**

Gregory Klass\*

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That which has been produced, being found  
serviceable for certain ends, begets use.

– Lucretius, *De rerum natura* 4.835<sup>1</sup>

Pluralists have an apparent problem. Robust pluralism maintains that the law is justified by or answerable to multiple independent, nonordered principles. But independent principles can come into conflict. More to the point, different principles can recommend different legal rules or case outcomes. Without an ordering principle to resolve those conflicts, a pluralist theory cannot say what the law should be and so can provide legal decisionmakers no practical guidance. But then the theory is not performing its job.

A committed pluralist might answer the objection by denying that the job of legal theory is to provide practical guidance. Legal theory is not the handmaiden of adjudication or legislation. Its job is to make sense of the law. And just as there are genuine ethical dilemmas, so too there are legal ones.<sup>2</sup> Where there exists a legal dilemma, the job of legal theory is not to resolve, but to expose and explain.

This response is fine as far as it goes. But it is only half the answer. The objection to robust pluralism assumes not only that the job of legal theory is to guide officials, but also that the only way to resolve a practical conflict between competing principles is by recourse to a higher-order principle. Stated at a high enough level of generality, that claim is a near tautology. True dilemmas are by definition irresolvable without recourse to

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<sup>1</sup> Lucretius, *On the Nature of Things* 4.835 (J.S. Watson tr. 1851).

<sup>2</sup> See, famously, Lon L. Fuller, *The Case of the Speluncean Explorers*, 62 Harv. L. Rev. 616 (1949).

some higher-order rule or principle. But the tautology does not tell us how common true dilemmas are or where they are likely to occur. Nor does it address tools lawmakers might have to resolve competing principles or to create multipurpose rules.

This Article examines those questions, with special emphasis on how a law of contract can be designed to resolve conflicts between multiple justificatory principles and plural functions. The past fifty years have witnessed significant advances in the micro-economic analysis of contract doctrine. Non-economically oriented contract theorists have tended to focus on one strain of that work: efficiency theories within the tradition of welfare economics, which maintain that contract law is or should be structured to maximize the gains of trade and thereby social welfare. Theorists' focus on efficiency theories is not surprising. Welfare economics relies on a contestable theory of law, and efficiency theories can appear to ignore important aspects of contract law. That focus, however, has resulted in the neglect other results from the economic analysis of contracts. More specifically, theorists have largely ignored economic and functionalist scholarship on the *design* of legal rules. Over the past fifty years economists and others have produced important results on how remedial rules can affect not only post-breach behavior, but also the decision to breach or perform, renegotiation, pre-performance reliance, price, and other aspects of contractual transactions;<sup>3</sup> they have provided more systematic analyses of the likely effects of different rules of interpretation and more nuanced understandings of the possible preferences of parties with respect to those rules;<sup>4</sup> and there has emerged a huge

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<sup>3</sup> For an overview, see Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. Cal. L. Rev. 629 (1988).

<sup>4</sup> See, e.g., Omri Ben-Shahar, *The Tentative Case Against Flexibility in Commercial Law*, 66 U. Chi. L. Rev. 781 (1999); Lisa Bernstein, *The Questionable Empirical Basis of Article 2's Incorporation Strategy: A Preliminary Study*, 66 U. Chi. L. Rev. 710 (1999); George M. Cohen, *Implied Terms and Interpretation in Contract Law*, in 2 *Encyclopedia of Law and Economics* 78 (Boudewijn Bouckaert & Gerrit de Geeds eds., 2000); Richard Craswell, *Offer, Acceptance and Efficient Reliance*, 48 *Stan. L. Rev.* 481 (1996); Avery Weiner Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 *Colum. L. Rev.* 496 (2004); Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 *Tex L. Rev.* 1581 (2005); Alan Schwartz & Joel Watson, *Conceptualizing Contract Interpretation*, 42 *J. Legal Stud.* 1 (2013); Robert E. Scott, *The Case for Formalism in Relational Contracts*, 94 *Nw. U. L. Rev.* 847 (2000).

literature on the uses of default terms<sup>5</sup> and a nascent one on the rules for determining when a default does not apply.<sup>6</sup>

All this is relevant to the indeterminacy claim. Viewed in the abstract, it might appear impossible to reconcile, say, the claim that contract law should aim at efficiency with the claim that contracts are enforced because they entail promissory obligations. Whereas efficiency might recommend a rule encouraging efficient breach, the moral obligation to perform does not go away when performance becomes more costly. Whereas efficiency might recommend trading away more accurate interpretation for the reduced litigation costs and greater predictability textualism provides, a focus on promissory obligations might recommend more contextual rule of interpretation to ensure enforcement of the parties' actual agreement. And whereas efficiency recommends conditioning enforcement on the parties' intent to be legally bound, theories that focus on the moral wrong of breach suggest liability in the absence of such an intent. This Article's thesis is that conflicts like these, which can appear intractable in theory, can in fact often be resolved in practice through the design of legal rules.

The most straightforward way to show that something is possible is to do it. To examine the practical possibility of a contract law with several independent, non-ordered justifications, I construct models of what such a contract law would look like.

Part I begins by identifying several independent purposes a law of contract might serve. It is common wisdom among contract scholars that theories of contract law often reflect the type of contractual transaction the theorist imagines as paradigmatic. Neoclassical economists tend to focus on agreements between firms, which are arguably structured to be rational profit-maximizing machines.<sup>7</sup> Promise theorists think about transactions

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<sup>5</sup> See, e.g., Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87 (1989); Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 Stan. L. Rev. 1591 (1999); Omri Ben-Shahar & John E. Pottow, *On the Stickiness of Default Rules*, 33 Fla. St. U. L. Rev. 651 (2006); Lisa Bernstein, *Social Norms & Default Rules Analysis*, 3 S. Cal. Interdisc. L.J. 59 (1993); Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 Fla. St. U.L. Rev. 563 (2006); Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 389 Cal. Interdisc. L.J. 389 (1993); Alan Schwartz & Robert E. Scott, *The Common Law of Contract and the Default Rule Project*, 102 Va. L. Rev. 1523 (2016); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. Legal Stud. 597 (1990).

<sup>6</sup> See Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 Yale L.J. 2032 (2012); Gregory Klass, *Intent to Contract*, 95 Va. L. Rev. 1437 (2009).

<sup>7</sup> See, e.g., Alan Schwartz and Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 Yale L.J. 541, 544 (2003) (arguing that contracts between firms are "the main subject of what is commonly called contract law—namely, the rules

between natural persons, often picturing them as nonsophisticates or even acquaintances.<sup>8</sup> Relational theorists focus on small businesses in supply chains or trade associations.<sup>9</sup> Part I leverages this truism to provide stylized versions of several theories of contract law, and by extension several purposes a law of contract might serve, by modeling transactions with various types of parties in different situations. I construct five models distinguished along two dimensions: party preferences with respect to the allocation of the gains or losses of trade and the circumstances of contracting. I consider three preference types: purely self-interested rational utility maximizers, rational utility maximizers with a strong preference for sharing, and self-interested rational utility maximizers also committed to the moral principle that agreements are to be kept. With respect to the circumstances of contracting, I focus on the difference reputation and repeat play can make in transactions between self-interested rational utility maximizers.

In each model I ask both why the populace might want a law of contract and those reasons might find expression in legal doctrine. The models illustrate *inter alia* how untheorized assumptions about who parties are and how they transact can affect theoretical claims about contract law's function and optimal design. They also provide a common framework identifying tensions between different purposes contract might serve and for exploring how a law of contract might be designed to resolve those tensions.

Each model in Part I pictures a homogenous society, in which all parties have similar allocative preferences and transact in similar circumstances. Part II adds heterogeneity, both of party preferences and of conditions of contracting. I first model a society comprising a mix of amoral rational self-interested utility maximizers and persons committed to the moral principle that agreements are to be kept. I then consider what it would take to construct a single law of contract that serves reasonably well across several of the models in Part I. Part II focuses on three doctrinal choices: the role of intent to contract in the conditions of contractual validity, the rules of contract interpretation, and remedies for breach. By showing how these rules can be designed to serve the preferences and commitments of heterogeneous parties and the various purposes of contract law across heterogeneous societies, Part II demonstrates the practical

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in Article 2 of the Uniform Commercial Code (UCC) and the provisions of the Restatement (Second) of Contracts”).

<sup>8</sup> See, e.g., Seanna Shiffrin, *Is a Contract a Promise?*, in *The Routledge Companion to Philosophy of Law* 241, 243-48 (A. Marmor ed., Routledge 2011) (employing on detailed examination of a hypothetical agreement between Meg and Peter in which Peter is to build a bookshelf for Meg).

<sup>9</sup> Most famously and influentially, Stewart Macaulay in *Non-Contractual Relations in Business: A Preliminary Study*, 28 *Am. Soc. Rev.* 55 (1963).

possibility of a contract law that serves multiple purposes and is justified by several independent nonordered principles. It demonstrates, in other words, the possibility of convergence by design.

Cutting across all the models is a broad difference I have noted elsewhere between theories that picture contract law as a power-conferring rule and theories that picture it as a duty-imposing one.<sup>10</sup> Modeling parties as self-interested rational utility maximizers suggests a contract law that confers on private persons a quasi-legislative power to purposively undertake legal obligations when they wish. On this power-conferring picture of contract law, contractual liability stems from the parties' intent, at the time of formation, to undertake a legal duty. Modeling parties as committed to the moral principle that agreements are to be kept suggests instead that contract law is a duty-imposing rule. On this picture, contractual obligations result not from the parties' intent to undertake them, but from the moral obligations that attach to an agreement for consideration and promises to perform. Part II demonstrates *inter alia* how a law of contract can be designed to at one and the same time be both a power-conferring and a duty-imposing rule.

Part III draws lessons for the theory of contract law. My thesis is not that a contract law can be designed to serve any imaginable collection of laudable principles or purposes, but that it is possible to construct a law of contract that serves several socially valuable independent purposes, and by extension, is answerable to multiple independent, nonordered principles. I identify seven reasons why this is so. First, though convergence by design does not require perfect congruence between the doctrinal implications of different principles, it does require that they not diverge too radically. I identify salient purposes and principles that meet this requirement. Second, it is enough for conflicts between principles to be resolved on the level of doctrine. We need not resolve them in every possible, or even actual, case. Third, the principles that animate contract law are themselves somewhat indeterminate in their prescriptions as to what the law should be, making it easier to find a workable resolution among them. Fourth, the implications of many principles depend on empirical facts about which we have limited data. Empirical uncertainty weakens principles' prescriptive claims, again making resolution easier. Fifth, as the Part I models suggest, both the social interests in enforcement and the design options available depend on who contracts and the circumstances of contracting. This creates an opportunity to tailor rules to the type of transaction. Sixth, and crucially, default terms can be designed to balance contract law's duty-imposing and power-conferring functions. More specifically, defaults can advance social interests in imposing nonchosen legal duties and at the same time grant

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<sup>10</sup> See Gregory Klass, *Three Pictures of Contract: Duty, Power and Compound Rule*, 83 N.Y.U. L. Rev. 1726 (2008).

parties the power to choose alternative legal obligations. Seventh, the altering rules that govern what parties must do to avoid a default can also be crafted to take account of contract law's several functions. Impeding altering rules, for example, can achieve a separating equilibrium that again both takes account of contract law's duty-imposing function and gives the right parties the power to choose alternative regimes. Taken together, these facts entail that the indeterminacy objection is not as fatal as it might appear.

This Article's method and thesis are both novel. The analysis does not start from general political or moral principles—the value of autonomy, the desirability of maximizing social welfare, parties' duties to keep their promises, the demands of corrective justice, or the like—and derive from them what the law of contract should be. Nor does it attempt to interpret the law of contract we have to identify the principles or purposes embedded within it. Rather than providing an account of the design, function or justification of our contract law, this Article compares and contrasts several stories one might tell about the law. The models of homogenous societies in Part I serve to isolate several distinct functions the law of contract might serve and to examine the doctrinal implications of each. The models of heterogeneous societies in Part II provide a way to think generally about how a single contract law can serve several purposes at once, again with an emphasis on the interplay between function and doctrine. The goal is not to argue for one or another principled or interpretive theory of contract—though I believe that the models I discuss capture important aspects of contemporary contract law. It is to map out a theoretical space that principled and interpretive theories might occupy to the end of better understanding what we can accomplish with the law of contracts.

## I. Five Simple Stories About One Thing

This Part borrows a method from Carol Rose's *Property as Storytelling* to think about reasons for having a law of contract.<sup>11</sup> Rose's observes that theories about what the law is or should be often assume one or another picture of legal subjects, one or another picture of the people whom the law is to govern. She describes several idealized legal subjects. Each is defined by a preference ordering among the following possible allocations of some valued resource X:

- I get a lot of X, and so do you
- I get pretty much X (where "pretty much" is something over one-half of "a lot"), and so do you

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<sup>11</sup> Carol M. Rose, *Property as Storytelling: Perspectives from Game Theory, Narrative Theory, Feminist Theory*, 2 Yale J. L & Human. 37 (1990).

- I get a little of X, and so do you
- I get a lot of X, and you get nothing
- I get nothing, and you get a lot of X

I will begin with two of Rose's possible personalities, whom she calls "John Does" and "Moms" and whom I will rename "Takers" and "Sharers."<sup>12</sup> A Taker has the preferences of a self-interested rational utility maximizer:

- Choice 1: I get a lot of X, you get a lot of X  
2: I get a lot of X, you get zip  
3: I get pretty much X, you get pretty much X  
4: I get a little X, you get a little X  
5: I get zip, you get a lot of X

It will be noticed that a Taker is not solely self-interested. Their ordering of the first two options indicates that, other things being equal, a Taker would prefer that another succeed so long as they also succeed. Except for those choices, however, a Taker's ordering is driven in each scenario by the first-person clause to the left of the comma. A Taker cares first and foremost about the size of their own share.

A Sharer's preference ordering is less self-interested:

- Choice 1: I get a lot of X, you get a lot of X  
2: I get pretty much X, you get pretty much X  
3: I get zip, you get a lot of X  
4: I get a lot of X, you get zip  
5: I get a little X, you get a little X

A Sharer's choices are systematically other-regarding, though not to the exclusion of their own welfare. A Sharer prefers that both get pretty much (their choice 2) to another get a lot and they get nothing (choice 3). Rose also suggests that the ordering between choices 4 and 5 reflects the fact that if a Sharer gets a lot, which Rose stipulates is more than twice a little, they can transfer some of it to the other, moving both to choice 2. Unlike a Taker, satisfaction of a Sharer's preferences always results in the greatest joint welfare. That is, a Sharer always prefers an allocation where there is more total X to one in which there is less X.

Rose describes several other characters, but I am going to work with only Takers and Sharers, and later add a third of my own. And whereas

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<sup>12</sup> Rose's names reflect several feminist claims she makes in her article. See *id.* at 53-57. I have changed the names because I have little or nothing to say on that topic—which is not to say that some of the conclusions of this Article could not be taken in that direction.



Rose keeps the situation static, I want to think about how these personalities interact in different circumstances. The goal is to explore how, under varying social conditions, transactions between different types of legal subjects could work, and then to ask what social function contract law might play in each context.

#### A. Takers in Takerland

Takers are primarily self-regarding. A Taker will always prefer more for themselves, even if this means less for another. If there is a pie to divide, each Taker at the table wants the biggest piece they can get. In this section I consider Takers who live in a place I call “Takerland,” defined by three features. First, all residents of Takerland are Takers. Second, Takerlanders live largely independently of and know very little about one another. In Takerland, people come together only when there is a reason to do so, and it is unusual for a resident of Takerland to transact with the same person more than once or twice in a lifetime. Third, Takerlanders do not have a preference for realizing the requirements of morality, justice, fairness or the like. They do not orient their behavior by what they believe to be right.

One reason for Takers to come together is that they can sometimes create more value by working jointly than they can by working individually. Takers will choose to work together if by doing so they can increase the size of the pie. Bigger pies can mean bigger pieces for everyone involved. But there is a problem. Working together can create the risk of opportunism, the risk that one party will appropriate a large share of the pie at the expense of the other. Worries about opportunism can prevent Takers from entering value-creating transactions.<sup>13</sup>

Consider the following example. Suppose Anne and Bruce are Takers living in Takerland. Anne has the ingredients to make one peach pie, but neither the skills nor equipment to bake it. Bruce has the skills and equipment to bake pies but lacks ingredients. Both will benefit if they can work together to bake a pie. They can shift themselves from a no-pie world into a pie world, and having a pie is more valuable than the resources (ingredients, equipment, time) it takes to bake it. So long as Anne and Bruce split the resulting pie somewhat evenly,<sup>14</sup> each will be better off than before. But there is a problem. Anne worries that if she gives Bruce the ingredients, Bruce will bake a pie and keep it all for himself. Anne has this

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<sup>13</sup> See Thomas Hobbes, *Leviathan* 84-85 (Hackett 1994) (1668); David Hume, *A Treatise on Human Nature* 520-21 (L.A. Selby-Bigge & P.H. Nidditch eds., Oxford Univ. Press 2d ed. 1978) (1739-1740)

<sup>14</sup> The split must give Anne at least as much pie as she would be willing to accept to sell her ingredients to a third party and give Bruce at least as much pie as he would be willing to accept to sell his time and rent his equipment to a third party.

worry because she knows Bruce is a Taker. Anne knows that Bruce's preference ordering includes:

- ....  
 2: Bruce gets a lot of pie, Anne get zip  
 3: Bruce gets pretty much pie, Anne get pretty much pie  
 ....

So Anne worries that if she shares her ingredients with Bruce, he will not share the resulting pie with her. Call this the "mistrust problem."

Left entirely to their own devices, Anne and Bruce might come up with any number of solutions to the mistrust problem. Anne could stay in the kitchen while Bruce bakes the pie. Bruce might offer Anne a hostage to hold during the pie-baking process, say a box of cookies equivalent in worth to Anne's portion of the finished pie. Or Anne and Bruce might offer to share some of their pie with Zeno, on the condition that Zeno enforce the sharing of the finished pie.

If there is a law of contracts in Takerland, Anne and Bruce can instead solve the mistrust problem by entering a contract. Here society provides for free something like the service that Anne and Bruce might have paid Zeno to perform. Suppose contract law in Takerland looks more or less like our contract law, and generally enforces agreements with money damages or specific performance. Such a contract law solves the mistrust problem in two ways at once. First, the threat of a lawsuit gives Bruce a new reason to share. It *deters* Bruce's defection from their agreement. Bruce's preference ordering now looks like:

- ....  
 2: Bruce gets pretty much pie, Anne gets pretty much pie  
 3: Bruce gets a lot of pie *and (a) pays the costs the remedy for breach, Anne gets zip plus (b) any benefits from the remedy for breach*  
 ....

The deterrence effect is described by clause (a) in Bruce's new choice 3. Its magnitude depends on the remedy for breach. So long as that remedy costs Bruce at least as much as the benefit he would receive from keeping Anne's share of the pie, Bruce will prefer sharing to keeping the pie for himself. Second, legal liability for breach *insures* Anne against the possibility that Bruce will choose not to share. This insurance effect is captured by clause (b). As a self-interested rational utility maximizer, Anne does not really care whether Bruce shares the pie. When deciding whether to provide the ingredients under the proposed agreement, all Anne cares about is that doing so will make her better off than not doing so. All that is important to

Anne is that she will prefer the world with the transaction to the world that would have been without it. If Anne ends up preferring the transaction world because it includes pie rather than pie-ingredients, great. If she ends up preferring it because it includes, say, a cash payment worth more to her than the ingredients were, that's great too.

The above paragraph assumes that the remedy for breach involves a transfer from Bruce to Anne, whether in the form of a cash payment or an injunction requiring that Bruce provide Anne something like performance. This need not be the case. If the remedy is that Bruce will be beaten with sticks for a refusal to share, the law gives Bruce a new reason to share without insuring Anne, who is generally indifferent to Bruce's pleasure or pain, against Bruce's defection. Alternatively, if the remedy is a payment to Anne from a general insurance fund, to which all pie-bakers like Bruce must contribute (compare workers' compensation), Anne's gain from the transaction is guaranteed without giving Bruce a new reason to share.

Either pure deterrence or pure insurance could, in theory, be enough to solve the mistrust problem. But given the choice, Anne and Bruce will opt for a transfer remedy, which at one and the same time both deters and insures. As compared to beating Bruce with sticks, a transfer remedy can provide the same deterrence plus the added benefit of a transfer to Anne. Bruce will therefore agree to the transfer remedy either because he is mildly other regarding (Anne benefits and it costs Bruce nothing), or because Anne will offer to give up some of her share of the pie in exchange for that added benefit (Anne and Bruce both come out ahead). The reason Anne and Bruce prefer a transfer remedy to pure insurance is a bit more subtle. Under a pure insurance approach, Anne and Bruce pay a third-party insurer, who prices the policy based on the probability that Bruce will defect. But it is cheaper for Bruce to provide that insurance himself. Bruce knows more about the chance that he will defect than does any third party. And the fact that he is paying reduces the likelihood of his breach, lowering the ex ante risk-adjusted costs. Bruce can keep all these benefits of being the insurer, or he can share them with Anne in the form of a bit more pie. Either way, the parties again come out ahead with a transfer remedy.

Parties' mutual preference for transfer remedies in Takerland is an important result. Advocates for corrective justice and civil recourse theories of tort have argued that efficiency theories, which generally assume that people act like Takers in Takerland and that the only goal is to maximize overall welfare, cannot explain the bilateral structure of tort remedies—why the law requires a transfer from the tortfeasor to the tort victim.<sup>15</sup> If, as

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<sup>15</sup> See, e.g., Benjamin C. Zipursky, *Civil Recourse, Not Corrective Justice*, 91 *Geo. L.J.* 695, 735 (2003); Jules Coleman, *Risks and Wrongs* 374-85 (2d ed. 2003); Jules

efficiency theorists argue, the point of tort law is to force people to internalize the costs of their actions, damages could just as well be paid to the state or a general insurance fund rather than to the victim. In fact, from the perspective of efficiency a nontransfer tort remedy has distinct benefits. Payments can reflect the riskiness of the behavior rather than to the harm it happened to cause. And potential victims have better incentives to take precautions against the negligence of others. The fact that transfer to the victim appears to be a deep part of our tort law, these theorists argue, is evidence that efficiency accounts are at best incomplete. Corrective justice or civil recourse explains the obligations of wrongdoers to those whom they have wronged in a way that efficiency cannot.<sup>16</sup>

There is no parallel bilateralism problem for efficiency theories of contract law.<sup>17</sup> Tort law, according to economic accounts, is designed primarily to influence one decision: how much care to take when acting. Economic theories explain contract law as designed to influence two decisions: the choice at the time of formation whether to enter a value-creating transaction and the choice at the time of performance whether to perform. The first function explains the prevalence of transfer remedies in contract law. Transfer remedies, because they at one and the same time deter breach and insure against it, are the cheapest solution to the mistrust problem at the time of formation. If efficiency cannot explain the bilateral structure of tort law, it does explain the bilateral structure of contract.

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Coleman, *The Practice of Principle* 13-24 (2001); Ernest J. Weinrib, *The Idea of Private Law* 47 (1995).

<sup>16</sup> This is not to say that efficiency theories of tort have no explanation for why damages are paid to victims. Payment to victims allows for a system of contributory negligence, which gives the right incentives to potential tort victims as well. And insurance against negligent harm might prevent the inefficient chilling of certain activities. The claim is that these arguments do not explain the strength of our attachment to a transfer remedy.

<sup>17</sup> Nathan Oman's argues that bilateralism is a problem for economic accounts of contract. Nathan B. Oman, *The Failure of Economic Interpretations of the Law of Contract Damages*, 64 Wash. & Lee. L. Rev. 829, 851-59 (2007). Oman, like the economists he criticizes, focuses on efficiency arguments concerning the performance decision. He does not consider the efficiency gains from bilateralism when it comes to the formation decision. See also Brian Bix, *Contract Law: Rules, Theory and Context* 113 (2012) ("[T]he bilateral structure of contract law . . . is one of the strongest pieces of evidence that contract law is related to corrective justice."); Jody S. Kraus, *Transparency and Determinacy in Common Law Adjudication: A Philosophical Defense of Explanatory Economic Analysis*, 93 Va. L. Rev. 287, 336-43 (2007) (arguing that economic analysis doesn't need to explain bilateralism in contract or tort); Stephen A. Smith, *Contract Theory* 397 (2004) ("[F]rom an efficiency perspective, the link between defendant and plaintiff is merely one of administrative convenience.").

As between these two decisions—Anne’s decision whether to enter the transaction and Bruce’s decision whether to perform—the above story gives Anne’s decision a certain priority. Legal liability for breach in Takerland serves first and foremost not to deter Bruce from the wrong of not sharing, but to assure Anne that she can rely on Bruce doing so. Without such assurance, there would be no agreement from which Bruce might defect. In Takerland, deterrence (together with insurance) serves assurance.

This is not to say that assurance, deterrence and insurance are the only functions of a law of contract in Takerland. Having provided a framework that allows Anne and Bruce to cooperate to bake a pie, contract law can serve their interests in other ways as well.

First, contract law can simplify Anne and Bruce’s negotiations by providing default terms. Anne and Bruce want to bake a pie, not spend time defining the ingredients Anne will provide (Do nectarines count as peaches?), their respective rights and duties in every possible future (What happens if Bruce’s kitchen catches fire while the pie is in the oven?), or even the remedy for defection (Can Anne beat Bruce with a stick, force Bruce to give her some pie, or force a money payment?). The law can simplify matters by providing Anne and Bruce a set of default constructions of their unadorned agreement to bake and share a pie, thereby freeing them from the need to specify every aspect of the transaction. Contract law here serves a *coordinating* function. It provides off-the-rack agreement structures that parties can adopt as-is or alter to fit their individual needs.

Second, contract law can *guide* Anne and Bruce to the terms that will enable them to extract the most value possible from their agreement to bake. It is not just that Anne and Bruce do not want to spend time specifying every possible detail of the transaction. They also do not want to spend time working out the optimal way to structure it. The law can help by providing default terms that are likely to get Anne and Bruce as much pie from the transaction as possible. Efficient defaults have two advantages. First, parties who know what is efficient need not expend the effort to contract around the default. Because efficient defaults are in Takerland majoritarian defaults, they save transaction costs. Second, parties who are not certain which terms will maximize the value of the transaction can rest assured that the defaults are their best bet. In those transactions, efficient defaults make lemonade out of the transaction costs of opting out.

Consider the default remedy for breach. To keep things simple, suppose lawmakers in Takerland face a choice between three measures of money damages: reliance, expectation and treble damages. There is a familiar argument that, in many circumstances, the expectation measure allows Bruce and Anne to realize the most value possible from their pie-

baking venture.<sup>18</sup> The reasons why this is so have to do with the incentives Bruce will face should his costs of performance go up—if, for example, it suddenly becomes more expensive for Bruce to run his oven (unexpected out-of-pocket costs), or if Zelda offers Bruce much more money for Anne's share (an unexpected opportunity cost). If Anne and Bruce would find it difficult in such circumstances to negotiate an exit or renegotiate a performance price, they can realize more value from the transaction by giving Bruce the option and an incentive to avoid performance when it costs Bruce more to provide Anne her share than the share is worth to her. By forcing Bruce to internalize the value of the transaction to Anne, the expectation measure provides this result. Under the reliance measure, Bruce might choose to breach even though Anne values her share of the pie more than Bruce's costs of sharing. Under treble damages, Bruce might choose to perform even though the costs of sharing exceed the value Anne attaches to her share. The expectation measure lies at the Goldilocks point in between. At the time of formation, Anne likes this result too. Because Bruce expects to gain more from the transaction by avoiding wasteful performance, he will be willing when they cut the deal to share a bit more of the pie with Anne. The expectation measure gives Bruce the incentives that, at the time of formation, both parties want.

The law can help Anne and Bruce arrive at this efficient remedy by setting it as the default. If Anne and Bruce are sophisticated parties, the rule saves them the trouble of saying which remedy they want. Silence gets them their preferred term. If they are unsophisticated, the rule helps them get the result they should want, given their preferences. They can take their cue from the default, using it as a guide to arrive at the agreement that best serves their interests. The coordination function helps Anne and Bruce save the transaction costs of reaching advance agreement on every aspect of the transaction; the guidance function helps them end up with the best transaction possible.

All these functions—assurance, which involves both insurance and deterrence, coordination, and guidance—aim to help Anne and Bruce satisfy their primarily self-regarding preferences. Satisfying party preferences is not the only possible reason to have a contract law in Takerland. But it is the most obvious one. It is not clear that Anne and Bruce, or any of the

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<sup>18</sup> This argument, which is of course the theory of efficient breach, was first articulated by Robert Birmingham in his 1970 article, *Breach of Contract, Damage Measures, and Economic Efficiency*, 24 Rutgers L. Rev. 273, 284, 288-89 (1970). As a policy prescription for what the remedy should be in the actual world, the argument simplifies much too much. See Gregory Klass, *Efficient Breach*, in *The Philosophical Foundations of Contract Law* (G. Klass, G. Letsas & P. Saprai, eds., OUP 2014). I stipulate here that the theory holds true in Takerland because the efficient breach theory is often viewed as at odds with other theories of contract law.

other inhabitants of Takerland, would want a contract law that did more. Recall that the inhabitants of Takerland have no interest in morality or justice. They are indifferent to the fact that Bruce's defection from the agreement wrongs Anne, or that Bruce might owe Anne compensation as a result. They care only about satisfying their self-regarding preferences. If contract law can help them do so, they're all for it. If it cannot, they would rather not be bothered.

#### B. Sharers in Sharerland

What of a world made up of Sharers? Like Takers, Sharers are defined by their preference ordering. Unlike Takers, Sharers' preferences are other regarding. A Sharer prefers "I get pretty much, you get pretty much" (their choice 2) to "I get a lot, you get zip" (their choice 4). But a Sharer does not completely ignore their own interests. They also prefer "I get pretty much, you get pretty much" (their choice 2) to "I get zip, you get a lot" (their choice 3).

These other-regarding preferences give Sharers a significant advantage when they want to engage in value-creating cooperative activities. Suppose two Sharers, Carl and Doris, want to bake a peach pie. Carl is to provide the ingredients and Doris to do the baking, and they agree to share the resulting pie. Because Carl knows that Doris is a Sharer, he is not worried about opportunistic breach—that Doris will take his ingredients, bake the pie, then refuse to share. Carl knows that Doris's preference ordering includes:

- ....
- 2: Doris gets pretty much pie, Carl gets pretty much pie
- ....
- 4: Doris gets a lot of pie, Carl gets zip
- ....

As a result, Carl, who himself prefers getting pretty much pie to getting zip, trusts that if he provides the ingredients, Doris will bake and share the pie. Sharers in Sharerland therefore enjoy a significant advantage over Takers in Takerland. Whereas mistrust can keep Takers from entering mutually beneficial transactions, Sharers' preferences take opportunism off the table. A preference for sharing makes cooperation easy.

Nor do Sharers need a legal remedy to help them exit agreements whose performance has become inefficient. The argument for expectation damages in Takerland had a hidden premise: that when performance becomes inefficient, it would be expensive or impossible for Anne and Bruce to negotiate an exit from the contract. The efficiency of the expectation measure presupposes the efficiency of giving Bruce an incentive to choose between performance and breach without consulting

Anne. The canonical explanation is that the parties are in a bilateral monopoly, which makes it difficult for them to jointly arrive at an exit price.<sup>19</sup> Two Sharers face no such obstacle to renegotiation. Suppose Carl would be willing to sell his share of the pie for \$10 and that Zora offers to buy it from Doris (who was going to deliver it to Carl) for \$16. Doris, who knows Carl's preferences, will choose to sell Carl's share to Zora and split the gains from nonperformance with him—giving Carl \$13 and keeping \$3 for herself. Doris chooses to split the \$6 gain from nonperformance because she prefers that both she and Carl get pretty much to getting a lot for herself and leaving nothing extra for Carl. Carl is happy because he is better off than if Doris had delivered the pie, and because Doris is better off too. Carl and Doris will arrive at a similar result if Doris's costs of baking unexpectedly go up, except that now Doris and Carl will agree to share the losses. The theory of efficient breach does not hold true in Sharerland. Sharers' mutual preference for sharing makes it easy for them to agree on an exit price: both prefer to split the gains from nonperformance.

Sharers find it easy to cooperate both at the time of formation and at the time of performance because Sharers want the same thing. This is obvious if we put Doris and Carl's preference orderings side by side.

Doris's Preferences

- 1: Doris gets a lot, Carl gets a lot
- 2: Doris gets pretty much, Carl gets pretty much
- 3: Doris gets zip, Carl gets a lot
- 4: Doris gets a lot, Carl gets zip
- 5: Doris gets a little, Carl gets a little

Carl's Preferences

- 1: Carl gets a lot, Doris gets a lot
- 2: Carl gets pretty much, Doris gets pretty much
- 3: Carl gets zip, Doris gets a lot
- 4: Carl gets a lot, Doris gets zip
- 5: Carl gets a little, Doris gets a little

Doris and Carl disagree only in their ordering of Choices 3 and 4. But neither represents an equilibrium. Whoever ends up with a lot will choose to share with the other, moving the parties to something like each's Choice 2. Because Sharers' preferences orderings coincide, there are no intrapersonal conflicts for contract law to mediate. All Sharers prefer transactions that maximize joint welfare and produce something like an equal distribution. The upshot is not only a preference against opportunism, but that two Sharers will generally prefer the same outcomes. It is therefore difficult to see why Sharers in a Sharerland would ask the law to provide any remedy for breach.

This is not to say that there is no reason to have a law of contract in Sharerland. Recall the two other functions contract law plays in Takerland: coordination and guidance. Although Carl and Doris are not worried about

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<sup>19</sup> See Robert Cooter, *The Cost of Coase*, 11 J. Legal Stud. 1, 16-20 (1982).



defection, they do need to agree on the details of how they are going to bake the pie—who is going to provide what, how they will divide the pie, what each should do in various unlikely circumstances. The law can help them cheaply reach agreement on these details by providing a set of default terms. And as in Takerland those defaults can be structured to guide Sharers toward transactions that create more value, better satisfying their preferences. The law might, for example, offer default terms that point the way toward efficient risk allocation. But as the example of the expectation remedy shows, efficient terms in Sharerland might be very different from efficient terms in Takerland. If there is a contract law in Sharerland, it is there only to provide something like advice about the best rules of the road for exchange agreements. It is a device for standard setting, not for remedying nonperformance. Given the trouble of putting those standards in place, and the fact that cooperation works so well without them, perhaps contract law does not exist at all in Sharerland.

### C. Takers in Smallville

When there are gains to be had from working together, Sharers enjoy a significant advantage over Takers. Because any two Sharers' preference orderings coincide, Sharers find it easy to cooperate. Because any two Takers' preference orderings diverge, Takers find cooperation difficult. And although contract law allows the inhabitants of Takerland to solve the mistrust problem, that solution does not come cheap. First, there are the obvious costs of enforcement—lawyers, courts, juries, sheriffs—borne by the parties and by society at large. Add to these the higher transaction costs of entering a contract. Because they rely on legal enforcement rather than on one another's good will, Takers want their agreement to cover as many substantive details and contingencies as possible in a form that will be unmistakable to a third-party enforcer. Although majoritarian and tailored defaults can help reduce those costs, in an atypical or high-value deal Takers will expend a lot of time and effort negotiating and recording their contract. Exclusive reliance on legal enforcement can also cost Takers in the performance of their agreement. When an event occurs the contract does not anticipate, Takers must either stick to the original plan or undertake expensive renegotiations. In short, Takers find themselves wasting individual and social effort reaching, modifying, monitoring and enforcing agreements. Sharers can just get on with the business of mutually beneficial cooperation.

All these expenses might make a Taker wish they were a Sharer in Sharerland. But getting from Takerland to Sharerland is difficult. Although an individual Taker might, through reflection or training, be able to change their preference ordering, it does them no good to become a Sharer all by themselves. The benefit of being a Sharer is the chance to live in Sharerland. Sharers enjoy no advantages in a world of Takers but are systematically

exploited.<sup>20</sup> A Taker in Takerland will choose to become a Sharer only if other Takerlanders agree to convert too. But this is just the sort of cooperative, trust-based venture that Takers are especially bad at.

Takers might achieve some of the advantages of Sharerland if we change a feature of their environment: that they transact with each other only sporadically. We know from game theory that if self-interested rational utility maximizers cannot solve a one-shot prisoner's dilemma, they can arrive at cooperative solutions when the dilemma is repeated indefinitely.<sup>21</sup> Successful strategies to iterated prisoner's dilemmas involve a mix of trust and retaliation. We might begin, then, by allowing our Takers to enter multiple transactions with one another.

To get at this possibility, I want to move the analysis to Smallville, a quiet town nestled in the hills just inland from the eastern seaboard. Smallville is no more than a village, and its population is relatively immobile. It is not uncommon for a person to be born, live and die in Smallville. The residents of Smallville are all Takers. But there are two important differences between the circumstances of transacting in Takerland and those in Smallville. First, Smallvillers often engage in repeat transactions with the same person. Second, Smallvillers know a lot about one another.

Now consider the situation of Edna and Fred, two Takers who live in Smallville. Edna is a farmer who produces peaches, flour, sugar and butter. Fred owns and runs a bakery. Each can realize new value by using his or her assets to bake a pie with the other. Unlike Anne and Bruce (our Takers in Takerland), however, Edna and Fred have the opportunity to bake multiple pies together. If Edna and Fred both adopt a tit-for-tat strategy—defection by one will lead to a future defection or refusal to deal by the other—it will be in the interest of each to perform. Recall that the origin of the mistrust problem in Takerland lay in Bruce's preference ordering:

- . . . .
- 2: Bruce gets a lot of pie, Anne get zip
  - 3: Bruce gets pretty much pie, Anne get pretty much pie

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<sup>20</sup> Consider the outcome when a Sharer plays a one-shot Prisoner's Dilemma with a Taker. The Sharer's dominant strategy is cooperation. The Taker's dominant strategy is defection. As a result, the Taker gets a lot, the Sharer gets zip. This outcome ranks first among available outcomes in the Taker's preference ordering, second in the Sharer's.

<sup>21</sup> Robert Axelrod, *The Evolution of Cooperation* (1984). Axelrod's analysis suggests some qualifications on the claims in the previous paragraph. Although it is not advantageous to be one Sharer in a world of Takers, it might be worth it to be a Sharer if there were a critical mass of Sharers and the cooperative payoff of a Sharer-Sharer transaction was significantly higher than the gains from a Taker-Taker transaction. See *id.* at 63-65.

....

Because he is a Taker, Fred would have the same preference ordering in a one-time pie-baking transaction. But if he sees the opportunity for iterated pie baking with Edna and knows that Edna will play tit-for-tat, Fred's preference ordering might well flip to:

....

- 2: Fred gets pretty much pie<sub>1</sub>, pie<sub>2</sub>, pie<sub>3</sub>, . . . ; Edna gets pretty much pretty much pie<sub>1</sub>, pie<sub>2</sub>, pie<sub>3</sub>, . . .
- 3: Fred gets a lot of pie<sub>1</sub> and no pie<sub>2</sub>, pie<sub>3</sub>, . . . ; Edna gets zip

....

Fred's preferences will flip if the present value of pie<sub>2</sub>, pie<sub>3</sub>, . . . is worth more to Fred than is the difference between a lot of pie<sub>1</sub> and pretty much pie<sub>1</sub>. In these circumstances, Fred will choose to perform the agreement to share. If Edna is aware of these facts, she will trust Fred to share. Repeat players in Smallville can solve the mistrust problem without the law's help.

This solution works only if Edna and Fred know a lot about one another. At a minimum, Edna must know that Fred prefers a long-term pie-baking relationship to the gains he would get from defecting on the first pie; Fred must know that Edna will play tit-for-tat; and Edna must know that Fred knows that about her. This is much more knowledge than was required in Takerland. There Anne and Bruce's attempt to bake a single pie ran up against Anne's knowledge that Bruce, like any other Taker, was a self-interested rational utility maximizer and therefore preferred defection to sharing. And the contract solution worked because Anne knew that Bruce, again like any Taker would, preferred sharing to the legal remedy for breach.

How is it Edna and Fred know so much about one another? Herein lies the importance of Smallville's other distinguishing feature: reputation. Because they live in Smallville, Edna and Fred might with very little effort know all sorts of things about each other. They might be acquaintances or even neighbors. Even if they have never met, they know or can easily find out about one another by repute. Edna can easily learn that Fred is a professional baker who would value a long-term relationship with a supplier. And Edna knows that a few questions to his neighbors will tell Fred that Edna typically plays tit-for-tat. Armed with that knowledge, Edna will trust Fred to deliver his share of the pie.

In fact, reputational forces are so strong in Smallville that Edna and Fred might be able to agree to bake even a single pie without the law's help. If Fred does not expect to bake another pie with Edna, he still prefers a future in which he can work with other Smallvillers to produce pies and other confections. To do so he will need their trust, which defection from

his agreement with Edna might cost him. Reputational effects mean that Fred's choices in a one-time transaction in Smallville can look very much like they do in iterated pie baking:

- ....
- 2: Fred gets pretty much pie<sub>1</sub>, pie<sub>2</sub>, pie<sub>3</sub>, . . . ; Edna gets pretty much pretty much pie<sub>1</sub>, pie<sub>2</sub>, pie<sub>3</sub>, . . .
- 3: Fred gets a lot of pie<sub>1</sub> and no pie<sub>2</sub>, pie<sub>3</sub>, . . . ; Edna gets zip
- ....

The only difference is that that now “pie<sub>2</sub>, pie<sub>3</sub>, . . .” in Fred's preference ordering refers to baked goods that Fred might produce in cooperation with other Smallvillers. With enough information, either repeat play or reputation can solve the mistrust problem.

In all this, Edna and Fred remain Takers—self-interested rational utility maximizers. But because they live in Smallville, they enjoy many of the benefits of being Sharers in Sharerland.<sup>22</sup> Repeat play and reputation provide cheaper and, in some cases, more effective enforcement mechanisms. Refusing to deal with Fred in the future is not costless to Edna. But it can be less expensive than getting lawyers and courts involved. And the threat to Fred's reputation costs Edna next to nothing—simply talking to her Smallville neighbors. Repeat play and reputation are also more effective than legal enforcement when Fred's defections are observable by Edna and other Smallvillers but would be difficult to verify in court. And these mechanisms give Edna and Fred greater flexibility in their dealings with one another. When something unexpected happens—a bad shipment of peaches, an oven that isn't working, an attractive offer from a third party—it is in the interest of both to resolve the issue to their mutual satisfaction to preserve the relationship and reputations. Consequently, Edna and Fred do not feel the need to work out every detail of their agreement in advance and will find it easier to modify when necessary. Lastly, because they do not have to express their agreement in a form that a third-party enforcer can understand, Edna and Fred also save on drafting costs. It is enough that they understand one another.

This is not to say that life in Smallville is ideal. Although Edna and Fred find it possible to work together without the law's help, they remain rivals with respect to the pies they produce. Each prefers as large a share for her- or himself as possible, including when that share comes at the

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<sup>22</sup> For the classic empirical account of the phenomena described in this paragraph, see Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 Am. Soc. Rev. 55 (1963). For an introduction to relational contract theory generally, see Robert W. Gordon, *Macaulay, Macneil, and the Discovery of Solidarity and Power in Contract Law*, 1986 Wis. L. Rev. 565.

expense of the other. These conflicting preferences create at least three costs. First, when disagreements arise or there is a need to modify the agreement, Edna and Fred find themselves in the same bilateral monopoly Anne and Bruce sometimes landed in. As a result, each wastes resources trying to secure the largest possible share of the renegotiated pie for her- or himself. Second, although it is cheaper for parties to observe defections than it is to prove them in court, monitoring performance is not free. Given the chance, Edna will provide substandard ingredients, and Fred will keep more pie for himself. Each will therefore expend resources to ensure that the other is not defecting. Finally, repeat play and reputation work only when Edna and Fred both expect that Fred will continue work as a baker, either with Edna or with other residents of Smallville. But no one bakes forever. If Edna believes Fred might be headed for bankruptcy, planning a move away, or otherwise ending his career in Smallville, repeat play and reputation no longer assure performance.

These observations suggest two functions for a contract law in Smallville. First, Edna and Fred might want a law of contract for those rare occasions in which repeat play and reputation do not solve the mistrust problem. If everyone knows that Fred is planning to leave Smallville for good, Fred will find himself in something like Takerland when he wants to bake pies with others. Because Edna knows that Fred no longer has a reason to care about future pies, she will require other assurances that Fred will not defect. A law of contract can provide them. When repeat play and reputation break down, contract law can play the same assurance function *at the time of formation* in Smallville that it does in Takerland.

Second, sometimes in Smallville repeat play and reputation are enough to solve the mistrust problem—the parties do not require the assurances of legal liability—but one or the other party nonetheless finds it in her interest to defect. This distinguishes Smallville both from Takerland and from Sharerland. In any given Takerland transaction, expectation damages both deter breach and insure the nonbreaching party against it, perfectly solving the mistrust problem. In Sharerland, parties who defect always share the gains from defection, perfectly avoiding the mistrust problem. In Smallville, in distinction, trust in repeat play and reputation is a calculated bet, one that sometimes fails to pay off. A second possible function of contract law in Smallville, therefore, is not to provide assurances at the time of agreement, but to address failures of repeat play and reputation *at the time of performance*.

It is fairly obvious why the residents of Smallville would want a contract law to serve the first function. It allows them to engage in mutually beneficial transactions that would otherwise fail for a lack of trust. But why would they want contract law to serve the second function—to provide a remedy for breach when there was no mistrust problem at the time of formation? This is a more difficult question. Like the denizens of Takerland,

Smallvillers by hypothesis do not have a preference for morality, justice or fairness. They therefore have no interest in punishing the wrong of breach, in compensating its victims, or in using remedies to express that a wrong has occurred. As Takers, however, Smallvillers are interested in rules that maximize preference satisfaction in the aggregate. The agreement between Edna and Fred is prima facie evidence that the transaction is value creating. This is a reason for the Takers in Smallville to enforce the agreement to share—to get the pie in the hands of the person who most likely values it most highly. When repeat play and reputation do not give Fred a reason to perform, the threat of legal liability might.

This second function of contract law in Smallville has nothing to do with assurance. It is pure deterrence. The focus is not on Edna's earlier decision whether to enter into the transaction, but on Fred's later decision to share or not to share. In Takerland, deterrence played second fiddle to assurance. In Smallville, deterrence comes into its own, and, in this respect, contract law looks a bit more like tort. Just as tort law can function (for Takers) to force potential tortfeasors to internalize the costs of their harmful activities, so contract law can give parties a reason to perform when performance is efficient, thereby maximizing social welfare.

The residents of Smallville, who generally prefer bigger pies, would be happiest if contract law gave Fred a reason to share only when Edna values her share of pie more than Fred does. They would prefer a rule that incentivizes efficient breach. But it is more difficult to construct such a rule in Smallville than it was in Takerland. Parties' incentives in Takerland are monothetic. Because he lives in Takerland, Bruce's only reason to perform is the threat of legal liability. This makes it relatively easy to craft a remedy that gives Bruce a reason to share when and only when Anne values her share of the pie more than Bruce values nonperformance. This is not so in Smallville. If repeat play and reputation are insufficient to cause Fred to perform, that does not mean that they are inert. The costs of breach in Smallville often include a mix of legal and nonlegal consequences. This makes it difficult to use legal liability to fine-tune Fred's incentives. Efficient breach might be desirable in Smallville, but it is difficult for the law to incentivize it.

This is not the only difference between remedies for breach in Takerland and remedies for breach in Smallville. If the focus in Smallville is more on Fred's decision whether to perform or defect, as distinguished from Edna's decision whether to enter the transaction, it is somewhat less obvious in Smallville why the legal remedy should involve a transfer. The argument for a transfer remedy in Takerland was that its combination of deterrence and insurance was the least expensive and most effective solution to the assurance problem. Assurance in Smallville is more often secured through repeat play and reputation. There is therefore less reason in Smallville to adopt a remedy that benefits the nonbreaching party. This is

not to say that there are no reasons. But the use of a transfer remedy in Smallville looks a bit more contingent than it does in Takerland, and again more like the use of transfer remedies in tort.

To summarize: If there is a contract law in Smallville, it serves two distinct functions. First, at the time of agreement contract law picks up the slack in those few transactions in which repeat play and reputation do not provide sufficient assurances of performance. Second, at the time of performance contract law deters inefficient breaches when repeat play and reputation fail to do so. To these we can add the coordination and guidance functions that contract law also plays in Takerland and perhaps in Sharerland too. Here as elsewhere, legal defaults can reduce the costs of contracting and guide parties toward efficient terms.

The question remains whether in Smallville the contract game is worth the candle. One might worry that many of the advantages of repeat play and reputation are lost when legal enforcement is added to the mix.<sup>23</sup> The possibility of legal enforcement means Edna and Fred will want to decide on and spell out more details of their transaction in advance, out of fear that a court will later misinterpret their agreement. And the opportunity to sue for breach might make parties less flexible in the face of unforeseen circumstances. If the remedy involves a transfer, for example, the chance to recover damages might tip the balance against cooperative flexibility for the sake of future dealings. Parties might also worry about court error, especially findings of breach when there was performance. Lastly, widespread availability legal enforcement could interfere with the signals performance otherwise sends. Without legal enforcement, Fred's performance is evidence, for Edna and for others, that he cares about his reputation and wants to continue doing business with Edna and in Smallville. With legal enforcement, Fred's motives for performance are less certain. Contract law could end up undermining the very conditions that support repeat play and reputation.

The residents of Smallville will therefore want to limit contract law to transactions in which legal enforcement adds more value than it takes away. Because it is difficult to say in advance which transactions those are, the best solution is to allow parties to decide at the time of their agreement whether it will be legally enforceable. If, when they agree to bake a pie together, Edna and Fred say that they want their agreement to be legally enforced, the law should provide a remedy for breach. If they say they do not want enforcement, the law should keep out of it.

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<sup>23</sup> For arguments related to this point, see Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 Colum. L. Rev. 1377 (2010) (arguing *inter alia* that legal enforcement can "crowd out" informal enforcement mechanisms).

What should courts do when parties do not say one way or the other? Given the strength of repeat play and reputation in Smallville, the majoritarian default is almost certainly no legal enforcement. This further distinguishes Smallville from Takerland, where parties always face the mistrust problem and therefore always have a good reason to want the assurances of contract law. That said, the right default depends on other factors as well, such as what types of parties are more likely to know the rule and the relative costs of opting into or out of enforcement.<sup>24</sup> No matter how lawmakers resolve the question, however, we can expect the conditions of contractual validity that involve the parties' contractual intent to differ between Smallville and Takerland.

#### D. Takers in Gotham

The reason for making Smallville small was to explain how two Takers, both of whom expect to engage in multiple transactions with one another and who therefore each have a reason not to defect, can know all that about each other. In Smallville everyone knows everyone else's business. We can investigate other ways Takers might gain such knowledge by moving the model to the city of Gotham. Like the denizens of Takerland and Smallville, the residents of Gotham are all Takers. They are self-interested rational utility maximizers who have no preference for achieving moral or just outcomes. Like Smallville, it is not uncommon for two Gothamites to engage in multiple transactions with one another over an extended period. But Gotham is bigger. There is often a full six degrees of separation between any two Gothamites, whereas in Smallville there is never more than one or two. As a result, reputation is a much weaker force in Gotham. In Smallville, reputation is like cream stirred into coffee, quickly diffusing through the whole. In Gotham, it is like a marshmallow in hot chocolate, melting slowly and spreading unevenly.

The most immediate consequence of the move to Gotham is that residents entering one-time transactions find themselves in the same situation as do parties in Takerland. In Smallville, Fred's defection from his agreement with Edna costs him not only future business with Edna, but also business with other Smallvillers, who as a result are less likely to trust him. Defection from a one-time transaction in Gotham does not carry those costs. Suppose two Gotham residents, George and Harriet, agree to bake a single peach pie together, George supplying the ingredients and Harriet the labor and equipment. Because reputation does not flow in Gotham like it does in Smallville, Harriet's defection will have little or no impact on her ability to bake with other Gothamites. Unable to rely on repeat play or

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<sup>24</sup> I explore these in greater detail in Gregory Klass, *Intent to Contract*, 95 Va. L. Rev. 1437 (2009).



reputation, George and Harriet will have to look to other forms of assurance, such as legal enforcement, to solve the mistrust problem.

With respect to one-time transactions, then, contract law can serve exactly the same function in Gotham it does in Takerland: solving the mistrust problem. And contract law should look the same when applied to transactions of that type. If, for example, expectation damages are efficient in Takerland, they are likely also efficient in one-time transactions in Gotham.

Although reputation cannot solve the mistrust problem in Gotham, repeat play might. Suppose George and Harriet each wants to bake many pies with one another over a course of several years. That fact might give each a reason not to defect from the agreement to bake and share any given pie. Like Fred in Smallville, if Harriet's decision not to share pie<sub>1</sub> will cost her shares of future pie<sub>2</sub>, pie<sub>3</sub>, . . ., she will choose to share rather than defect. Like Edna, George can make this so by adopting a strategy of tit-for-tat in response to defections by Harriet. If they lived in Smallville, George and Harriet would know all this about one another. The question is how, as strangers in Gotham, they might gain that knowledge.

Here contract law can help. Suppose George and Harriet's agreement to bake pie<sub>1</sub> is legally enforceable. George now trusts Harriet not because he knows Harriet wants to bake future pies with him, but because he knows he can sue if Harriet defects. After they bake a pie together, George and Harriet are no longer strangers. Nor, however, are they fully transparent to one another. George might not know whether Harriet shared because she wanted to avoid a lawsuit or because she did not want to lose the chance to bake future pies with George. Harriet is not yet certain whether George is the type of person who plays tit-for-tat. But they know a bit more about one another. And as they continue to bake pies, they will learn even more. This is especially so if unforeseen circumstances arise that call for departures from their original agreement. If one summer George is unable to deliver peaches, but has a surplus of apples, Harriet might agree to bake apple rather than peach pies, though peach pies would be of more value to her. If Harriet's oven breaks down, George might give Harriet extra time to bake the pie or accept a smaller share in light of Harriet's extra expenses. Through such acts of unforced flexibility, George and Harriet get to know more about one another's interests and habits of reciprocity. Also relevant will be unexcused breaches and the responses to them. If Harriet sells George's share to a third party, and George responds not with a lawsuit but by refusing to provide peaches for a week, Harriet will learn that George is likely to retaliate—that he plays tit-for-tat. As their knowledge of one another increases, George and Harriet can increasingly rely on their shared interest in maintaining the relationship, rather than the threat of a lawsuit.

This is not to say that George and Harriet become friends. Friendship includes generosity and care. Because they remain Takers, George and Harriet will never be friends in this sense. Given the chance, either will defect and take more than his or her share of pie at the expense of the other. They share only so long as each values the continuation of their cooperative venture more than the benefits of defection. This means that they will want to have a law of contract not only at the beginning of their relationship, to help them get to know one another, but also when it is coming to an end, when the prospect of repeat play can no longer sustain the trust between them. Contract law in Gotham functions to provide both an entry into repeat transactions and a smooth exit from them.

What sort of contract law best serves those purposes? There is an argument that when it comes to such long-term relational contracts, the law must be careful *not* to track the parties' actual expectations of one another.<sup>25</sup> George and Harriet appreciate the flexibility that reliance on repeat play gives them. But if every departure from their original agreement will result in a change in their legal rights and obligations, they will be less likely make concessions for one another's benefit. Although during the life of the relationship each relies primarily on the nonlegal assurances of repeat play, both know that at its end they will be relying on the threat of a lawsuit. (Smallvillers, in contrast, can often rely on reputational incentives at the end of a relationship.) Consequently, George and Harriet want the law to enforce the rights and obligations that they agreed to when they began transacting, rather than the actual practices and expectations they might have developed while working together. They will want courts to enforce contracts as they are written, rather than contracts as they have been performed or in light of the parties' actual expectations of performance.

Repeat players in Gotham, therefore, might want a different sort of contract law than do the residents of Takerland, or even one-time transactors in Gotham. Takers who do not expect to deal with one another again and who cannot rely on reputational incentives do not expect flexibility or concessions from one another. They rely entirely on the law. They therefore want the law to track their actual agreement and expectations as closely as possible. Takerlanders therefore want courts to interpret their agreements using past dealings, course of performance, evidence from negotiations, usage of trade and the like, so long as those contextualist modes of interpretation are cheaper and more accurate than writing out more detailed contracts and relying on more textualist

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<sup>25</sup> See Robert E. Scott, *The Case for Formalism in Relational Contracts*, 94 *Nw. U. L. Rev.* 847 (2000); Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 *U. Pa. L. Rev.* 1765 (1996).

interpretation.<sup>26</sup> Gothamites who enter into repeat transactions, on the contrary, want courts to take a somewhat more textualist approach to interpreting their agreements. Rules of interpretation that exclude course of performance and prior dealings make it easier for Gothamites to be flexible when they are in the middle of their relationship and are relying more on their shared interest in preserving it than on the threat of legal enforcement. As a result, Gothamites want their contract law to apply different rules of interpretation to one-time transactions than to repeat transactions. One-time transactions in Gotham are like transactions in Takerland and often benefit from relatively contextual rules of interpretation, whereas repeat transactions in Gotham almost always benefit from more textualist ones.

It is worth noticing one additional difference between Gotham and Smallville. Legal enforcement imposed several costs in Smallville: the need to clearly articulate in advance more details of the agreement, a loss in flexibility, the possibility of judicial error, and interference with signals that performance might otherwise send. I argued that Smallvillers would therefore want to limit contract law to transactions in which legal enforcement adds more value than it takes away. The way to do so is to ask whether the parties to a given transaction intended their agreement to be legally enforceable. Contract law imposes many of the same costs on repeat transactions in Gotham. As in Smallville, sometimes those costs will outweigh the benefits of legal enforcement. So Gothamites too will want their law of contract to be sensitive to whether the parties, at the time of agreement, wanted or intended enforcement.

But the rules for discerning that preference or intent are likely to differ between the two locales. Because repeat play and reputation are so strong in Smallville, most transactions do better without a contract. The majoritarian default in Smallville is therefore no legal enforcement. Because reputational forces are much weaker in Gotham, more parties want legal enforcement. This includes both those who are engaging in one-time transactions, who cannot rely on repeat play, and parties to repeat transactions, who need legal enforcement to get their relationship off the ground and want it when their relationship is coming to an end. Because, unlike most Smallvillers, these parties rely on contract law's assurance function, they are more likely at the time of agreement to think about and want enforcement. Consequently, whereas the majoritarian default in

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<sup>26</sup> Alan Schwartz and Robert Scott argue that in the actual world, firms (who have the preferences of Takers) generally prefer textualist rules—that the real-world costs of taking context into account in interpretation are not worth the benefits in increased accuracy. Schwartz & Scott, *supra* note 7. To keep things interesting, I am not going to assume that this is the case in Takerland. That is, I will assume that a larger proportion of parties in Takerland prefer letting more evidence of context into the interpretation of their agreements than Scott and Schwartz claim is true in the actual world. I treat the question in greater detail in Part II.B.

Smallville is no enforcement, the majoritarian default in Gotham is likely to be enforcement. As in Smallville, there might be reasons to adopt anti-majoritarian or more tailored defaults. But we should not expect the conditions of contractual validity in Gotham to be the same as those in Smallville, much less the same as those in Takerland or Sharerland.

#### E. Akrastic Dorights in Metropolis

The discussion so far has focused on parties' allocative preferences. Takers prefer more pie for themselves and are relatively indifferent to how much others get. Sharers care about how much others get and would rather share their pies. Each of the above scenarios explored how the law might help parties realize those preferences by helping them maximize the joint gains of trade—the size of the pie.

But this is hardly the only purpose a law of contract might serve. To get at other possible functions, this section adds a new character, whom I will call a "Doright." A Doright is like a Taker in that, other things being equal, they prefer more for themselves, even if it at the expense of others. But their selfishness is tempered by three additional attitudes. First, a Doright believes in a number of moral rules, including the rule *pacta sunt servanda*—agreements are to be kept. Second, a Doright has a general preference for doing what is right, even when doing what is right conflicts with their preference for getting more for themselves. Third, a Doright prefers to live in a world where others act morally over a world in which they do not. I call a person with these beliefs and preferences and whose preference for doing right always wins out over her preference for getting more for herself a "Perfect Doright."

To represent the preference orderings of a Perfect Doright, we must distinguish between situations in which there is a moral duty to act one way or another and situations that are morally neutral. Suppose the only relevant moral rule is that agreements are to be kept. If there is no agreement, a Perfect Doright's preferences would look just like those of a Taker:

- Choice 1: I get a lot of X, you get a lot of X
- 2: I get a lot of X, you get zip
- 3: I get pretty much X, you get pretty much X
- 4: I get a little X, you get a little X
- 5: I get zip, you get a lot of X

If there is an agreement to share, a Perfect Doright's preferences start off looking like those of a Sharer:

- Choice 1: I get a lot of X, you get a lot of X
- 2: I get pretty much X, you get pretty much X

The ordering further down the list depends on the content of the agreement—whether it says what should happen when sharing a lot or pretty much is not possible. Suppose the agreement says that so long as sharing is possible, the parties should share, and then the agreement runs out. This would make the remainder of the preference ordering:

- 3: I get a little X, you get a little X
- 4: I get a lot of X, you get zip
- 5: I get zip, you get a lot of X

Whereas the first two lines in a Perfect Doright's agreement-to-share preference ordering mirror those of a Sharer, the last three might change depending on the content of the agreement.<sup>27</sup>

In a world comprised entirely of Perfect Dorights, everyone would adhere to the *pacta* rule, agreements would always be kept, and there would be no mistrust problem. A Perfect Doright World would therefore look something like Sharerland, in that its residents would not need the law's help to enter value-creating agreements. But there would be features of Takerland as well. As the last two lines in the Perfect Doright's agreement-based ordering suggest, for example, Perfect Dorights might find it difficult to negotiate an exit if a new higher-value use for the resources appears or the costs of performance dramatically increase. The preference of each to get more for herself means that they might find it difficult to arrive at an agreement about how to divide gains from nonperformance. That said, other moral rules could help here. If both parties also adhere to the rule "share and share alike," they might find it relatively easy to agree on an exit price.

More interesting than a world composed of Perfect Dorights is one in which Dorights have a slightly weaker preference to do what is right, one that does not always win out over their preference to get more for themselves. I will use "Akrastic Doright" to describe Dorights that satisfy two conditions. First, although an Akrastic Doright always knows that it is right to keep their agreements, and their considered preference is to do what is right, even at the expense of getting more for themselves, an Akrastic Doright occasionally fails to realize that preference. Sometimes—not often—an Akrastic Doright's preference to get more for themselves wins out over their preference for doing what is right. Second, Akrastic Dorights tend to rationalize their moral failures. An Akrastic Doright who has done wrong often will not recognize their moral failure. They will be ready with an exonerating reason, for the benefit of others and themselves.

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<sup>27</sup> They might also vary depending on the requirements of other moral rules not here considered.

Let Metropolis be a city whose residents are all Akrastic Dorights. Everyone in Metropolis knows it is wrong to defect from an agreement, and everyone has a general preference for doing what is right. But people occasionally fail to realize that preference. Because they generally do the right thing, Metropolitans usually keep their agreement. But not always.

Just as repeat play and reputation, imperfect though they are, are usually enough to solve the mistrust problem in Smallville, so in Metropolis the shared preference for doing what is right, even though imperfectly realized, usually provides a sufficient basis for mutual trust in exchange transactions. Suppose that Iris and John, two Akrastic Dorights, enter an agreement in which Iris is to supply peaches and other ingredients, John is to use them to bake a pie, and John is to share that pie with Iris. Knowing that he is an Akrastic Doright, Iris is willing to trust John with her ingredients, even if their agreement is not legally enforceable. Iris knows that John's preference for doing what is right will most likely win out over his preference for having more pie. John's general adherence to the *pacta* rule means that he is likely enough to perform the agreement to share that Iris can trust him with her ingredients.

Compare the conditions of transacting in Metropolis to those in Smallville, another place where the mistrust problem is rare. Contract law in Smallville serves two salient functions. First, it solves the mistrust problem in those atypical transactions where repeat play and reputation fail to do so, such as when one party is exiting the market. The Akrastic Dorights in Metropolis do not need contract law in those circumstances, for they do not rely on repeat play and reputation. They rely on the fact that their compatriots adhere to the *pacta* rule often enough to make trusting them a good bet.<sup>28</sup>

The second salient function of contract law in Smallville is to deter breach when repeat play and reputation fail and performance is efficient, thereby maximizing parties' gains from the transaction. Like the Takers in Smallville, Akrastic Dorights occasionally fail to perform their agreements, albeit for a different reason: moral lapse. And like the residents of Smallville, Metropolitans might want the law to address these occasional failures to perform. But Metropolitans' *reasons* for wanting legal liability in those instances will be quite different from those of Smallvillers. Unlike the residents of Smallville, Metropolitans are Dorights. They care about morality. That concern looms large in thinking about legal liability for breach.<sup>29</sup>

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<sup>28</sup> There might be situations in which Metropolitans too could use contract law's assurance function. When profit margins are thin or the stakes are high and a party is risk averse, the slight chance of breach might be enough to deter her from transacting. I leave these possibilities aside for the sake of simplicity.

<sup>29</sup> The story of Metropolis is, of course, meant to capture the reasoning of promise-based theories of contract. The most important recent case for that approach can be

Akrastic Dorights' commitment to the *pacta* rule suggests three reasons they might want a law of contract. First, recall that all Dorights prefer to live in a moral society. Akrastic Dorights might think the *pacta* rule so important that performance should not be left to chance but should be enforced by the state. If this is Metropolitans' reason for wanting enforcement, the presumptive remedy for breach will be something like punitive damages or criminal sanctions. Either serves to deter breach *tout court*. If those remedies were also to deter some efficient breaches, that would be unfortunate. Like Takers and Sharers, Akrastic Dorights prefer legal rules that maximize the joint gains of trade. Their preference for doing what is right, however, means that they are sometimes willing to trade off efficiency for the sake of morality.

But perhaps Metropolitans see a difference between the *pacta* rule and, say, the moral injunction against homicide. Whereas the latter is so weighty as to warrant criminal enforcement, compliance with the *pacta* rule is best left to the *forum internum*, to the parties' moral choice. Akrastic Dorights might make this distinction because they consider homicide a more significant moral wrong than failure to perform an agreement. Or perhaps they believe keeping an agreement is more valuable when it is freely chosen, and that enforcement of the obligation to perform will interfere with the morality of agreement keeping.<sup>30</sup>

If Metropolitans do not want their law to enforce a party's obligations to perform, they might still want it to address the moral consequences of their failure to do so. Suppose Dorights believe that persons who violate the *pacta* rule owe their victims compensation for any resulting losses. They believe that a breaching party incurs obligations of corrective justice.<sup>31</sup> If Akrastic Dorights always recognized their own moral failures, there would be little call for legal enforcement of such obligations.

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found in Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 Harv. L. Rev. 708 (2007). The foundational work remains Charles Fried, *Contract as Promise: A Theory of Contractual Obligation* (1981). See also Charles Fried, *The Ambitions of Contract as Promise*, in *The Philosophical Foundations of Contract Law* (G. Klass, G. Letsas & P. Saprai, eds., 2014); Stephen Smith, *Contract Theory* 54-105 (2004). For a helpful account of the various moral functions contract law can serve, see Liam Murphy, *The Practice of Promise and Contract*, in *The Philosophical Foundations of Contract Law* (G. Klass, G. Letsas & P. Saprai, eds., 2014). For a broader account of the agreement-based moral obligations that might support performance, see Gregory Klass, *Promise Etc.*, 45 Suffolk U. L. Rev. 695 (2012).

<sup>30</sup> See Stephen A. Smith, *Performance, Punishment and the Nature of Contractual Obligation*, 60 Mod. L. Rev. 360 (1997).

<sup>31</sup> See John Gardner, *What Is Tort Law For? Part I*, 30 L. & Phil. 1, 38 (2011); Joseph Raz, *Personal Practical Conflicts*, in *Practical Conflicts: New Philosophical Essays* 172 (P. Baumann & M. Betzler eds. 2004).

An Akrastic Doright who has failed to perform would recognize that fact, know that they were under a moral duty to compensate, and, because Akrastic Dorights usually do the right thing, they would choose to do so. I have stipulated, however, that Akrastic Dorights often fail to recognize their own moral failures. This creates a space for the law to step in—and a second reason Metropolitans might want a law of contract. Even if Metropolitans would prefer that the law not enforce the first-order obligation to perform, they might want it to enforce second-order obligations of corrective justice.

If corrective justice is the reason Metropolitans want legal enforcement, we can expect that fact to inform the remedy for breach. Rather than punitive awards or criminal sanctions, the law will provide compensatory money damages or specific performance.<sup>32</sup> The measure of any money damages will depend on how Akrastic Dorights conceive the harms of nonperformance, which in turn depends on the reasons they believe agreements should be kept. Both the reliance and the expectation measures are therefore compatible with corrective justice, and perhaps disgorgement too, depending on how one understands the reasons for the moral obligation. But no matter what the measure, the point of the award would be to identify a violation of the *pacta* rule and to assess the obligations that follow.

Finally, Akrastic Dorights' concern for morality might make them care not only about individual wrongdoing but also about moral culture in Metropolis and the moral character of Metropolitans. This suggests a third reason for the legal enforcement of agreements. By marking a failure to perform as a violation of the *pacta* rule, the law can signal that the community considers it wrongful. Such an expressive function has fewer remedial implications than does the enforcement of first- or second-order obligations. Remedies need not be ideophones (an eye for an eye) to send a message. Given that Akrastic Dorights are already attuned to the importance of keeping their agreements, it might be enough for a court to announce that a wrong has been done. Declaratory relief might suffice. But one can also imagine arguments that a more severe remedy would send a clearer message. Nor is the expressive function incompatible with either the enforcement of first- or of second-order agreement-based obligations. Lawmakers in Metropolis might use an enforcement function to determine the remedy, and allow the expressive function to take care of itself.

For the sake of the analysis that follows, I am going to stipulate that contract law in Metropolis serves only the second and third functions. The

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<sup>32</sup> Specific performance is better understood as enforcing second-order duties to compensate, not the first-order duty to perform. Punitive damages or criminal sanctions deter breach altogether. An award of specific performance gives the plaintiff not what they bargained for (performance without a lawsuit), but as close an approximation as possible.



goal in developing these models is to think systematically about how a single law of contract can have several independent purposes. I believe there is a real tension between the use of contract law to enforce first-order performance obligations in a place like Metropolis and its use as a value-maximizing tool in purely instrumental relationships in a place like Takerland. More specifically, a social interest in the enforcement of first-order moral obligations looks to be at odds with permitting parties to structure their agreements in ways that enable unilateral defection when performance becomes inefficient. This makes it difficult to design a contract law that both enforces the first-order moral obligation to perform and supports the creation of efficient incentives. I'll say more on this point in Part II.A. For the moment, I simply stipulate that the citizens of Metropolis believe that legal enforcement of parties first-order moral obligations is undesirable, and that they want the law to enforce agreements only for reasons of corrective justice and to promote the moral culture of making and keeping agreements.

All the above reasons for imposing legal liability are rooted in Metropolitans' adherence to the *pacta* rule. A party's failure to perform might implicate other moral commitments as well. Suppose, for example, Metropolitans also believe in the rule share and share alike, which requires that people sometimes act like Sharers. That rule recommends withholding enforcement from unfair or one-sided agreements, and might even support a requirement that parties share losses when for no one's fault the costs of performance go up. Metropolitans might also believe in the second-order rule that a person should not benefit from her wrong. In that case, they might want to require disgorgement for especially wrongful breaches. If I bracket these and other moral considerations, it is for the sake of simplicity, not because they do not exist.<sup>33</sup>

Because Akrastic Dorights in Metropolis generally rely on one another's moral responsiveness rather than on legal enforcement, they often will not bother to write their agreements down in a way that is easily intelligible to third-party enforcers. This is not to say that they will not agree in advance on the details of their transaction. Because each knows that in the absence of agreement the other will act like a Taker, both want their agreement to cover as many contingencies as possible. Here contract law

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<sup>33</sup> There is a growing literature on how non-agreement-based moral obligations do or should figure into the rules of contract law. See, e.g., Aditi Bagchi, *Distributive Justice and Contract*, in *The Philosophical Foundations of Contract Law* (G. Klass, G. Letsas & P. Saprai, eds., 2014); Mindy Chen-Wishart, *The Nature of Vitiating Factors*, in *The Philosophical Foundations of Contract Law* (G. Klass, G. Letsas & P. Saprai, eds., 2014); and George Letsas & Prince Saprai, *Mitigation, Fairness and Contract Law*, in *The Philosophical Foundations of Contract Law* (G. Klass, G. Letsas & P. Saprai, eds., 2014); Prince Saprai, *Contract Law Without Foundations: Toward a Republican Theory of Contract* (2019).

can help by providing a set of off-the-rack default terms. Contract law in Metropolis plays the same coordination and guidance functions it does in the other regions.

But there will be differences in how those rules are structured. First, because Metropolitans' interest in legal enforcement is rooted in parties' moral obligations to one another, they are especially concerned that the law enforce the parties' actual agreement—the one to which the parties objectively agreed. When interpreting it, Metropolitans are more likely to want courts to take into account all the relevant facts surrounding that agreement. Metropolitan courts are therefore more likely to look to evidence of the course of negotiations, of past practices, of trade usage and the like when interpreting agreements. Like the residents of the other regions, Akrastric Dorights will want to be certain that the costs of using such context evidence are warranted by the gains in interpretive accuracy. But because they care about the parties' moral obligations, Metropolitans attach a higher value to accuracy, and are therefore willing to incur greater costs to achieve it. On the whole, the moral purpose of contract law in Metropolis requires that courts pay more attention to context when interpreting agreements.

Second, courts in Metropolis are more likely to choose majoritarian defaults than are courts in the other the jurisdictions considered above. Nonmajoritarian penalty or information-forcing defaults<sup>34</sup> work only when parties know the default and know that they will be subject to it. For this to be so, the parties must, at a minimum, understand themselves to be entering into not just an agreement, but also a contract—an agreement that is legally enforceable. For reasons discussed below, lawmakers cannot assume that Metropolitans are thinking about legal liability when they enter into agreements. This is an argument in favor of majoritarian defaults. If parties are less likely to be thinking about legal liability, a default that reflects the terms most parties choose is more likely to lead to accurate enforcement.

Should Metropolitan courts care about whether the parties intended legal liability? I have argued that both in Smallville and in Gotham courts will condition enforcement on the parties' intent to contract, though they are likely use different methods to test for that intent. Smallville courts employ a majoritarian nonenforcement default and require parties to say when they want legal enforcement. The majoritarian enforcement default in Gotham, on the contrary, is enforcement, suggesting a requirement that parties say when they do not intend their agreement to be legally binding.

Unlike the residents of Smallville and Gotham, Metropolitans do not want to condition contractual validity on the parties' intent to be legally bound. Whether the purpose is to enforce the first-order moral obligation to

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<sup>34</sup> See the two articles by Ayres & Gertner, *supra* note 5.

perform, to enforce a second-order moral obligation to compensate, or to support the moral culture of making and keeping agreements, there is no reason to limit enforcement to agreements in which the parties preferred, intended, or even merely expected legal liability. The contrast with Gotham is especially stark. In Gotham, parties to one-time transactions and at the beginning of a repeat transaction rely on contract law's assurance function. Without legal enforcement, their value-creating agreement would not be possible. Parties in Metropolis, in distinction, rely on one another's responsiveness to the *pacta* rule. Their instrumental calculus does not provide a reason to think they want or expect legal enforcement. Nor do the reasons for enforcement require such an intent. The Metropolitan law of contract, therefore, will not condition contractual liability on the parties' intent to contract.

This is not to say that courts will be indifferent to the parties' shared intentions with respect to the legal consequences of their agreements. It is possible that in some situations Akrastric Dorights might want their agreement to *not* be legally enforced. If their agreement is especially complicated, they might worry that courts will mistake what is going on should one party defect. Or parties might feel that legal enforcement would pollute their moral relationship. Such party preferences would be in tension with the community's preference that the law respond to all violations of the *pacta* rule. That said, Metropolitan lawmakers might recognize that legal enforcement is not costless. And they might place a positive value on the ability to place certain areas of life beyond the law's reach. If so, one might find a rule that, although the parties' intent *to be* legally bound is not a condition of contractual validity, their intent *not to be* bound will prevent the creation of a contract. They might adopt a rule such as that described in Section 21 of the Second Restatement of Contracts: "Neither real nor apparent intention that a promise be legally binding is essential to the formation of a contract, but a manifestation of intention that a promise shall not affect legal relations may prevent the formation of a contract."<sup>35</sup>

Again courts will have to develop rules for how to decide when parties have such an intent. They might presume, for example, that parties to some forms of agreements, such as agreements between family members, do not want legal liability, while requiring parties to other sorts of agreements to express their intent not to be bound.<sup>36</sup> But the underlying question will be very different from the question in Smallville and Gotham. Because the point of contract law in those regions is to enable the parties to better realize their own preferences, courts ask whether parties intend legal liability. Because the point of contract law in Metropolis is to respond to moral wrongs, courts ask only whether parties intended not to be bound.

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<sup>35</sup> See Restatement (Second) of Contracts § 21 (1981).

<sup>36</sup> See *id.* cmt. c.

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I have told the stories of Takerland, Sharerland, Smallville, Gotham and Metropolis in some detail because I am interested both in several possible functions of contract law and in how contract law might be designed to serve them. And the models illustrate how closely both the purpose and the design of contract law might be tied to who the parties are and the circumstances in which they find themselves.

The stories say something how theory often gets done. Rose uses her stories, which inspired mine, to illustrate the importance of narrative in theories of the private law. The great property theorists of the seventeenth and eighteenth centuries—Hobbes, Locke, Blackstone—do not simply reason from first principles to what the law should be. They tell stories about how law comes to be based on assumptions about the character of legal subjects and the circumstances in which those subjects find themselves.<sup>37</sup> Rose's alternative cast of legal subjects provide materials for telling counter-narratives to those theories. Those counter-narratives demonstrate how the classical stories assume a picture of human decisionmaking that does not always describe how real people act in the real world.<sup>38</sup> And they reveal gaps in the classical accounts.<sup>39</sup>

Rose's observation applies equally to many twentieth century theories of contract law. It matters very much whether a theorist pictures contracting parties as independent moral agents who undertake obligations to one another by acts of will, as persons who find themselves in a web of relationships and obligations that are only partly structured by the law, or as purely self-interested rational utility maximizers who need the law's help to engage in joint projects. The resulting theories of contract law cannot be used to justify the pictures. They presuppose them.

## II. Two Slightly More Complex Stories

The five stories in Part I engage in a form of economic reasoning. Each describes a model of human decisionmaking and then explores the

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<sup>37</sup> Rose, *supra* note 11, at 38-39.

<sup>38</sup> *Id.* at 43-48, 53-55.

<sup>39</sup> Rose makes the very strong claim that stories about self-interested rational utility maximizers cannot be the whole story. Creating and enforcing a property regime is an other-regarding activity that purely self-interested rational utility maximizers would not undertake. The classical stories therefore tacitly assume that at least some people at least some of the time act like Sharers. *Id.* at 48-53. As claim about the model, I think this argument is not entirely successful. In repeat-play situations, Takers can figure out ways to work together and establish binding norms. With respect to how the law actually comes to be and works, however, I think Rose is correct. Other-regarding preferences will figure into any descriptively adequate story about the creation of social organization.

possible purposes of a law of contract in that model. The models are distinguished by persons’ preferences—Takers, Sharers, Akrastic Dorights—and by the conditions in which they find themselves—anonymity and episodic interaction (Takerland, Sharerland and Metropolis), familiarity and repeat play (Smallville), anonymity and repeat play (Gotham). These combinations can be represented in tabular form as follows:

Table 1:

		Party Type			
		<i>Sharers</i>	<i>Takers</i>	<i>Akrastic Dorights</i>	
Transaction Conditions	<i>Episodic transactions</i>	Sharerland	Takerland		Metropolis
	<i>Repeat play</i>		Smallville	Gotham	
	<i>Reputation</i>				

If it seems odd to call these stories a form of “economic” reasoning, it is because they are premised on the thought that neoclassical economics does not capture everything that is happening in the law of contract. *Homo economicus*—the self-interested rational utility maximizer, or pure Taker—is a theoretical construct. Modeling people as Takers allows economists to ignore the blooming, buzzing confusion of humanity and, by focusing on a few salient propensities, to generate powerful predictive results and nontrivial normative arguments. But the generative power of the model should not be confused with descriptive accuracy or normative completeness. Real people are not all, or always, Takers. Sometimes they act like Sharers; sometimes they exhibit the preferences of a Doright. The above stories are meant in part to provide alternatives to the neoclassical economic emphasis on self-interested decision making and to identify stories that support alternative theories of contract.<sup>40</sup> If the question is why have a contract law in the actual world, we might want to think about other possible preference orderings and practical commitments.

That said, the five models remain just that: models. They are neither descriptions of our world nor principled arguments about what our law of contract should be. The stories employ a number of simplifying assumptions. First, in all but one, everyone is perfectly practically rational. The residents of Takerland, Sharerland, Smallville and Gotham always know what their preferences are, know what they need to do to realize them, and act accordingly. Even the Akrastic Dorights in Metropolis are

<sup>40</sup> For an attempt to complexify the neoclassical account in ways compatible with the analysis in Part I, see Rebecca Stone, *Economic Analysis of Contract Law from the Internal Point of View*, 116 Colum. L. Rev. 2005 (2016).

mostly rational, suffering only from the occasional moral lapse. Real people in the real world are at best imperfectly rational, and are perhaps systematically irrational.<sup>41</sup> Second, the models assume that individuals' preference orderings are largely independent of the law. The preferences of Takers and Sharers are treated as given and remain fixed no matter what the surrounding conditions. And whereas in Metropolis law can affect people's preferences by supporting the moral culture of agreement keeping, in that story too preferences come first, the law second. In the actual world, the circumstances in which a person finds themselves often shape their preferences, and those circumstances often include the existence of one legal rule or another.<sup>42</sup> A complete theory of contract law would take both imperfect rationality and the endogeneity of preferences into account.

That is not the project of this Article. I want to instead ask what happens when we relax a third simplifying assumption: homogeneity. In each of the above models, everyone has the same preference ordering, the transactions occur in similar circumstances, and there are only one or two transaction types. The remainder of this Part explores what happens when we add heterogeneity. The first section explores what role contract law might play in a mixed society of Takers and Akrastric Dorights. The second adds diversity of transaction types by asking how we might construct a single contract law that would work reasonably well across most of the models. The goal is to explore how a single contract law might be designed to serve the multiple functions identified above. The doctrinal tools discussed in this Part provide materials for the Part III's broader discussion of pluralism by design.

#### A. Takers and Akrastric Dorights in Borderland

Consider a place called "Borderland," lying on the frontier between Takerland and Metropolis. The residents of Borderland are evenly divided between Takers and Akrastric Dorights. Like in Takerland and Metropolis, transactions in Borderland are episodic and occur in conditions of anonymity. The same two parties rarely transact with one another more than once or twice, and they arrive at a transaction as strangers. Borderland appears in the above table as follows:

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<sup>41</sup> For an overview of both behavioral economics and more radical challenges to the rational choice model, Mark Kelman, *The Heuristics Debate* (2011).

<sup>42</sup> See, e.g., Jon Elster, *Sour Grapes: Studies in the Subversion of Rationality* (1982) (arguing that people change their preferences in light of their options); Jurgen Habermas, *The Theory of Communicative Action*, Vol. 2 (1987) (describing ways that social forces shape people's preferences); Mark Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. Cal. L. Rev. 669 (1979) (arguing that legal entitlements are likely to affect preferences).

Table 2:

		Party Type			
		<i>Sharers</i>	<i>Takers</i>	<i>Akrastic Dorights</i>	
Transaction Conditions	<i>Episodic transactions</i>	Sharerland	Takerland		Metropolis
		Borderland			
	<i>Repeat play</i>		Smallville	Gotham	
	<i>Reputation</i>				

Notice that parties in Borderland know less about one another than do parties in Takerland or Metropolis. In those homogeneous societies, each party at least knows their counterpart’s type—that they are a Taker or an Akrastic Doright. In Borderland, each party arrives at the transaction not knowing whether the other side is a Taker or an Akrastic Doright.

Now imagine a possible pie-baking exchange between two Borderlanders, Karl and Lorraine. Karl has the ingredients, Lorraine the equipment and labor. When deciding whether to trust Lorraine with his ingredients, Karl would like to know whether she is an Akrastic Doright or a Taker. If Lorraine is an Akrastic Doright, Karl can trust her to keep her agreement to share the resulting pie. If Lorraine is a Taker, Karl should worry that Lorraine will take his peaches then defect. Whether he is a Taker or an Akrastic Doright, Karl would be unhappy with the latter outcome. Both Takers and Akrastic Dorights rank “I get zip, Lorraine gets a lot” last in their preference orderings.

Unfortunately for Karl, I’ve stipulated that at the beginning of the transaction he does not know Lorraine’s type. Nor can Karl trust Lorraine’s representations that she is an Akrastic Doright who will do the right thing and keep her agreement. If Lorraine is a Taker, she is as insensitive to the moral rule, “Do not tell a lie,” as she is to the *pacta* principle.<sup>43</sup> Like parties in Takerland, Karl and Lorraine face a mistrust problem. Though they might both benefit from cooperating to bake a pie, Karl does not trust Lorraine to keep her agreement to share.

Like the Takers in in Takerland, Borderlanders might use contract law to solve the mistrust problem. A rule that imposes legal liability on Lorraine for breach of her agreement to share assures Karl that he can trust her with his ingredients. Also like in Takerland, the cheapest and most

<sup>43</sup> This example touches on a broader topic: the ways a well-functioning law of contracts relies on duties of candor. I explore the theme in Gregory Klass, *Misrepresentation*, in *Research Handbook on the Philosophy of Contract law* (P. Saprai & M. Chen-Wishart eds., Elgar forthcoming 2023).

effective way to achieve assurance in Borderland is with a transfer remedy. A transfer remedy at one and the same time deters Lorraine from breach and insures Karl against it. And because legal liability for breach is designed for situations in which Lorraine turns out to be a Taker, the optimal remedy in Borderland is likely to be the same as the optimal remedy in Takerland. If Lorraine is a Taker, expectation damages give her a reason to perform only when the shared benefits of performance exceed its costs. This is a good result for both parties, as it produces the most expected value for the two to allocate between themselves. Of course Lorraine might turn out to be an Akrastric Doright. But then the threat of legal liability will probably make no difference in her performance decision. Akrastric Dorights typically perform their agreements because it is the right thing to do, not because of any negative consequences the law attaches to nonperformance. Nor, however, does legal liability do any obvious harm in such a case.

In addition to the assurance function, contract law in Borderland might also serve the familiar coordination and guidance functions. By setting default rules for terms like the time and place of delivery, risk of loss, quality of goods and the remedy for breach, the law can save Karl and Lorraine the trouble of writing down, or even expressly agreeing on, every detail of the transaction. And by setting those defaults as the terms that maximize the value of most exchanges, contract law in Borderland can guide Karl and Lorraine to the best pie-baking outcome.

All this is largely continuous with contract law's function in Takerland. There is, however, an important difference. Takerlanders recognize one and only one reason to have a law of contract: to better satisfy their individual preferences for getting more. The same goes for the Takers who live in Borderland. They want a contract law only to increase the size of the collective pie, so everyone can get a larger slice for themselves. Half the population of Borderland, however, is comprised of Akrastric Dorights. Like Takers, Akrastric Dorights generally prefer getting more pie. They too want a contract law that increases the gains of trade. But the Akrastric Dorights in Borderland also care about the moral obligation to perform. They also want contract law to respond to the moral wrong of breach.

The remainder of this section explores how contract law might be structured in Borderland to serve these two very different purposes: maximizing the gains of trade and responding to the moral wrong of breach. I focus on two doctrinal questions: remedies and rules of interpretation. The next section, which further complicates the story, will also address rules regarding parties' intent to contract.

### 1. *Remedies*

Part I.E distinguished three moral functions Akrastric Dorights might want contract law to serve: to enforce first-order obligations to perform



agreements; to enforce second-order obligations to compensate the victims of wrongful breaches; and to support the moral practice of entering and keeping agreements.

If the Akrastic Dorights in Borderland believe that contract law should enforce the first-order obligation to perform, that commitment might cause them to disagree with their Taker neighbors as to the right remedy for breach. The moral obligation to perform does not end at the edge of efficiency. And although parties might agree to perform only if performance is efficient, that is not the best interpretation of many Borderlander agreements.<sup>44</sup> If Lorraine agrees to share the pie with Karl and then fails to do so, she has wronged Karl—even if her costs of production have gone up or she can now sell it to Zachary for a higher price. Lorraine has wronged Karl even she pays him the cash value of the pie she had agreed to share. Many Akrastic Dorights believe that to enforce the first-order obligation to perform, expectation damages are not enough. Enforcing first-order obligations requires that the remedy for breach include punitive damages or even criminal sanctions—measures that will deter or punish even efficient breaches.<sup>45</sup>

There will be less disagreement about remedies if the Akrastic Dorights in Borderland agree with their Metropolitan neighbors that the job of contract law is not to compel performance or punish breach, but to enforce a breaching party's second-order obligation to compensate. Expectation damages do just that: they put the nonbreaching party in something like the position she would have occupied had the agreement been performed. Expectation damages compensate the victim of breach for harms she has suffered as a result of the breach.

Because I am interested in how a single law of contract can serve multiple functions, I am going to stipulate that the Akrastic Dorights in Borderland, like those in Metropolis, do not want contract law to enforce first-order obligations to perform. They believe performance decisions are better left to the relatively unconstrained choice of moral agents and that

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<sup>44</sup> I have the luxury of stipulating that in Borderland most agreements are best interpreted as agreements to perform, not to perform or pay damages, or to perform or await a lawsuit. For arguments that this is not the best interpretation of contractual agreements between sophisticated parties, see Daniel Markovits & Alan Schwartz, *The Myth of Efficiency Breach: New Defenses of the Expectation Interest*, 97 Va. L. Rev. 1939 (2011). I question Markovits and Schwartz's interpretive approach in Gregory Klass, *To Perform or Pay Damages*, 98 Va. L. Rev. 143, 146-47 (2012).

<sup>45</sup> This is a bit overstated, as it assumes that legal enforcement of an obligation comes only in the form of deterrence and punishment. Lesser remedies can also serve to mark a legal wrong as such. That said, the intuition that enforcing a moral obligation means punishing its breach is a strong one. See Shiffrin, *supra* note 29 at 726-27.

the legal enforcement of the obligation to perform would degrade the moral culture of making and keeping agreements. Their moral compasses lead them to want contract law only to enforce second-order obligations to compensate and to support the moral practice more generally.

Even with this stipulation, the heterogeneous residents of Borderland might not be in perfect agreement on the remedy for breach. Consider the mitigation rule: a breaching party need not pay for losses that the nonbreaching party with reasonable efforts might have avoided.<sup>46</sup> If the residents of Borderland want contract law to provide efficient incentives all around, they will want the mitigation rule. The transaction between Karl and Lorraine creates more value if Karl has a reason, should Lorraine fail to hand over the pie, to limit his losses. The mitigation rule gives him such a reason. But the rule might strike Akrastic Dorights as contrary to the requirements of morality. Suppose they agree with Seana Shiffrin that “[i]t is morally distasteful to expect the promisee to do work that could be done by the promisor when the occasion for the work is the promisor’s own wrongdoing.”<sup>47</sup> Akrastic Dorights will then be unhappy with a rule that expects Karl to mitigate when Lorraine might do so instead, even if it would be cheaper for Karl to do so. Although it creates efficient incentives, the mitigation rule would not reflect Akrastic Dorights’ understanding of the parties’ moral situation.

On these assumptions, the remedial rules in Borderland will therefore require a compromise between the pure efficiency concerns of Takers and the additional moral concerns of Akrastic Dorights. If Borderland contract law includes the mitigation rule, the Akrastic Dorights who live there will consider it less than perfect. If the damage measure includes payment for avoidable losses, Takers will think it suboptimal. But compromise is possible. Both Takers and Akrastic Dorights find an imperfect contract law better than no contract law. And importantly, the rule for avoidable losses need only be a default. If the default is no recovery for avoidable losses, an Akrastic Doright might propose adding a term to the contract permitting their recovery. If her counterpart is also an Akrastic Doright, or wants to appear to be one, she is likely to agree to it. Although the new term might reduce the efficiency of the transaction, for two Akrastic Dorights it would represent a moral gain. Alternatively, if the default allows recovery of avoidable losses, two Takers might end up

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<sup>46</sup> Restatement (Second) of Contracts § 350 (1981).

<sup>47</sup> Shiffrin, *supra* note 29 at 725. I have argued elsewhere that Shiffrin’s concerns are more apposite to express promises than to other sorts of agreements. Klass, *supra* note 29 at 716-17. George Letsas and Prince Saprai argue that it is supported by nonpromissory principles of fairness. Letsas & Saprai, *supra* note 33, *passim*; Saprai, *supra* note 33 at 173-98. Because I am interested in possible conflicts among contract law’s functions, I stipulate that Akrastic Dorights agree with Shiffrin on this point.

contracting for the mitigation rule. Given that the parties have agreed ex ante to a responsibility to mitigate—essentially including it as a term of their agreement—it is not obvious why an Akrastic Doright would object to the outcome. The ability to contract around the rule, together with the broader agreement on the type of remedy, make compromise possible.

## 2. *Interpretative Rules*

Remedial rules are not the only site of potential disagreement amongst Borderlanders. They might also have divergent opinions as to how adjudicators should go about interpreting contractual agreements. Recall that both the Takers in Takerland and the Akrastic Dorights in Metropolis want adjudicators to sometimes consider interpretive evidence from outside the four corners of a writing—what the parties said in negotiations, their past dealings, their course of performance, usage of trade. Generally speaking, adjudicators should consider such context evidence when the benefits from increased accuracy and lower drafting costs outweigh the increases in litigation costs and uncertainty of outcomes that contextual rules can bring.

Tensions arise in Borderland because the Takers and the Akrastic Dorights there attach different values to interpretive accuracy. The Takers value accuracy because, absent defects in the bargaining process, self-interested rational parties choose terms that maximize the joint gains of trade. Enforcing the parties' actual agreement is therefore likely to result in the greatest value for everyone involved. The Akrastic Dorights in Borderland value interpretive accuracy for that reason. They too want *ceteris paribus* to maximize the gains of trade and appreciate the role of contract law in doing so. But they additionally value accuracy because they ascribe to contract law a moral function. The law can enforce second-order obligations to compensate and support the moral culture of promising only if it is attuned to parties' *actual* moral obligations, which requires accurately interpreting the content of their actual agreement. Akrastic Dorights therefore attach more value to accuracy than do Takers. They have an additional reason to want correct interpretation.

We should not make too much of this difference. First, recall that the Takers in Borderland are more sympathetic to using context to interpret contracts than are, say, repeat players in Gotham. Repeat players in Gotham worry that using course of dealings and course of performance evidence to interpret their agreements will prevent the emergence of extra-legal forms of trust. They therefore prefer more textualist interpretation. Because Borderlanders transact only episodically, they are not concerned about such relational costs. Consequently, although the Takers in Borderland are somewhat less favorably inclined toward context evidence of meaning than are their Akrastic Doright compatriots, they want less textualist rules than do repeat players in Gotham.

Second, the Akrastic Dorights in Borderland are less opposed to textualist rules of interpretation than are their counterparts in Metropolis. In Borderland, parties always face the mistrust problem and so always expect and want legal enforcement. Whereas Metropolitans entering into agreements are unlikely to be thinking about legal consequences, Borderlanders of all stripes are highly attuned to them. If the interpretive rule excludes some evidence of context, Borderlanders are likely to take that into account when expressing their agreement. They will choose to record more of it in language intelligible by a third-party adjudicator. Textualist rules of interpretation are therefore likely to be more accurate in Borderland than they are in Metropolis, and the Akrastic Dorights in Borderland therefore more willing to adopt them.

In short, although there are differences of opinion among Borderlanders as to the best interpretive rule, the residents are not so far apart on the issue. Moreover, like the mitigation rule, the choice of how much context to let in need be only a default. Borderlanders are happy to allow parties to contract for more or less textualist rules of interpretation, making compromise on the default all the more palatable. This does not yet say whether Borderland's lawmakers should set the default to allow slightly less context evidence of meaning, as preferred by the Takers, or slightly more, as preferred by the Akrastic Dorights. I address this problem in the Section B. But no matter what the default, the solution will likely be one that all Borderlanders can live with.

### 3. *Remedies Again: The Penalty Rule*

I have emphasized the advantages of defaults in resolving disagreements about how contract law should be structured. But not all disagreements in Borderland can be resolved by adopting a rule parties can contract around. Borderlanders might also disagree, for example, on the desirability of the penalty rule. Everyone in Borderland agrees that parties should be able to liquidate damages at or below a reasonable forecast of losses due to breach. Liquidated damages save litigation costs and increase certainty in transacting. And though underliquidated damages mean less than full compensation, the Akrastic Dorights in Borderland can live with that result. Like their neighbors in Metropolis, they attach a positive value to giving parties the ability to control the legal consequences of their agreements. So long as both parties' assent is informed and voluntary, Akrastic Dorights want to enable them to opt out of legal enforcement of their moral obligation to compensate. Underliquidated damages can be considered a form of doing so.

But Borderlands might disagree on in whether parties should be able to choose penalties for breach—liquidated amounts that exceed the

anticipated and actual costs of breach.<sup>48</sup> Borderland Takers, though they recognize that compensatory damages are almost always more efficient, see no reason to prevent parties from agreeing to more. First, there might be situations in which penalties create more value, such as when a party wants to signal that she is especially likely to perform.<sup>49</sup> Second, the Takers might worry that adjudicators will do a bad job distinguishing penalties from reasonable forecasts of losses.<sup>50</sup> For Borderland Akrastic Dorights, on the contrary, penalties are incompatible with a core commitment: that enforcement serves not to punish breach but to compensate its victims. As Ian Macneil has written, the power to contract should be defined by “the general purposes of society in enforcing contracts through its courts.”<sup>51</sup> As far as Akrastic Dorights are concerned, penalizing breach is contrary to society’s interest in enforcing contracts—which is to compensate the victims of breach. They want a rule against penalties.

With respect to the penalty rule, there is no default compromise. The rule the Akrastic Dorights in Borderland want is of necessity a mandatory one, whereas Borderland Takers want a rule that gives parties more control over remedies.<sup>52</sup> But the commitments of both Takers and Akrastic Dorights still leave room for play in the choice of legal rule. Although Takers believe penalties sometimes create value, they recognize that sophisticated parties can achieve similar results using performance bonds and other mechanisms.<sup>53</sup> Akrastic Dorights, for their part, know that moral culture is not so fragile that it cannot withstand some exceptions to the penalty rule. The law might enforce some forms of penalties in agreements between sophisticated parties while still affirming the

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<sup>48</sup> Restatement (Second) of Contracts § 356(1) (1981). There is disagreement amongst U.S. jurisdictions as to whether a penalty is defined as such relative to the anticipated costs of breach, the actual costs of breach, or both. To keep things simple, I consider only the Borderland rule for cases in which both prongs are satisfied.

<sup>49</sup> For an overview of the literature on when penalties can be efficient, see Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 Chi.-Kent L. Rev. 33 (2003).

<sup>50</sup> See Alan Schwartz, *The Myth That Promisees Prefer Supercompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 Yale L.J. 369, 370 (1990); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 Colum. L. Rev. 554, 578-93 (1977).

<sup>51</sup> Ian R. Macneil, *Power of Contract and Agreed Remedies*, 47 Cornell L.Q. 495, 498 (1962).

<sup>52</sup> Similar disagreements might arise with respect to other possible mandatory rules, such as the unconscionability doctrine and the scope of the implied duty of good faith.

<sup>53</sup> See Ronald J. Mann, *Verification Institutions in Financial Transactions*, 87 Geo. L.J. 2225 (1999).

importance of freely choosing performance. And there are other tools for compromise. The possibility of adjudicator error concerns the Akkrastic Dorights in Borderland as much as it does the Takers. If Borderland does adopt a penalty rule and if adjudicator error is a real worry, everyone might agree on procedural mechanisms, such as heightened burdens of proof, designed to prevent false positives. Although no rule for penalties will perfectly satisfy everyone, the disagreement is not so sever as to prevent Borderlanders from arriving at a rule that serves well enough.

B. The Federation: One Contract Law to Rule Them All


By adding to the analysis of Part I a limited diversity of party type, Borderland illustrates how a single contract law might be designed to serve both the self-interested profit-maximizing goals of Takers and the additional moral commitments of Akkrastic Dorights.

Borderland remains homogenous, however, when it comes to the conditions of transacting. Exchanges in Borderland are all one-shot deals between parties who encounter each other as strangers and need not worry about the reputational consequences of breach. We can add more heterogeneity to the analysis by changing a key assumption in all the above stories: local laws of contract. A single contract law for all the regions would have to serve the needs of diverse party types across varying transaction conditions.

Suppose that five of the six lands described above decide to unite into a single political unit, the “Federation,” to be governed by a single law of contract. The Federation includes Takerland, Smallville, Gotham, Metropolis, and Borderland. Sharerland, whose residents have very little need for a law of contract anyway, has decided not to join.

Table 3:

		Party Type		
		<i>Sharers</i>	<i>Takers</i>	<i>Akrastic Dorights</i>
Transaction Conditions	<i>Episodic transactions</i>	Sharerland	Takerland	Metropolis
			Borderland	
	<i>Repeat play</i>		Smallville	Gotham
	<i>Reputation</i>			


  
**The Federation**

For simplicity’s sake, I stipulate for the moment that there are no cross-border transactions in the Federation. This allows us to add heterogeneity of transaction type without adding new types of transactions. Furthermore,

assume lawmakers in the Federation want the federal law of contract to satisfy, as best as possible, the various purposes of contract law in all regions comprising the union. Federation lawmakers do not have their own agenda for contract law but are committed to doing their best to satisfy the commitments of the component communities. The end of this section briefly considers what happens when each of these assumptions is relaxed.

What would contract law in the Federation look like? Here I consider only two design questions: the rules governing intent to contract and those governing interpretation. A discussion of remedies in the Federation would mostly repeat what was said about remedies in the Part II.A analysis of Borderland.

### 1. *Intent to Contract*

When Federation adjudicators decide whether to enforce an agreement, should they take account of the parties' intent at the time of agreement with respect to legal liability? More specifically, should the conditions of contractual validity be designed to limit enforcement to those agreements parties intended to be legally binding?

When the question stated so abstractly, citizens of the Federation disagree. As far as Federation Takers are concerned, enforcement should always be conditioned on the parties' intent to be bound. Takers want a contract law that increases the gains of trade by solving the mistrust problem and by providing coordination and guidance. Contract law can serve those functions only if the parties expect legal liability for breach. Moreover, Takers want enforcement of their agreement only when it will increase the gains of trade, and they recognize that the parties' intent with respect to enforcement of their agreement is a good test for when such enforcement adds value.

The Federation Akrastric Dorights, on the contrary, believe the purpose of contract law is instead or also to enforce a breaching party's moral obligation to compensate and to support a culture of respect for the *pacta* principle. These goals recommend legal liability for breach even when the parties did not at the time of formation want, intend, or even expect to be legally bound. Although Akrastric Dorights are willing to permit parties to opt-out of enforcement, they believe it would be a deep mistake to condition legal liability on the parties' intent to contract.

Notwithstanding these diverging commitments, there is considerable overlap in the preferred legal rules for deciding when a contract is binding. It is sometimes possible to agree on a rule while disagreeing about the reasons for it.

We can begin with the Takers' preferred rule. Recall that in both Takerland and Borderland, all parties face the mistrust problem and therefore nearly everyone wants and expects legal enforcement. So do most parties in Gotham, though some repeat players there might prefer no legal

liability. In all three regions, therefore, the majoritarian default construction of an exchange agreement is enforcement. Lawmakers get most parties the result those parties want by enforcing their exchange agreements unless the parties express a contrary intent.

Akrastic Dorights in the Federation want the same enforcement default, but for a very different reason. There are good reasons to think that in Metropolis, which is composed entirely of Akrastic Dorights, most parties are not thinking about legal enforcement when they enter into exchange agreements. Metropolitans rely not on legal incentives to perform, but on each other's moral compass. Consequently, enforcement might not correspond to most parties' intent at the time of agreement. It might not be the majoritarian default in Metropolis. But that does not matter to the Akrastic Dorights living there. The Akrastic Dorights in both Metropolis and Borderland want legal duties that track or reinforce the parties' moral obligations, and whether the parties intended to acquire those legal duties is immaterial to that purpose. They want enforcement even when the parties are oblivious to the legal effect of their agreement. The Federation Akrastic Dorights therefore also want a rule that enforces exchange agreements without requiring evidence of the parties' contractual intent.

The convergence among the preferred conditions of contractual validity in Takerland, Gotham, Metropolis and Borderland has an analog in contemporary contract law. I have argued elsewhere that our contract law serves the dual functions of conferring powers and imposing duties and that this compound function is possible only because four facts hold true: (1) entering into an agreement is not a formal legal act, but one that exists outside of the law; (2) the fact that a person has agreed to perform is a sufficient reason to impose on her a legal duty to perform, whether or not she intended to acquire that duty; (3) a significant portion of parties who enter exchange agreements nonetheless expect and want their agreements to be enforced; and (4) parties' desire to undertake a legal obligation to perform is a separately sufficient reason to enforce their exchange agreement.<sup>54</sup> These four conditions are also satisfied in the Federation. But in the model, their satisfaction is divided between regions or party types. (1) and (2) hold true in Metropolis and for the Akrastic Dorights in Borderland; (3) and (4) are true in Takerland, Gotham and Borderland. In the actual world, the conditions of contracting and functions of contract law are not so neatly divided.

The Federation outlier is Smallville. In Smallville, most parties want no enforcement, as the Takers who live there prefer to rely instead on the incentives provided by repeat play and reputation. And because they are Takers, Smallvillers have no interest in enforcing agreements when the parties themselves do not want or expect legal liability. Smallvillers would

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<sup>54</sup> Klass, *supra* note 10 at 1783.



prefer the local majoritarian default of no enforcement of exchange agreements.

An obvious solution is to tailor the enforcement default to the place of contracting. A tailored default applies only to transactions satisfying some factual predicate other than the parties' revealed intent.<sup>55</sup> Federation legislators might adopt an enforcement default in Takerland, Gotham, the Federation and Borderland, and a non-enforcement default in Smallville. Those who prefer no legal liability in the former regions would be able to opt out of enforcement. In those rare situations in which repeat play and reputation fail in Smallville, parties would be able to opt into it.

Elegant as the tailored-default solution is, it does not serve my purposes. I want to think about how a single contract law might be designed to work across these multiple jurisdictions and to serve several independent functions at once. Regionally tailored defaults make the solution too easy. I will therefore stipulate that legal rules in the Federation cannot be tailored based on the place of contracting. This forces us to ask whether we can find a single rule that provides the right results across different preference orderings and transaction types.

The best off-the-rack rule for the Federation as a whole is an enforcement default, which serves the purposes of enforcement in four of the five regions. Federation lawmakers might formulate the validity rule as follows:

(VDef) Absent evidence of the parties' contrary intent, an exchange agreement shall be legally enforceable.

Although Smallvillers do not especially like VDef, there is room to accommodate their needs. Every interpretive default comes with an altering rule, which says what parties must do to contract around the default.<sup>56</sup> It will be recalled that everyone in the Federation, whether a Taker or an Akrastric Doright, agrees that parties should be able to avoid enforcement when they want. Takers view the power to avoid enforcement as necessary to allow parties to maximize the joint gains of trade. Akrastric Dorights value autonomy and see the benefits in being able to put certain areas of one's life beyond the law's reach. Having set the default at enforcement, Federation lawmakers must determine how parties can avoid legal liability when they want. The needs of Smallvillers can be met by giving them a cheap and simple tool for doing so. This suggests a moderately formal

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<sup>55</sup> Article 2 of the UCC, for example, tailors the default warranties based on the identity of the seller. Every sale triggers the implied warranty of title, but only when the seller is a merchant is there an implied warranty of merchantability. UCC §§ 2-312 & 314.

<sup>56</sup> See Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 Yale L.J. 2032 (2012).

altering rule. Parties who want to avoid legal liability for their agreement should be able to do so by expressly agreeing to no enforcement. Adapting the language of Samuel Williston's Model Written Obligations Act, Federation lawmakers might arrive at the following rule:

(VAlT) An otherwise enforceable agreement shall not be enforced if and only if the parties expressly agree, in any form of language, that they do not intend to be legally bound.<sup>57</sup>

VAlT is a *formal* rule because it requires parties to expressly state their non-default intent, rather than inviting adjudicators to discover that intent using other sorts of evidence. It is only *moderately* formal because it does not require that parties use any specific words or symbols to avoid legal liability. It does not require anything like the Roman *stipulatio* or the common law seal. VAlT permits the parties to express their intent not to contract using any words they wish.

Takers in the Federation like VAlT because it allows parties to easily avoid enforcement when there exist other, less expensive solutions to the mistrust problem. This includes Smallvillers who, though they would prefer a nonenforcement default, consider a cheap and predictable way of avoiding legal liability the next best thing. In fact, although VAlT does not require special words or symbols for opting out of enforcement, Smallvillers might decide on a simple standard way to signal their common intent to do so, such as saying "TINALEA" ("This is not a legally enforceable agreement") when they enter an exchange transaction. That convention would establish a sort of anti-seal: a formality whose conventionally defined meaning lies entirely in its legal effect. Legal formalities give parties a cheap and reliable tool for communicating their legal intent, both to each other and to a possible future adjudicator.

One might think the Akrastic Dorights in Metropolis and Borderland would be less sympathetic to a formal altering rule like VAlT. Express talk about legal obligations can sow the seeds of doubt among parties who would otherwise trust in friendship or moral responsiveness. Saying "Let's agree that this is not a legally enforceable agreement," could be interpreted as evidence that the speaker thinks they might not perform, that the speaker believes the hearer is likely to litigate, or that the speaker themselves is overly legalistic. Rules that encourage parties to expressly exercise the power to contract can interfere with nonlegal relationships of trust.<sup>58</sup>

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<sup>57</sup> See Uniform Written Obligations Act § 1, in Handbook of the National Conference of Commissioners on Uniform State Laws and Proceedings 584 (1925); 33 Pa. Cons. Stat. Ann. § 6 (1997) (enactment of the Model Written Obligations Act).

<sup>58</sup> I discuss this point in *Intent to Contract*, *supra* note 24 at 1473-75.

As it happens, these costs do not exist in the models. Because Metropolis is a completely homogenous society, a Metropolitan always knows that the person sitting across the table is an Akrastic Doright and can therefore be trusted to keep her agreements. Trust in Metropolis is so robust it is not threatened by asking to opt-out of enforcement. In Borderland, the opposite is true: there is no moral trust to begin with. A Borderlander never knows whether the person sitting across the table is a Taker or an Akrastic Doright. There is therefore no moral relationship for an express request to opt out of legal enforcement might degrade. Finally, like the other residents of the Federation, the Akrastic Dorights in Metropolis and Borderland want a rule that gives parties control over the legal consequences of their agreements. VAlt gives it to them.

When establishing the conditions of contractual validity, therefore, wise Federation legislators will adopt enforcement default VDef together with the moderately formal altering rule VAlt. VDef is the majoritarian default among Federation Takers and, whether majoritarian or not, matches the duty-imposing purpose Akrastic Dorights assign to contract law. And VAlt gives parties who want to avoid legal liability a cheap and effective way to do so.

A brief comment on the relationship between the conditions of contractual validity in the Federation and those we find in our world. As my comments on the relational costs of formal altering rules indicate, the design problem in the actual world is more difficult than it is in the Federation. A rule like VAlt might impose significant relational costs on some parties who prefer no legal liability. One party's suggestion that both agree to no enforcement might cause the other to question their motives or character. Between friends, the suggestion might be taken as a sign that the friendship is on shaky grounds. Between strangers, it might be taken as evidence that the speaker does not expect to perform. In the actual world, a rule like VAlt might have the perverse effect of eroding relationships, creating mistrust where it did not exist before.

Part of the solution is one I have ruled out in the Federation: tailoring. Our law of contract tailors both defaults and altering rules to get the best results across different types of transactions.<sup>59</sup> Although the default for most exchange agreements is enforcement, courts and commentators have suggested a nonenforcement default for preliminary agreements, for agreements between family members, for reporters' confidentiality promises, and for other categories. Altering rules can be tailored as well. Most preliminary agreements involve sophisticated parties negotiating complex transactions. Here a rule that requires an express statement of the

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<sup>59</sup> I explore these mechanisms with respect to intent to contract requirements in Gregory Klass, *Intent to Contract*, *supra* note 6.

parties' intent to contract imposes few relational costs.<sup>60</sup> The relational costs of expressly opting for enforcement might be much higher in agreements between family members. In those transactions it might be better to permit courts to infer the parties' contractual intent from the circumstances of the transaction.<sup>61</sup> Tailoring can also be used to address cases in which the social interest in enforcement is stronger or weaker. The Massachusetts Supreme Court has held that a physician's assurances of positive results should be enforceable in contract only where there is "clear proof" that a promise was made.<sup>62</sup> That rule can be read as establishing a nonenforcement default for most physician-patient communications, satisfying the social interest in protecting those communications from the chilling effect of strict liability for breach and favoring the negligence standard of malpractice. At the same time, the relatively informal altering rule—clear proof that a promise was made, which does not require an express intent to be legally bound—captures cases in which liability is appropriate, whether or not the parties intended the promise to be legally binding. In short, although the design problem is more difficult in the actual world than it is in the model, lawmakers also have more tools with which to address it. They can tailor defaults and altering rules to capture both factual and normative differences among transaction types.

## 2. *Interpretive Rules*

A second design problem is one also considered in *Borderland*: Should adjudicators take a more textualist or a more contextualist approach to resolving disagreements about the meaning or scope of the parties' agreement? Left to their own devices, different regions of the Federation would arrive at very different answers, ranging from the relatively textualist preferences of repeat-play Takers in Gotham, who would exclude all evidence of course of performance and prior dealings, to the very contextualist preferences of the Akrastic Dorights in Metropolis. This makes the design problem in the Federation considerably more complex than it is in the regions comprising it. It is not, however, intractable.

The choice of how much context to use when interpreting a contractual agreement is not a binary one. An interpretive rule can let in more or less evidence of context, depending on what types of evidence it allows (the rule might permit, for example, usage of trade but not course of performance), on when that evidence is allowed in (always, only when the plain meaning is ambiguous, etc.), on who may consider the evidence (only the judge, also the jury), and so forth.<sup>63</sup> The question is not whether to

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<sup>60</sup> *Id.* at 1486-87.

<sup>61</sup> *Id.* at 1496-97.

<sup>62</sup> See, e.g., *Sullivan v. O'Connor*, 363 Mass. 579 (1973).

<sup>63</sup>

adopt a textualist or a contextualist rule, but how much context evidence to permit, where the possible answers include “None,” “All,” and many points in between.

The answer to the question of how much context evidence to let in turns on the answers to three subsidiary questions.<sup>64</sup> First and most fundamentally: How much does society value interpretive accuracy? As the discussion of *Borderland* showed, the answer to that question depends in part on the function or functions contract law serves. Akkrastic Dorights, who view legal enforcement as serving a moral function, value accuracy more than Takers, who want a contract law only to maximize the gains of trade. A Taker might be happy with an interpretive rule that is right on average.<sup>65</sup> An Akkrastic Doright would not be. The second question is: How large are the gains in accuracy from permitting adjudicators to consider additional evidence of context? For the purposes of this analysis, I assume that the more context evidence a rule permits, the more accurate the interpretations it produces, though the marginal gain of each additional piece of evidence goes down. Just how much more accurate depends in part on the conditions of transacting. If parties expect legal liability, for example, they will respond to textualist rules by producing clearer and more complete writings. This feedback effect reduces the gains in accuracy from permitting more context evidence. If parties are not thinking about the legal consequences of their agreement, they are unlikely to take textualist interpretation rules into account when choosing their words. Under those conditions, we get greater gains in accuracy with rules that permit more context evidence. The third question concerns the relative costs and benefits of permitting additional context evidence. The most salient benefits of permitting context evidence are greater accuracy and lower drafting costs. The most salient costs are threefold: increased cost of adjudication; additional costs of uncertainty, to the extent that the outcome of contextualist interpretation is more difficult to predict; and possible interference with extralegal grounds for trust, which sometimes operate better when legal preferences are left unspoken.

Designing a single interpretive rule is difficult in the Federation because the answers to the three questions are so different in the different regions. I have suggested that among repeat players in Gotham, using course of performance and course of dealings can threaten the

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<sup>64</sup> For other lists of the factors relevant to evaluating rules of interpretation, see Avery Weiner Katz, *The Economics of Form and Substance in Contract Interpretation*, 104 Colum. L. Rev. 496, 522-36 (2004); Eric A. Posner, *The Parol Evidence Rule, The Plain Meaning Rule, and The Principles of Contractual Interpretation*, 146 U. PA. L. REV. 533, 543-47 (1998).

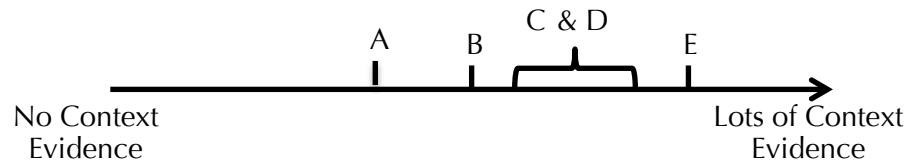
<sup>65</sup> See Schwartz & Scott, *supra* note 7, at 573-84 (arguing that many firms are likely to prefer cheaper interpretive rules that are correct on average than more expensive rules that are more likely to produce the right answer in a given case).

development of cheaper and more flexible extralegal forms of trust. These relational costs give repeat players in Gotham a strong preference for relatively textualist rules of interpretation. At the other end of the spectrum is Metropolis, where the residents highly value accurate interpretation and where parties are unlikely to be thinking about legal liability, meaning they are unlikely to choose their words in light of a textualist rule of interpretation. Metropolitans would choose a rule that permits a lot of context evidence.

The preferred rules of other Federation members lie between these two extremes. As noted in the previous section, the residents of Takerland, one-shot transactors in Gotham and the Takers in Borderland all have similar preferences with respect to context evidence. Because all transact only episodically, they like context evidence more than the repeat players in Gotham do. Because they are Takers, they value accuracy less than Akrastric Dorights do and prefer less context evidence than Metropolitans would. The Akrastric Dorights in Borderland fall yet elsewhere on the spectrum. They attach a higher value to accuracy than their Taker compatriots do, making them prefer a somewhat more contextualist rule than the Takers in Borderland want. But they also recognize that more context evidence brings smaller accuracy gains in Borderland than in Metropolis. Unlike Metropolitans, when Borderlanders are entering into agreements they are likely to be thinking about its legal consequences, meaning they will respond to textualist rules by writing more complete and clear agreements. Akrastric Dorights in Borderland are therefore somewhat more inclined to allow context evidence of meaning than are the residents of Takerland and less inclined to permit it than are their Metropolitan counterparts. Finally, Smallvillers also prefer a rule that lies somewhere between the preferred rules in Takerland and those in Metropolis, though not necessarily the same rule as the one Borderland's Akrastric Dorights would choose. Smallville is like Metropolis in that parties do not think much about the law when they enter into agreements that might, because of the enforcement default, result in legal liability. This means greater accuracy gains from more context evidence. But the Takers in Smallville also care less about accuracy than do the Akrastric Dorights in Metropolis, meaning that Smallvillers won't want adjudicators to take quite as much context into account as do Metropolitans.

We can represent the preferred rules in the different regions by ordering them according to how much context evidence each would permit in the legal interpretation of agreements.

Figure 1:



- Rule A: Preferred rule of repeat players in Gotham
- Rule B: Preferred rule (1) in Taker World; (2) of one-shot transactors in Gotham; (3) of Takers in Borderland
- Rule C: Preferred rule of Akkrastic Dorights in Borderland
- Rule D: Preferred rule in Smallville
- Rule E: Preferred rule in Metropolis

The further to the right the rule, the more context evidence it permits adjudicators to consider when interpreting agreements.<sup>66</sup>

The question is whether it is possible to come up with a single interpretive rule that works reasonably well in each region. Once again, tailoring could solve the problem. Federation legislators might adopt a relatively textualist default rule of interpretation for repeat-play transactions in Gotham, a much more context-sensitive default rules of interpretation for transactions in Metropolis, and default rules somewhere in between for the other regions or transaction types. Tailoring allows lawmakers to create majoritarian defaults that satisfy most parties most of the time, while giving those with atypical preferences the ability to contract for a different rule. Unfortunately for the citizens of the Federation, I have ruled out regional tailoring. The task is to find an off-the-rack rule that works across the different regions.

Like the rules for contractual validity, a completely specified rule of interpretation should include both a default and an altering rule. The default will stipulate what the rule of interpretation is if parties do not express an intent to the contrary. The altering rule will specify what evidence of an intent to the contrary is required to defeat the default.

In discussing the conditions of contractual validity in the Federation, I suggested that an enforcement default was desirable for majoritarian

<sup>66</sup> The positions of Rules C and D are relatively indeterminate for the following reason. Though we know that the preferred rules of the Akkrastic Dorights in Borderland (Rule C) and in Smallville (Rule D) both fall somewhere between the preferred rules in Takerland and in Metropolis (Rules B and E), the above analysis does not tell us their position relative to one another. On the one hand, textualist rules are less accurate in Smallville than in Borderland. On the other, the Akkrastic Dorights in Borderland care more about accuracy than do the Taker residents of Smallville.

reasons. Alan Schwartz and Robert Scott suggest similarly with respect to rules of interpretation that “[t]he relevant question . . . is what should be the majoritarian default.”<sup>67</sup> Figure 1 suggests that in the Federation, the majoritarian default might well be Rule B. Whereas each of the other rules are preferred by only one category of Federation members, three groups—Takerlanders, one-shot transactors in Gotham and the Takers in Borderland—prefer Rule B. Whether Rule B is actually majoritarian will depend on empirical facts such as the populations of the different regions, how many transactions occur in each, how often extra-legal forms of assurance fail in each, and the like. Still, at first glance it looks like Rule B corresponds to the preferences of at least a plurality the citizens of the Federation, if not a majority.

But majoritarian defaults are not always optimal in a society like the Federation. Scott and Schwartz focus on a relatively homogenous category of contracts: transactions between firms, in which they argue contract law’s primary goal is to maximize the joint gains of trade and parties always expect and want legal enforcement of their exchange agreements. Under such conditions, parties, if given the chance, will choose the value-maximizing interpretive rule for their agreement. Schwartz and Scott further assume that parties know enough to pick the rule that will get them there. On these assumptions, the best rule is the one that makes it as cheap as possible for parties to get their preferred rule. Majoritarian defaults achieve that goal.

The virtues of a majoritarian default are less obvious if the task is to create a single rule for a heterogeneous society whose members do not all enter into transactions with the same knowledge, commitments, or expectations. Most importantly, heterogeneity creates the possibility of differential stickiness. The stickiness of a default term is the likelihood that parties who do not prefer that term will not opt-out of it—the likelihood that parties will end up with a nonpreferred term merely because it is the default. A default might be sticky, for example, because the parties do not know to contract around it, because it takes too much effort to do so (partly a function of the altering rule), or because parties treat the default as authoritative. Even if we follow Schwartz and Scott and assume the goal is to give parties their preferred rule, lawmakers should choose, other things being equal, less sticky defaults. A majoritarian default that is stickier than the minoritarian one might do worse at getting more parties their preferred outcome.

These considerations are relevant because there are two regions in the Federation where defaults are especially sticky. In Smallville, repeat play and reputation are almost always enough to solve the mistrust problem without legal intervention. In Metropolis, parties rely not on legal

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<sup>67</sup> Schwartz & Scott, *supra* note 7, at 569.



enforcement, but on their shared belief in and general responsiveness to the *pacta* principle. In both regions, parties know there is a chance that the law will eventually figure into the transaction. But they do not expect it to. Law therefore casts only a pale shadow in Smallville and Metropolis. Given the low probability that the law will intervene in their transaction, informing oneself of the default and deciding whether to opt-out are not worth the effort. Neither Smallvillers nor Metropolitans waste much mental energy thinking about legal consequences when agreeing to an exchange, and they are unlikely to take the effort to opt-out of a legal default they do not prefer.

In Takerland, Gotham and Borderland, on the contrary, defaults are much less sticky. At the beginning of a transaction in these regions, parties always face a pressing mistrust problem and generally rely on legal enforcement to solve it. When they enter an exchange agreement, each expects the threat of legal liability to play a significant role in shaping the other's behavior. They are therefore attuned to the agreement's legal consequences and are more likely to contract out any default that does not match their preferences.

The stickiness of all defaults in Smallville and Metropolis suggests setting the default rule of interpretation to accord with the majority preferences in one or both those regions. In short, it suggests setting the default rule at the contextualist end of the spectrum—at Rule D, at Rule E, or at some point in between. Again we have reached a point where compromise is necessary. But the range of options has been rationally narrowed and a solution is easier to find. The choice of a default interpretive rule can now be made on the basis of empirical facts, to the extent that they are known, like the relative frequency of breach in Smallville versus that in Metropolis and the intensity of Metropolitans' attachment to accuracy as compared to the costs of allowing more context evidence in Smallville. For the purposes of the discussion that follows, assume that the Federation lawmakers choose a default interpretive rule that lies at the far right end of Figure 1. A rule such as the following has the advantage of both simplicity and clarity:

(IDef) When interpreting an agreement, an adjudicator may consider any context evidence of meaning that the adjudicator deems probative.<sup>68</sup>

Having set the default, the next question is what the altering rule should be. How should Federation adjudicators decide whether parties have opted out of IDef? As was the case with the conditions of contractual validity, a moderately formal altering rule performs well in the model. The

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<sup>68</sup> Compare *Investors Compensation Scheme v. West Bromwich Building Society*, [1998] 1 WLR 896; [1998] 1 All ER 98.

Federation members who prefer more textualist rules of interpretation—Takerlanders, Gotham and Borderland—all enter transactions expecting legal liability and craft their agreements accordingly. Such parties can be required to expressly say what interpretive rule they want. The wise legislators of the Federation will therefore adopt something like the following altering rule:

- (IAIt) If and only if the parties expressly agree on what evidence shall be used in the interpretation of their agreement, an adjudicator shall use only that evidence in interpreting their agreement.

For example, parties who want a highly textualist rule of interpretation might agree to:

- (F) This agreement shall be interpreted solely on the basis of the parties' words, a standard English language dictionary, and the adjudicator's experience and understanding of the world.

It is worth noting that U.S. contract law does not include an analog to IAIt. The Second Restatement includes many rules of interpretation, but none that say what parties must do to contract around them. The closest thing U.S. law has is the parol evidence rule. By integrating their agreement, parties can only exclude extrinsic evidence of contrary or additional terms, but also limit the evidence that will go into its interpretation.<sup>69</sup> It is somewhat odd that this interpretive rule is imbedded in a test for integration. Whereas an interpretation clause like F says what evidence shall be used to interpret a writing, a merger clause says which terms the writing shall determine—all or some, depending on whether it is completely or partially integrated. Even more interesting, however, is a structural difference between VAIt and the parol evidence rule. The parol evidence rule provides that inclusion of a merger clause is generally *sufficient* to conclude that a writing is integrated, but is not *necessary* to find integration. Courts may find integration absent a merger clause, based only on the writing's apparent completeness.<sup>70</sup> Under IAIt, inclusion of an interpretation clause like F is both *sufficient and necessary* to opt-out of the

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<sup>69</sup> See, e.g., Restatement (Second) of Contract § 212 (1981).

<sup>70</sup> See Restatement (Second) of Contracts § 209(3) & cmt. c (1981).

contextualist default rule for interpreting the contract. The parol evidence rule is, therefore, less formalist than is VAlt.<sup>71</sup>

Let me return to the fictional, simpler, and more easily explicable world of the Federation and to another issue raised by VAlt. The decision whether a given string of words constitutes an interpretation clause—whether it expresses the parties' intent to opt out of IDef—is itself an act of interpretation. Should that decision be made on textualist or on contextualist grounds? Given the constraints of the model and the requirements of IAlt, adjudicators should adopt a textualist approach to interpretation clauses.<sup>72</sup> As already noted, those who want to opt out of the contextualist default are already attuned to the legal consequences of their agreements. It would be surprising to find a clause like F in a negotiated agreement between parties who in fact preferred a more contextualist interpretive rule, or for parties who preferred a more textualist approach to fail include clear language opting out of the default. Better, then, not to permit a clear interpretation clause to be attacked by context evidence of its meaning.<sup>73</sup> The advantages of formal altering rules are lost when they are interpreted contextually.

In sum, and simplifying somewhat, Federation lawmakers will adopt something like the following rule of interpretation: When there is a dispute as to the meaning of an agreement, adjudicators should interpret it using any context evidence they deem probative, unless the parties have expressly agreed that their agreement shall be interpreted according to a more textualist rule.

### 3. *Relaxing the Assumptions*

Three comments on this result. First, as already noted, many citizens of the Federation would benefit from regionally tailored default validity and interpretation rules, which would save them the transaction costs of contracting around a nonpreferred default. Tailored defaults are not available in the Federation only by stipulation. In the actual world, lawmakers often can tailor defaults to achieve greater accuracy at a lower cost. Schwartz and Scott argue, for example, that most firms mostly prefer a highly textualist interpretive rule—one lying to the left of A in Figure 1. If they are correct, the fact that an agreement is between firms would be a

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<sup>71</sup> I suggest reasons to adopt nonformalist altering rules in a discussion of *Jacob & Youngs v. Kent* in Part III.C. It is not obvious to me that those reasons apply to the parol evidence rule.

<sup>72</sup> This is an analog to the four-corners rule that New York courts apply to the interpretation of merger clauses. See, e.g., *Indep. Energy v. Trigen Energy Corp.*, 944 F. Supp. 1184 (S.D.N.Y. 1996).

<sup>73</sup> This is not to say that context evidence shouldn't be permitted to show fraud, mistake, duress or some other invalidating cause.

good reason to adopt, absent the parties' agreement to the contrary, a textualist approach to interpreting it—no matter what the default rule of interpretation for other transaction types. Alternatively, when interpreting agreements between family members, we might want to allow more context evidence even if the default were more textualist, again unless the parties have agreed otherwise. In the actual world, there are more tools for finding a satisfactory rule than I have permitted Federation lawmakers.

Second, allowing yet more heterogeneity to creep into the Federation suggests additional functions an altering rule might serve and yet other design options. Consider, for example, a one-time, cross-border pie-baking transaction between Anne, the peach supplier from Takerland, and John, the Akrastic Doright baker who lives in Metropolis who has previously only dealt with Akrastic Dorights. Suppose that during negotiations John makes clear that he requires freestone peaches to bake the pie.<sup>74</sup> Taker Anne then drafts and Doright John signs a written contract specifying that Anne shall provide “peaches,” a term that according to all dictionaries in the Federation refers to both the freestone and clingstone varieties. Suppose also that Anne has included formalist interpretation clause F in the writing. John, a Metropolitan who is not used to dealing with detailed and legally sophisticated contractual writings, does not fully understand the clause when he reads it, but figures they have agreed on all the necessary details and so signs anyway.

Where cases like this are possible, a textualist approach to interpretation clauses is much less attractive. Although there has been no fraud or undue influence, Federation lawmakers might want to allow the adjudicator to take surrounding circumstances into account when deciding whether F represented both Anne's and John's understandings of how their agreement would be interpreted. They might want a rule that an interpretation clause creates only a strong presumption that the parties agreed to contract out of the default, one that might be rebutted with sufficient context evidence.<sup>75</sup> Here again we might, if possible, tailor the rule. If tailoring is available, Federation lawmakers might apply this somewhat more contextualist altering rule only to cross-border agreements in which one party is an Akrastic Doright from Metropolis. In the actual world, lawmakers might apply such a rule to negotiated agreements between firms and natural persons, such as employment contracts. Although a textualist altering rule works well in the simple model of the

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<sup>74</sup> Freestone peaches have stones that are easily removed from the flesh, whereas the flesh of a clingstone peach adheres to the stone.

<sup>75</sup> This rule might be compared to Corbin's and the Second Restatement's approach to merger clauses. Both advocate that courts always consider context evidence on the theory that “a writing cannot of itself prove its own completeness.” Restatement (Second) of Contracts § 210 cmt. b (1981); see also Arthur L. Corbin, *The Parol Evidence Rule*, 53 Yale L.J. 603, 630 (1944).

Federation, contextualist ones may sometimes be appropriate in more complex models and in the actual world.<sup>76</sup>

Finally, we can ask what happens if we relax the assumption that Federation lawmakers want their law of contract to serve the locally preferred functions of contract law in each of its five regions. The strong assumption of localism about the purposes of contract law means that Federation lawmakers want contract law in Takerland, Smallville and Gotham to maximize the gains of trade and are not especially concerned whether in those regions it corresponds to breaching parties' moral duty to compensate or supports the moral culture of keeping agreements; that they want contract law Metropolis to serve a moral function that corresponds to Metropolitans' commitments; and that in Borderland, contract law should play a mixed function.

This deference to local commitments simplifies the above analysis. It is also artificial. In a heterogeneous society, lawmakers might well be committed to substantive legal goals that do not match the preferences of every member of society. Contract law might have substantive ends that are sometimes at odds with the individual purposes of parties entering a contract. Courts commonly refuse to enforce agreements, for example, that the parties intended to be binding when enforcement would be contrary to public policy. There is no reason to assume that society's reasons for enforcing agreements are always going to match parties' reasons for wanting enforcement.

We can get at something like this in the model. Suppose Federation lawmakers believe parties' contractual duties should track their moral obligations, even in regions made up entirely of Takers. Perhaps Dorights wield more political power in the Federation. Or maybe legislators are convinced of the general social benefits of the *pacta* principle, which include increasing gains of trade. Such legislators consider contract law to have a moral purpose throughout the Federation, including in Takerland, Smallville and Gotham. They therefore attach a greater value to interpretive accuracy than do the residents of those regions.

In such a world, there would be much less reason to allow party preference to control the framework rules that govern contract enforcement. If a contextualist interpretive rule is better suited to the moral purpose of contract law, lawmakers might not care whether it is the parties' preferred rule of interpretation. They might adopt a mandatory contextualist rule of interpretation. Or they might choose a contextualist default paired with an altering rule that makes it costly to choose a more textualist interpretation. High altering costs can ensure that parties' gains from a more textualist

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<sup>76</sup> Compare Sections 8 and 9 of the recently approved Restatement of the Law: Consumer Contracts, which all but do away with the parol evidence rule for consumer contracts of adhesion.

interpretive approach outweigh society's moral interest in achieving greater accuracy. Again it is possible to achieve a rational compromise.

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The stories of Borderland and the Federation illustrate both the practical challenges of contract design in a heterogeneous society and tools lawmakers have at their disposal use to meet them. More generally, they illustrate how it is possible to construct a single law of contract that serves several independent functions at once. I have discussed only a few doctrinal questions in each model, and one might say much more about how contract law would work in each. Moreover, the models remain relatively simple. In the actual world, there are many more types of transactions, and contract law serves yet other purposes and principles. That said, Borderland and the Federation provide the materials for a general defense of pluralist theories of contract law against the objection that they cannot provide lawmakers practical guidance.

### **III. Convergence by Design**

Part I identified several different functions a law of contract might serve. Depending on parties' general preference orderings, on the circumstances of their transaction, and on society's interest in enforcing their agreements, contract law might seek to provide some combination of assurance, deterrence, insurance, coordination, guidance, punishment for moral wrongs, compensation for wrongful harms, and support for the moral practice of entering into and keeping agreements. The reader familiar with the past fifty years of contract scholarship will recognize several theoretical perspectives embedded in the models, though the models are not meant to capture every aspect of any theory or all theories that have been proposed.

Part II demonstrated how a single law of contract might be designed to serve several independent purposes identified in Part I at once, even when those purposes point in different directions. I discussed three doctrinal questions: whether a plaintiff should be able to recover for avoidable losses, how much context evidence should figure into the interpretation of agreements, and whether to put an upper limit on liquidated damages. These doctrinal questions hardly exhaust possible points of doctrinal disagreement among different theories of contract law. But the stories of Borderland and the Federation illustrate how lawmakers might construct rules that server different interests and multiple purposes.

The differences between the commitments of Takers and Akkrastic Dorights, and the corresponding differences between the goals each assigns to contract law, correspond to a broad distinction I have identified in other

work between various theories of contract law.<sup>77</sup> Both efficiency and autonomy theories commonly treat contract law as a private power-conferring rule, designed to give parties the power to undertake a legal duty to perform when they wish. Takers adopt a similar stance, which explains their preference for a strong intent to contract requirement, relatively formalist rules of interpretation, and remedies that correspond to parties' ex ante preferences. Promise, reliance and corrective justice theories, in distinction, commonly view contract law as a duty-imposing rule that responds to the moral wrong of breach. This perspective recommends not conditioning liability on the parties' intent to contract, more contextualist rules of interpretation, and remedies that reflect the nature of the wrong rather than parties' ex ante preferences.

My own view is that our existing law of contract is best understood as serving at one time both generic functions. On the one hand, contemporary contract law is designed to give parties the power to purposively undertake new or extinguish old legal obligations to one another. It anticipates that parties will often use it in order to change their legal obligations, and it is designed to enable such uses. On the other, existing contract law appears to impose duties on parties for reasons other than party choice. Contract law does not exhibit the usual markers of power-conferring laws. It attaches legal consequences to acts—entering into an agreement for consideration—without first asking whether the parties intended those consequences. And parties' ability to modify their legal obligations are limited and structured in ways that reflect moral concerns. These characteristics suggest that our contract law is also designed to impose legal duties on parties based on what they already owe one another. Contract law is, in this respect, special. Whereas most laws can be classified as either power conferring or duty imposing, contemporary contract law is a compound of the two. It is designed not only to confer a power to undertake legal obligations, but also to impose a duty to keep one's agreements.

The stories of *Borderland* and the *Federation* are not meant as a complete account of the compound functions of our law of contract. The models simplify far too much. Although their heterogeneities complexify them beyond the societies described in Part I, the models in Part II hardly capture the diversity of transactors and transactional situations in the actual world. More importantly, the hypothesized party preferences do not capture all the commitments that arguably animate our law of contract. Neither Takers nor Akkrastic Dorights value personal autonomy or self-authorship as such. They do not see the value of markets as tools for enabling important forms of social solidarity or for decentralizing political power. They are not committed to the principle of unjust enrichment or a right to recourse. A

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<sup>77</sup> Klass, *Three Pictures of Contract*, *supra* note 10.

complete account of the compound structure of our contract law would have to consider the greater factual and normative complexity of the actual world.

That said, the stories of Borderland and the Federation illustrate why a society might want and how it might achieve a compound law of contract—how a single law of contract might be designed to serve both these generic functions at once, as well as a number of more specific ones. Having worked through the models, I now draw some lessons about the contract law we find in the world around us.

#### A. The Indeterminacy Objection

I begin with a common objection to pluralist theories of contract law, which starts from the thought that the point of doing legal theory is to better understand what the law should be.<sup>78</sup> Meaningful theory is ultimately a practical activity: it begins with practical problems and succeeds when those problems disappear. We theorize about the law to resolve disagreements or recommend reforms. The problem with a pluralism that identifies multiple independent nonordered justifications for the law is that it cannot do that job. Distinct principles are likely to recommend different legal rules and different case outcomes. Where its principles conflict, a pluralist theory without a higher-order ordering principle suffers from indeterminacy. The theory cannot tell us how to go forward, what the law should be. And if a theory cannot do that, it is not doing its job.

One might respond that the objection misunderstands the job of legal theory. The reason to theorize an area of the law is not so much to resolve practical conflicts as to identify them, to explain the felt tension, and to locate it within broader political or social disagreements.<sup>79</sup> By recognizing the complexity of the normative landscape, we inoculate ourselves against arguments whose persuasive force lies in oversimplification and whose one-sided justifications might in fact serve to protect narrow interests and entrenched powers. The proper goal of theory, on this view, is critical. It is not to justify the law as it exists or point the way forward to reform, but to keep us constantly wary of the law's claim to authority. Whether with Whitman-like joy, Kierkegaardian dread, or Nietzschean suspicion, we should embrace conflict. Keeping the law's

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<sup>78</sup> I defend a modest version of this thesis, one compatible with pluralism, in Gregory Klass, *What Might Contract Theory Be?*, in *Understanding Private Law: Essays in Honour of Stephen A. Smith* (E. Fox-Decent, J. Goldberg & L. Smith eds, Hart forthcoming 2024).

<sup>79</sup> See, e.g., Duncan Kennedy, *Form & Substance in Private Law Adjudication*, 89 *Harv. L. Rev.* 1685 (1976); Roberto Unger, *The Critical Legal Studies Movement*, 96 *Harv. L. Rev.* 561 (1983). Each takes contract law as an object of analysis.



plural justifications constantly in view allows us to maintain an appropriately skeptical attitude toward it.

I think this answer is fine as far as it goes. As a human artifact, the law is built of crooked timber. We should scrutinize how lawmakers exercise their claimed monopoly on the legitimate use of force to create and maintain social order.<sup>80</sup> At the same time, I do not want to give up too quickly on a more constructive pluralist theory. The indeterminacy objection rests on the idea that different principles sometimes recommend different legal rules or case outcomes, between which a nonordered pluralist theory will be unable to choose. I want to argue that in the case of contract law, such conflicts often can be satisfactorily, if imperfectly, resolved at the level of doctrine.

Jody Kraus, thinking more narrowly about the tension between autonomy and efficiency theories of contract, has suggested three strategies for resolving conflicts among competing principles.<sup>81</sup> The first, which he calls the “convergence strategy,” argues that though contract law might be subject to multiple principles, those principles do not in fact conflict in their practical prescriptions. They “happily converge in their normative assessments of most contract doctrines, even though they do so on logically incompatible grounds.”<sup>82</sup> The second, “horizontal independence” strategy reconciles different principles “by construing them as making different kinds of claims about different kinds of things.”<sup>83</sup> One principle, for example, might be explanatory, the other justificatory. Or we might divide contract law into discrete domains, each governed by its own justificatory principle. The third strategy is “vertical integration,” in which the relevant principles are lexically ordered, so we know which wins when they come into conflict. Vertical integration subjects plural principles to a higher-level ordering principle, “construing them as comprising logically distinct elements within a unified theory.”<sup>84</sup>

Kraus has explored at length how the horizontal independence and vertical integration strategies might be used to reconcile autonomy and

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<sup>80</sup> “The highest leader should himself be just, and yet still human. This challenge is therefore the most difficult of all. Indeed its complete solution is impossible. Out of such crooked timber as humanity is made, nothing straight can be built.” Immanuel Kant, *Idee zu einer allgemeinen Geschichte in weltbürgerlicher Absicht* (1784).

<sup>81</sup> Jody S. Kraus, *Reconciling Autonomy and Efficiency in Contract Law: The Vertical Integration Strategy*, 11 *Phil. Issues* 420, 420-22 (2001) [hereinafter Kraus, *Reconciling Autonomy and Efficiency*]. See also Jody S. Kraus, *Legal Theory and Contract Law: Groundwork for the Reconciliation of Autonomy & Efficiency*, 1 *J. S. Pol. & Legal Phil.* 385 (2002) [hereinafter Kraus, *Groundwork*].

<sup>82</sup> Kraus, *Reconciling Autonomy and Efficiency*, *supra* note 82 at 320-21.

<sup>83</sup> *Id.* at 321.

<sup>84</sup> *Id.*

efficiency theories of contract.<sup>85</sup> He is less enthusiastic about the convergence strategy. Convergence is, in Kraus's view, "not a genuine reconciliation strategy because it purports merely to demonstrate the mere compatibility of efficiency and autonomy contract theories in practice, while conceding their logical incompatibility in principle."<sup>86</sup>

Borderland and the Federation model a more thoroughgoing pluralism than Kraus's dual commitment to autonomy and efficiency. Both autonomy and efficiency theories typically treat contract law as a power-conferring rule. The models in Part II add duty-imposing functions. All the same, I want to argue that Kraus is too quick to dismiss the possibility of convergence. Kraus assumes that any convergence among multiple principles or functions is a contingent fact. Such convergence is, in Kraus's view, like the fact that a hammer works well as a doorstop: a happy accident.<sup>87</sup> I want to argue that convergence of contract law's several duty-imposing and power-conferring functions, and by extension the principles that support them, is instead the result of careful design. The independent nonordered purposes of contract law are better analogized to the dual purpose of a claw hammer, which is designed both to drive nails in and to pull them out. The convergence of multiple legal functions in the law of contract is not a happy accident but results from an attempt by many hands to craft a contract law that serves multiple purposes and is justified by more than one principle. The stories of Borderland and the Federation demonstrate the possibility of such convergence by design.

This is not to claim that the multiple principles or purposes animating our law of contract perfectly converge in their doctrinal implications. As the models in Part II illustrate, constructing a single law of contract that serves several independent functions at once requires both creativity and compromise. But the models also show that those compromises need not be unprincipled, even absent horizontal border-marking or vertical integration under an ordering principle. To show how

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<sup>85</sup> In addition to the pieces mentioned *supra* note 82, see Jody S. Kraus, *Philosophy of Contract Law*, in *The Oxford Handbook of Jurisprudence & Philosophy of Law* 687, \_\_\_-\_\_\_ (J. Coleman & Scott Shapiro eds. 2002) (discussing methodological commitments that divide autonomy and efficiency theories). See also Nathan Oman, *Unity and Pluralism in Contract Law*, 103 *Mich. L. Rev.* 1483 (2005).

<sup>86</sup> Kraus, *Reconciling Autonomy and Efficiency*, *supra* note 82, at 421.

<sup>87</sup> Kraus, *Groundwork*, *supra* note 82, at 388 n.2 ("A third strategy for reconciling consequentialist and deontological legal theories is to demonstrate their *contingent convergence* on the same institutions in general, or on the precise contours of particular institutions." (emphasis added)); Kraus, *Reconciling Autonomy and Efficiency*, *supra* note 82, at 421 (The convergence strategy "attempts to demonstrate that efficiency and autonomy contract theories *happily converge* in their normative assessment of most contract doctrines, even though they do so on logically incompatible grounds." (emphasis added)).

this can be the case, I make four observations about the nature of the challenge then identify three tools lawmakers can use to address it. Together these facts provide identify both the conditions of the possibility and the means of achieving convergence by design in the law of contract.

## B. The Groundwork for Convergence by Design

I begin with four facts that necessary for convergence by design: the absence of radical conflicts between principles; the sufficiency of reconciliation at the level of doctrine; the multiple realizability of legal principles; and our imperfect knowledge of the world.

### 1. *Limited Convergence*

This Article does not follow the “convergence strategy” Kraus describes. I do not argue that the principles that animate our contract law “happily converge in their normative assessments of most contract doctrines, even though they do so on logically incompatible grounds.”<sup>88</sup> This is not to say, however, that a single law of contract can be constructed to serve any possible principles or purposes. The relevant principles or purposes cannot diverge too widely in their practical prescriptions.

In the analysis of Borderland, for example, I argued that there might be irreconcilable differences between using contract law to guide self-interested rational utility maximizers to the most efficient terms possible and using it to enforce parties’ first-order moral obligations to perform. If the theory of efficient breach is correct, in many contexts parties can maximize the expected value from their transaction with a remedy that effectively give one party an option to perform or pay damages. If, on the contrary, the goal is to enforce the first-order moral obligation to perform, the preferred remedy might be punitive damages or other penalties for breach. If all this were so,<sup>89</sup> it might be impossible to construct a contract law with the dual purpose of enforcing the first-order moral obligation to perform and maximizing the expected joint surplus of trade.

Similarly, it would be impossible to realize both contract law’s duty-imposing and power-conferring functions if the reason for imposing the legal duty precluded permitting individuals to opt out of enforcement. Suppose Federation Akrastric Dorights believed that the law should enforce agreements even when the parties, at the time of contracting, agree to no legal liability. Perhaps they believe that the moral wrong of breach is too severe to give parties control over its legal consequences. (Compare the

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<sup>88</sup> Kraus, *Reconciling Autonomy and Efficiency*, *supra* note 82 at 320-21.

<sup>89</sup> The theory of efficient breach rests on empirical assumptions, such as high costs of renegotiation, that might prove false. The claim that enforcing first-order obligations requires penalizing breach rests on a contestable theory about what legal remedies are necessary to enforce first-order moral obligations.

limits law places on parties' ability to contractually limit their liability in tort.<sup>90</sup>) Or maybe they think that to permit parties to contract out of legal enforcement would do serious damage to the moral culture of making and keeping agreements. Such commitments would make it very difficult for everyone in the Federation to agree on a generally applicable set of validity conditions. Mandatory liability for nonperformance is incompatible with Takers' broader commitment to a contract law that works as a power-conferring rule. Smallvillers especially would object, as in most circumstances they neither need nor want liability for breach.

In short, the multiple purposes contract law serves and the principles that justify them cannot diverge too widely in their doctrinal prescriptions. Contract law can serve both efficiency and morality only if both recommend or are compatible with transfer remedies, with compensatory damage measures, and with giving parties the ability to contract out of legal liability. Sufficient divergence on these or other doctrinal issues might be enough to thwart the project of developing a law of contract that serves several independent nonordered functions at once.

In fact, we can say even about the natural convergence necessary for the particular mix of functions we find in our law of contract. To repeat a point made above, the convergence of contract law's duty-imposing and power-conferring functions is possible only because a special set of facts pertains. Contract law's duty-imposing function assumes a social interest in attaching legal consequences to nonlegal acts for reasons that have nothing to do with the parties' legal preferences. Its power-conferring function assumes that, at the same time, a significant proportion of persons who engage in those acts want and intend those legal consequences, and that such an intention is an independently sufficient reason for legal enforcement. Exchange agreements satisfy both conditions. Only because of this limited convergence can our law of contract serve those two very different generic purposes.

## 2. *Reasons, Rules and Outcomes*

The second important fact is that we should expect any reconciliation of the several justifications for contract law to occur at the level of doctrine not case outcomes.

Recall the tension in Borderland concerning whether parties should have the power to contract for penalties. Borderland lawmakers will have done their job if they craft a rule that takes sufficient account of both the importance local Takers attach to party choice as evidence of efficiency and local Akrastric Dorights' commitment to the compensation principle, which suggests limiting party choice. Suppose we allow for a degree of tailoring and that Borderland lawmakers adopt a penalty rule that excludes

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<sup>90</sup> See Restatement (Second) of Contract § 195 (1981).

from its scope contracts between corporations and other artificial entities and includes a heightened burden of proof for any party raising the defense. Such a rule represents a reasoned compromise between the competing functions of enabling party choice and achieving corrective justice. Although neither Borderland's Takers nor its Akkrastic Dorights view the rule as ideal, both recognize that it serves their interests sufficiently well.

Kraus suggests that this is not enough. He writes, "an area of law cannot be justified unless it provides reasons that epistemically warrant the conclusion that its *adjudicatory outcomes* are uniquely justified."<sup>91</sup> If this is correct, it is not sufficient to reconcile competing principles at the level of doctrine. A justificatory theory of contract law succeeds only if it provides clear guidance on how particular cases should be resolved.

Kraus does not explain why a contract theory should provide determinate recommendations about case outcomes. I doubt his reasons are practical ones. We generally expect adjudicators to decide cases based on the law, not on the principles that justify the law. It is true that a good rule might not achieve the purpose or satisfy the principle behind it in every application. Hence the role of equity.<sup>92</sup> And when the scope of a rule is unclear, a court might look to its purpose or justification when applying it. But the need for predictability, judgments about institutional competence, and other considerations suggest we get better results when courts mostly decide cases based on legal rules, not on the principles that justify those rules.

Perhaps Kraus's reasons for thinking a legal theory should be able to uniquely justify adjudicatory outcomes stems instead from a broader commitment about what counts as a satisfactory theory of law. I am not sure what that commitment is. But I believe it is belied by the fact that individual cases can and do involve tragic choices. The first-year Contracts curriculum is full of examples. In *Williams v. Walker-Thomas Furniture Company*, the D.C. Circuit found it difficult to protect a poor and poorly educated consumer against a furniture company's unscrupulous practices without at the same time calling her judgment into question and possibly making it more difficult for poor people to obtain basic necessities.<sup>93</sup> In *Cohen v. Cowles Media Company*, the Minnesota Supreme Court believed that refusing to enforce a reporter's promise of confidentiality was the best way to protect freedom of the press and promote the strongly felt ethical norms of journalists, but at the same time was faced with a reporter's

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<sup>91</sup> Jody S. Kraus, *Legal Determinacy and Moral Justification*, 48 Wm. & Mary L. Rev. 1773, 1774 (2007) (emphasis added).

<sup>92</sup> See Henry E. Smith, *The Equitable Dimension of Contract*, 45 Suffolk U. L. Rev. 897 (2012).

<sup>93</sup> 350 F.2d 445 (D.C. 1965).

breach that caused the source significant harm and gave rise to a compelling claim for compensation.<sup>94</sup>

Not every case is a hard one. But there exist cases in which our incommensurable commitments point in different directions. Practical conflicts and tragic choices exist at the level of case outcomes. We do not need, and should not expect, the multiple principles and purposes that animate contract law to uniquely determine the correct outcome of every contract dispute. It is simply not the job of legal theory to say how individual cases should come out. It is enough to reconcile the several reasons why we have a law of contract in generally applicable rules. The rubber of legal theory meets the road of legal practice at the level of doctrine, not case outcomes.

### 3. *Multiple Realizability*

The third observation on the nature of the problem concerns the relationship between, on the one hand, legal principles and purposes and, on the other, the rules that serve them. We care about the justifications for and functions of contract law because they tell us something about what the rules of contract law should be. They do not, however, provide axioms from which one can deduce the right rule. Many principles or purposes can be realized or served by any of several rules. Justification and function do not uniquely determine doctrine. Multiple realizability makes pluralism all the more plausible.<sup>95</sup>

For a simple example, recall contract law's expressive function in *Metropolis and Borderland*. I stipulated that the Akrastic Dorights who live in those regions want contract remedies to signal that the breaching party has committed a wrong. Not every legal response to breach can serve that purpose. A tax break for efficient breachers would send the wrong message. So too might criminal sanctions, which could signal that breach is equivalent to more serious wrongs. Between these extremes lie many remedies lawmakers can use to send the desired signal. They include money damages in any of the familiar compensatory measures, specific performance or other injunctive relief, declaratory judgment, and shaming

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<sup>94</sup> 457 N.W.2d 199, reversed, 501 U.S. 663 (1991), opinion on remand, 479 N.W.2d 387 (1992).

<sup>95</sup> Prince Saprai makes a similar observation in *Contract Law Without Foundations*, supra note 33, at 9.

This point is something like the flip-side of what Fuller and Perdue call the "divergence between method and motive." L.L. Fuller and William R. Perdue, Jr., *The Reliance Interest in Contract Damages: 1*, 46 Yale L.J. 52, 66-71 (1936). Fuller and Perdue's point is about whether one can abduce from a given legal rule ("the method") its *raison d'être* (its "motive"). Their argument that one cannot turns in part on the multiple functions of contract law. My point goes the other way: nor can we deduce from motive a single right method.

sanctions. An expressive function leaves room for choice between remedial options, which is also a space for the operation of other principles or purposes.

If the point is especially obvious with respect to expressive functions, it is not limited to them. First-order obligations can be enforced with a variety of deterrence sanctions, including punitive damages and criminal punishment. Second-order obligations of corrective justice might be enforced with money damages or specific performance, both of which encourage a breaching promisor to attend to her remaining moral obligations. Even an interest in efficiency might not point to a single remedial rule.<sup>96</sup> I stipulated in the models that in contracts between Takers, efficient breach was cheaper than negotiating a release. But there are good arguments that in many circumstances specific performance or even punitive damages provide efficient incentives.<sup>97</sup>

None of this is to deny that sometimes the reasons we have a contract law come into conflict with one another. But the multiple realizability of the principles and purposes behind contract law reduces the places where this is so. Flexibility in design makes it easier to craft a single rule that serves several independent purposes or is justified by multiple non-ordered principles.

#### 4. *Limited Knowledge*

The fourth observation on the problem is an epistemic one. The best choice among possible rules often turns on facts to which lawmakers do not have complete access.

The models in the first two Parts of this Article make heroic assumptions about lawmakers' knowledge of the practical effects of various legal rules—assumptions that do not hold in the real world. Consider again the theory of efficient breach as it applied in Takerland. Even supposing that among Takers efficient breach is cheaper than a negotiated release, how is it that lawmakers come to know that fact? How would we know it about transactions in the actual world? Theoretical accounts of the costs of negotiating in a bilateral monopoly or the incentive effects of underenforcement can identify relevant variables. But they do not tell us their values in actual transactions. And the simplicity of the models I have constructed masks the complexity of the problem.<sup>98</sup> The efficiency of a remedial rule depends not only on its effects on the performance decision, but also is determined by the rule's effects on the obligee's reliance investments, on the selection of contracting partners, on the parties' risk

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<sup>96</sup> For a more detailed discussion of the issues discussed in the rest of this paragraph, see Klass, *Efficient Breach*, *supra* note 18, Part III.

<sup>97</sup> See Alan Schwartz, *The Case for Specific Performance*, 89 Yale L.J. 271 (1979).

<sup>98</sup> See Klass, *Efficient Breach*, *supra* note 18, Part III.

preferences, and on other party decisions.<sup>99</sup> Those effects are difficult to predict, and likely to depend on the circumstances. In 2003, Eric Posner canvassed thirty years of scholarship on the economic analysis of contract law and found no clear answers about which rules were most efficient. “Simple models do not justify legal reform because these models exclude relevant variables. Complex models do not justify legal reform because the optimal rule depends on empirical conditions that cannot be observed.”<sup>100</sup> Nothing in the subsequent two decades of scholarship suggests a different conclusion.

The point is not limited to economic theories. I have argued that Akroastic Dorights should worry about the effect of legal rules on moral culture. But it is difficult to know what those effects are or would be. Is Seanna Shiffrin correct that that expectation damages, by giving parties a choice to perform or pay damages, are likely to produce habits of practical reasoning that in the long run will degrade the moral culture of making and keeping agreements?<sup>101</sup> Or does Dori Kimel have it right when he suggests that more severe remedies for breach like specific performance or punitive damages “cast a thick and all-encompassing veil over the motives and the attitudes towards each other attributable to the parties to contracts, thus leaving reliance, performance, and other aspects of contractual conduct largely devoid of expressive content”?<sup>102</sup> It is not difficult to tell stories or find theories that support one or another prediction. But we have limited empirical data to support either.

Here I do not want to sound too pessimistic. If we do not know everything, we do know a lot. The point is simply that empirical uncertainty often limits the practical upshot of abstract principles, leaving room for creative compromise. If we are uncertain whether expectation damages or specific performance is the more efficient remedy, we might decide between them based on moral considerations. If we do not know what the effect of punitive damages for breach would be on moral culture, this is a reason to defer to efficiency arguments against their widespread application.

### C. Tools for Reconciliation

Having identified some reasons to think convergence by design is possible, I now turn to tools lawmakers can use to reconcile the multiple

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<sup>99</sup> See Craswell, *supra* note 3.

<sup>100</sup> Eric A. Posner, *Economic Analysis of Contract Law after Three Decades: Success or Failure?*, 112 *Yale L.J.* 829, 854 (2003).

<sup>101</sup> Shiffrin, *supra* note 29 at 740-41, 747-49.

<sup>102</sup> Dori Kimel, *From Promise to Contract: Towards a Liberal Theory of Contract* 74 (2003).



principles and purposes that can animate a law of contract: tailoring, defaults, and altering rules.

### 1. *Tailoring*

First, lawmakers can tailor rules by transaction type. In the models, geographical location tells us most of what we need to know about the relevant conditions of contracting and the social interest in enforcement. Were tailoring permitted in Borderland or the Federation, it would be a simple matter for lawmakers to craft contract rules that match local conditions and commitments.

Boundaries in the real world are not so crisp. That said, there exist well-defined transaction types in which the conditions of contracting are relatively uniform and some principles and purposes are more salient than others. If we define “contract law” broadly as the law of agreement-based legal obligations, we find large parts of it tailored to fit who parties are, the type of agreement, and the conditions of contracting. The law marks out for special treatment the sale of goods, individual employment agreements, collectively bargained employment agreements, agreements to arbitrate, the sale of securities, secured loans, consumer transactions, government contracts, leases, partnership agreements, and many other transaction types. Tailoring also happens within those broader regions, as individual rules can take account of who the parties are and the type of transaction. Many provisions of Article Two of the Uniform Commercial Code provide different rules for merchants and nonmerchants; there is a new Restatement proposing specialized rules for contracts between businesses and consumers; courts have crafted special rules to govern a physician’s assurance of a particular outcome, a reporter’s promise of confidentiality, and agreements between family members; and minors, the mentally disabled and intoxicated persons all get special treatment. Tailoring permits contract law to take account of factual differences between different types of transactions, such as the sophistication of the parties, their relative bargaining strength, the duration of their relationship, the availability of extra-legal forms of assurance, and so on. Tailoring also responds the fact that society has different reasons for, and concerns about, enforcing various types of transactions. By dividing the law of contract into smaller units, we can design its rules both to fit the conditions of transacting and to advance society’s principal interests in the transaction.

All of this is something like what Kraus calls “horizontal independence,” which avoids conflict between principles by distinguishing between the claims they make or the types of transactions to which they apply. But though tailoring defines regional boundaries within contract law, it need not divide contract law into normatively monothetic units. The tension between, say, doing justice in this case and providing the right incentives to future parties exists as much in consumer contracts as in

securities transactions. The point is that the best resolution of that tension is not the same in each. The reason is twofold.

First, the relative strengths of social interests at stake vary across transaction types. In the models, for example, Akrastic Dorights' commitment to contract law's moral function causes them to attach a greater value to interpretive accuracy than do Takers. If permitted, Federation lawmakers could account for those different interests by tailoring the interpretive rule to the place of contracting—permitting more context evidence, say, in Metropolis than in Takerland.

We find such tailoring to social interests throughout our law of contract. Consider the different rules that apply to assurances a physician gives her patient and to representations of quality a seller of goods makes to a buyer. In both cases there is a social interest in imposing liability for breach. (If this isn't obvious in the physician-patient context, consider a plastic-surgeon's assurance: "If you pay me \$5,000, I will give you a beautiful nose.") In both cases there is also a social interest in not chilling productive or nondeceptive communications. But latter interest is much stronger in the physician-patient context, and so the law adopts different rules for the two situations. The Massachusetts Supreme Court has held that to bring a case based on a physician's assurances of a positive outcome, the patient-plaintiff must have "clear proof" that a promise was made and, if she prevails, might recover only reliance damages.<sup>103</sup> In sales of goods, on the contrary, any representation among the bases of the bargain creates a warranty, whether or not the seller uses words like "warrant" or "guarantee"; the successful plaintiff can recover expectation damages; and the seller bears the burden of proving that the statement was mere opinion or sales talk.<sup>104</sup>

More generally, where it is clear that one interest is stronger than another, lawmakers can adopt a local rule to reflect that fact. Tailoring here achieves, in Kraus's terms, something like a local vertical integration. The ordering principle, however, is not general lexical priority. It lies instead fact that the several social interests in enforcement do not have the same force in every type of transaction.

The second reason the best resolution of principled conflicts is not the same everywhere is that different contexts provide different tools for resolving competing interests. Tailoring can be used to apply the most locally effective legal tool. In the models, the Akrastic Dorights who live in Borderland are more attuned to the legal consequences of their agreements than are the Akrastic Dorights in Metropolis. In Borderland, everyone always relies on contract law's assurance function, whereas in Metropolis parties know they can rely on one another's moral responsiveness. As a

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<sup>103</sup> *Sullivan v. O'Connor*, 363 Mass. 579 (1973).

<sup>104</sup> UCC §§ 2-313(2) & 2-711-716.

consequence, textualist rules of interpretation and formal altering rules are more effective at achieving party preferences among the Akrastic Dorights in Borderland than they are among Akrastic Dorights in Metropolis. If Federation lawmakers are permitted to tailor the rules of contract law, they will take those factual differences into account.

Again there are many examples in contemporary contract law. Article Two of the Uniform Commercial Code imposes separate rules for merchants and for consumers in part because we expect merchants to be more sophisticated about the legal consequences of their actions. Statutes of Frauds limit their writing requirements to real estate transactions, long-term contracts, and high-value sales in part because it is more reasonable to expect parties to such transactions to comply with their requirements. Or consider Alan Schwartz and Robert Scott's argument that efficiency is the most salient value in contracts between firms and that between firms, efficiency is best achieved by highly formalist rules of contract interpretation.<sup>105</sup> By its own terms the argument applies only to one (albeit significant) region of contract law. It is therefore not in tension, for example, with the Restatement of Consumer Contract Law's suggestion that standard terms in a consumer contract are never integrated against prior contrary statements of fact or promises made by the business.<sup>106</sup> In such instances, tailoring is used to improve the effectiveness of the rule.

## 2. *Defaults*

A second method for reconciling the competing functions of contract law is the use of defaults. Many conflicts among the principles that animate contract law involve the more fundamental tension between the law's duty-imposing and power-conferring functions. Defaults provide an especially apt tool for resolving those conflicts.

Recall the argument for an enforcement default in the Federation. Majoritarian or not, the enforcement default captures Akrastic Dorights' desire for a contract law that serves corrective justice and supports the moral practice. For Akrastic Dorights, the reason for enforcement is not the parties' intent to contract, but that their agreement generates moral obligations. Federation Takers, in distinction, attach more importance to party preferences with respect to legal liability, which they view as the best evidence that enforcement adds value to the transaction. Takers' attachment to party choice can be squared with Akrastic Dorights' moral commitments by permitting parties to contract around an enforcement default. When the costs of legal enforcement exceed its benefits, parties can choose to avoid enforcement.

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<sup>105</sup> Schwartz & Scott, *supra* note 7.

<sup>106</sup> Restatement of the Law: Consumer Contracts § 9.

The point can be generalized. In many contexts, setting the default in light of contract law's duty-imposing functions gives the right result for parties that are less likely to be thinking about the legal consequences of their acts or, if they are, are more likely to rely on their moral intuitions to predict what those consequences are. At the same time, the fact that it is a mere default gives sophisticated parties with contrary preferences the power to choose for themselves. And because the moral obligations that attach to contractual agreements are voluntary ones, that choice can in turn alter the parties obligations.

This simple rule is subject any number of exceptions. Where, for example, the reasons for imposing the duty are not especially compelling, it might be better to set the default to match majoritarian preferences. Recall, for example, the analysis of the mitigation rule in *Borderland*. The population in *Borderland* is half Takers and half Akrastic Dorights. If the Akrastic Dorights themselves are roughly split on whether a nonbreaching party has a moral obligation to avoid losses due to breach, yet is clear that most parties prefer no recovery for avoidable losses, lawmakers should adopt the latter as the default rule. In fact, even if the moral intuition is strong it might be the wrong default if it a vast majority of parties would contract around it. Here is another instance where the best rule depends on empirical facts. Contract law's duty-imposing functions need not perfectly match party preferences. But because we want a contract law that works, default duties cannot diverge too widely from what parties want from their agreements.

Whether and where there are such duty-imposing defaults in our law of contract depends on how one interprets the purposes of individual rules. I have argued elsewhere that the general enforcement default is best explained by ascribing a duty-imposing function to contract law.<sup>107</sup> A similar logic may be at work in default contextualist rules of interpretation, which tend to track parties' moral obligations. But then the rules of contract interpretation are a relatively unstable area of the law, to which both lawmakers and scholars bring different assumptions. In any case, my aim here is not to interpret the contemporary law of contract, but to examine what is possible within it. Default terms provide a powerful tool for crafting compromise among contract law's duty-imposing and power-conferring functions.

### 3. *Altering Rules*

The counterpart of a default is the rule for deciding when parties have contracted out of it, which is an altering rule.<sup>108</sup> Altering rules are a

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<sup>107</sup> Klass, *Three Pictures*, *supra* note 10 at 1769-73.

<sup>108</sup> Ayres, *Regulating Opt-Out*, *supra* note 56.

third mechanism lawmakers can use to reconcile contract law's competing functions.

The altering rules described in the models of Borderland and the Federation are moderately formal. The validity and interpretive altering rules in these regions, VAlt and IAlt, each require that parties expressly state their intent to contract around the enforcement or contextualist default. The reason is that VAlt and IAlt are designed to give Takers with nondefault preferences a cheap and easy way to avoid the default. Generally speaking, formal altering rules advance contract law's power-conferring functions by giving parties greater control over their legal obligations.

But this is not all altering rules can do. The formalism of the altering rules in Borderland and the Federation is an artifact of the models' simplicity. In the actual world altering rules might be crafted with other purposes or factual predicates in mind.

First, if society attaches special importance to a default term, we might want an altering rule that makes it costly to contract around it. As I have argued elsewhere, "[b]y combining an enforcement default with a relatively costly opt-out rule, we can permit sophisticated and sufficiently motivated parties to avoid legal obligations they would otherwise owe one another without significantly impairing the duty-imposing functions of contract law."<sup>109</sup>

Consider the Delaware rule for fraud in the inducement. It is well established that though parties have the power to contract out of liability for negligence, they do not have the power contract out of liability for intentional torts, including deceit.<sup>110</sup> In *Abry Partners V, LLP v. F&W Acquisitions LLC*, the Delaware Court of Chancery explained the rule as follows:

[T]here is a moral difference between a lie and an unintentional misrepresentation of fact. This moral difference also explains many of the cases in the *fraus omnia corrumpit* strain, which arose when the concept of fraud was more typically construed as involving lying, and thus it is understandable that courts would find it distasteful to enforce contracts excusing liars for responsibility for the harm their lies caused.<sup>111</sup>

The court went on to hold, however, that parties can insulate themselves from liability for deceit by stipulating in a written contract that they are not

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<sup>109</sup> Klass, *Intent to Contract*, *supra* note 24 at 1473.

<sup>110</sup> See Restatement (Second) of Contract §§ 195 & 196 (1981).

<sup>111</sup> 891 A.2d 1032, 1062 (Del. Ch. 2006).

relying on any extrinsic representations.<sup>112</sup> The holding's practical effect is a requirement that parties use special words to contract out of liability for deceit. Simply saying "Neither party shall be liable for fraud in the inducement" will not do the trick, whereas "Neither party has relied on extrinsic representations by the other" will.

The *Abry* rule recognizes both society's strong moral disapproval of lying and sophisticated parties' legitimate reasons for sometimes wanting to limit their liability for deceit. On the surface, the parties are not contracting out of the general duty not to tell a lie. Below the surface, the rule tells sophisticated parties what words to use to contract out of liability for deceit. The liability default corresponds to the socially preferred outcome; the altering rule makes that default stickier, sorts for the type of parties to whom we want to give the power of contracting out and requires that they do so in a way that affirms the relevant moral obligation. Impeding altering rules of this type can induce a separating equilibrium that both gives weight to society's duty-imposing interests in enforcement and permits parties who strongly prefer no enforcement to avoid those duties.<sup>113</sup>

Second, altering rules can be crafted to take account of parties' extralegal obligations in ways that also support contract law's duty-imposing functions. The moderately formal altering rules in *Borderland* and the *Federation* are designed to maximize parties' ability to purposively adopt non-default obligations. In the real world, altering rules are often designed also or instead to get at the parties actual agreement and obligations.

Consider Justice Cardozo's opinion in *Jacob & Youngs v. Kent*. The case is best known for its clear articulation of the substantial performance rule: "an omission, both trivial and innocent, will often be atoned for by allowance of the resulting damage, and will not always be the breach of a condition to be followed by a forfeiture."<sup>114</sup> What must parties do to avoid that default? Cardozo writes that they are "free by apt and certain words to effectuate a purpose that performance of every term shall be a condition of recovery."<sup>115</sup> This suggests a moderately formal route to avoid the

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<sup>112</sup> *Id.* at 1058. The court reasoned that to permit a claim of fraud despite a non-reliance clause would be "to excuse a lie made by one contracting party in writing—the lie that it was relying only on contractual representations and that no other representations had been made—to enable it to prove that another party lied orally or in a writing outside the contract's four corners." *Id.*

<sup>113</sup> On the use of impeding altering rules to create separating equilibriums, see Ayres, *Regulating Opt-Out*, *supra* note 56 at 2037. The above account adds to Ayres's economic account a new reason for impedance: a social interest that involves neither externalities nor paternalism.

<sup>114</sup> 129 N.E. 889, 890 (N.Y. 1921).

<sup>115</sup> *Id.* at 891. For a discussion of this portion of Cardozo's decision, see Ayres, *Regulating Opt-Out*, *supra* note 56 at 2056-58.

substantial performance default: it is enough if the parties expressly agree that breach by one side, no matter how trivial or innocent, will excuse the other side from performance.

Cardozo does not say, however, that parties *must* expressly state an intent to avoid the substantial performance default. When parties have not said one way or the other, “[c]onsiderations partly of justice and partly of presumable intention are to tell us” whether their promises are independent, fully dependent, or dependent only on substantial performance.<sup>116</sup> To decide the matter, a court “must weigh the purpose to be served, the desire to be gratified, the excuse for deviation from the letter, the cruelty of enforced adherence.”<sup>117</sup> The first two factors—the purpose of the term that has been breached and the desire that is meant to gratify—require interpreting the parties’ words and actions at the time of formation. Absent the parties’ express statement one way or the other, a court must engage in an open-ended inquiry into the objectively reasonable understanding of the parties’ purposes in specifying the duty and the foreseeable harms its breach would cause. This is an altering rule. Whether the parties’ duties were independent or dependent depends on what the parties said or did in reaching their agreement. “What the parties said or did,” however, refers not to their expression of some legal intent, but to acts with specified nonlegal meanings, to the parties’ actual agreement. Only by looking to those facts can the court determine the requirements of justice in the case. Nonformal altering rules that look to the parties’ actual agreement can thereby serve contract law’s duty-imposing functions.

This final point takes illustrates the limits of the simple models in Part I and II, and warrants a more detailed discussion than this Article will provide. But the models and the above discussion are enough to demonstrate that tailoring, defaults and altering rules provide powerful tools for reconciling the multiple functions a law of contract might serve. This explains why it is that the law of contract can be held accountable to several independent nonordered principles at once. Pluralist theories of contract do not face a binary choice between vertical integration and horizontal independence. There is also convergence by design.

## Conclusion

This Article has shown the possibility of a practically relevant pluralist theory of contract law. The models demonstrate how it is that a single law of contract can be designed to serve several different, even divergent, functions at once, and thereby also illustrate how a single law of contract might be accountable to several independent, nonordered principles. The analysis of those models shows both what is special about

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<sup>116</sup> 129 N.E. at 891.

<sup>117</sup> *Id.*

the law of contract that allows it to serve multiple purposes and the tools lawmakers can use to reconcile its underlying principles when they come into conflict.

This account is not a complete theory of our law of contract. The models are too simple, and the normative arguments remain undeveloped. But the analysis casts new light on the contract law we find in the world around us. Contemporary contract law exhibits a compound function similar to the contract law in the Borderland and Federation models. And, I would argue, there are good reasons to want a contract law that serves both an assurance function and a moral function, though we might want it to serve other purposes as well. If this Article has not provided a full account of those reasons, I hope it has at least convinced that a law of contract can be, and that ours might have been, designed to serve several such purposes once.