REGULATING CONTRACTS

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Rationality of Contractual Behaviour

Contractual behaviour often appears puzzling to the external observer. A legally enforceable contract is broken, but the injured party fails to assert any legal rights. A contractor demands extra money for the performance of a contractual undertaking agreed at a fixed price, and the other party willingly agrees without protesting against this apparent extortion.[1] Two businesses agree a contract, which their legal advisors tell them is probably unenforceable, but they appear to be unconcerned.[2] Many contracts are performed even though one party incurs a financial loss.[3] Some businesses such as large retail stores provide a replacement for goods even though the goods originally supplied were not defective and complied precisely with the written contract.[4] A purchaser of raw materials asks for less than the contractually agreed quantity, and the supplier agrees to the reduction without objection or price variation.[5] These are all common observations of contractual behaviour, and, at first sight, they appear quite odd.

Although contractual undertakings are often regarded as quintessential forms of rational self-interested action, these observations of contractual behaviour appear to detect an opposite type of motivation, which might be described as altruistic or even irrational. Why do the parties not stick to their contractual undertakings? Why do they not pursue their immediate self-interest by demanding performance of the contract or insisting upon the limits of their express contractual undertakings? Why do they not threaten to enforce the contract in the event of breach? Contractual

[1] e.g. *Williams v Roffey Bros & Nicholls (Contractors) Ltd* [1991] 1 QB 1, [1990] 1 All ER 512, CA.

[2] Macaulay, S., 'Non-Contractual Relations in Business' *American Sociological Review* 28 (1963) 45 (on requirements contracts, discussed in the previous chapter); Palay, T. M., 'Comparative Institutional Economics: The Governance of Rail Freight Contracting', *Journal of Legal Studies* 13 (1984) 265.

[3] Schultz, F., 'The Firm Offer Puzzle: A Study of Business Practice in the Construction Industry', *University of Chicago Law Review* 19 (1952) 237.

[4] Kamkas, A., and Rosenwasser, R., 'Department Store Complaint Management', in L. Nader (ed.), *No Access to Law: Alternatives to the American Judicial System* (New York: Academic Press, 1980) 283.

[5] Daintith, T., 'Vital Fluids: Beer and Petroleum Distribution in English Law', in C. Joerges (ed.), *Franchising and the Law: Theoretical and Comparative Approaches in Europe and the United States* (Baden Baden: Nomos Verlagsgesellschaft, 1991) 143.

behaviour appears to be rife with actions that appear to run contrary to rational self-interested action.

My first objective in this chapter is to explain how this kind of behaviour can be interpreted as rational action. It is true that the behaviour may not always be in the immediate economic self-interest of a party to a contract, but this should not be the only measure of rational action. Following an analysis of the rationality of contractual behaviour in terms of a competition between communication systems, we then examine the significance of the phenomenon that participants in markets appear to attach little weight to formal contractual relations. My analysis is also compared to a different type of explanation based upon the observation of the phenomenon of relational contracts. The chapter concludes by considering the implications for legal regulation of the complicated picture of competing rational standards of contractual behaviour. As ever, the underlying purpose of the enquiry is to discover how legal regulation may better achieve its objective of supporting transactions and markets.

Three Frameworks of Contractual Behaviour

We can begin to discern the rationality of these aspects of contractual behaviour by distinguishing between frameworks or points of reference within which actions take place. Most human action is oriented towards a particular normative system. It obtains its meaning and purpose by being directed towards the satisfaction of particular standards. These standards fit together to provide a systematic orientation for particular actions. Conduct acquires its point and purpose by using these standards as a reference. The rules of soccer, for example, provide the action of kicking a ball into a net with standards of reference which give it meaning (a goal) and purpose (to win the game). Unlike the simple model of a game, however, the social interaction of making transactions often involves multiple frameworks of reference.

In connection with contractual behaviour, I suggest that we can distinguish usefully, though schematically, between three dimensions or normative systems governing action: the business relation, the economic deal, and the contract. These three points of reference for contractual behaviour provide standards which the parties use to guide their own behaviour and their evaluation of the other party's behaviour. The patterns of social interaction described by these normative systems produce a differentiation between the communications between the parties according to the dominant point of reference. In other words, the parties to a contract can think and converse about their relationship in three radically different ways.

Business Relation

The social and business relation between the parties both precedes the transaction and is expected to persist after performance. It consists of the trading relation between the parties, made up by numerous interactions, some of which may involve contracts, but often will consist of enquiries, discussions of plans, and sorting out problems which have arisen. Surrounding and sustaining the trading relation, we are also likely to discover informal social relations, such as business lunches, links through family or social networks of friendships, membership of clubs, and ethnic identity.

We have already observed that this business relation provides an important source of the trust which encourages parties to enter into transactions. The normative system of orientation for this dimension is principally concerned with the development and preservation of trust, though in the event of betrayal it may also guide actions of recrimination and punishment. An important ingredient of this normative context will be the customary standards of trade, for conformity with these standards and support for their institutional framework will have served to create trust between the parties.

Action oriented towards the business relation has as its predominant purpose the preservation and enhancement of trust. Actions will be understood within this framework as either demonstrations of trustworthiness, or the opposite, a sign of betrayal. Failure to keep a promise sealed by a handshake within a long-standing business relation may therefore be treated as a deliberate signal that the business relation should no longer be regarded as a source of trust. Equally, the keeping of a promise, even though both parties are aware that this will cause economic losses, represents an affirmation that the business relation will be awarded priority in dealings between the parties, so that trust will be enhanced. The communication system of the business relation examines contractual behaviour with regard to the degree to which actions sustain or subvert the bonds of trust between the parties.

Economic Deal

Next, there is the deal or agreement between the parties, which specifies the reciprocal obligations created by this discrete transaction, and which establishes the economic incentives and non-legal sanctions. Economic rationality provides the normative framework of reference for this dimension of contractual behaviour in market transactions. It suggests a calculus of both short-term and long-term economic interest by which to measure and assess contractual behaviour. The communication system

between the parties examines behaviour by reference to rational self-interested action.

Within this frame of reference, actions are assessed solely by reference to economic self-interest. A breach of a contract in order to avoid loss represents a rational application of the criteria, despite the betrayal and loss of trust which the breach causes. The key measurement concerns the price or cost of performance in relation to the value placed upon the expected benefit. Rational conduct by this criterion requires contractual performance only when the benefits exceed costs of default combined with costs of making alternative transactions in the market.

The economic calculation within this framework has to integrate both long-term and short-term interest. It might be worth accepting short-term losses for the sake of long-term gains from contractual relations with a particular party. A useful model to describe this framework of both short-term and long-term interest is a repeated non-cooperative game.

In the model of a non-cooperative game, both parties pursue their economic self-interest, but are unable to control the actions of the other, and therefore cannot dictate outcomes. Their actions must be guided by predictions of the rational behaviour of the other, who also operates under the same conditions of uncertainty and lack of control over outcomes. Communication between the parties is always possible, but there is no guarantee that statements will be true or that any promises will be kept. This feature of the lack of reliability makes the game 'non-co-operative'. It is sometimes assumed in the economic theory of games that in the context of legally enforceable contracts we must be exploring the terrain of co-operative games. But our earlier insight with respect to the insignificance of legal sanctions in steering contractual behaviour reveals that such an assumption is false. The presence of a legally enforceable contract makes little difference to the credibility of commitments.

The parties' predictions of the other's future behaviour therefore place most weight on an analysis of the other's self-interest. The worker will perform the job because she needs her wages to survive; the employer will pay the promised wage as long as the required work has not been completed. Both parties count on this self-interest in order to predict the behaviour of the other. The creation of non-legal sanctions is a way of guiding how this self-interest will determine action, so that conduct becomes more predictable. This model of rational action emphasizes how self-interested action, such as defective but cheaper performance of a contract, must be assessed by reference to the costs incurred by the predictable response of the other party, such as the imposition of the non-legal sanction of a refusal to pay the agreed price in full.

This model derived from game theory has to become more elaborate in order to grasp the point that most transactions occur within a trading

relation that persists over a period of time. The transaction of a consumer purchasing goods in a shop, for instance, is likely to be one of an indefinite series of transactions between the parties. The theory of repeated games suggests that such a series of transactions will always be inherently unstable. In the final transaction of the series, there is an incentive to cheat, as in the case of the shopkeeper providing defective goods, because the sanction of withdrawal from the trading relation is removed in the final transaction of the series.[6] Knowing this problem, the consumer will be reluctant to enter each transaction for fear that the shopkeeper will treat it as the final one in the series and therefore cheat. The solution to this problem lies in ensuring that for every transaction in the indefinite series the shopkeeper will benefit more from continuing the series than cheating on that particular transaction. In the case of retail sales, this condition is likely to be met, for the benefit of cheating on a particular transaction is usually likely to be far less valuable than the benefit to be obtained from the profit margins on the indefinite series. Under this model, therefore, long-term interest in the context of an indefinite series of transactions usually requires proper performance of contractual undertakings. The game of repeated transactions achieves stability or equilibrium, because long-term interest nearly always requires the sacrifice of the short-term interest to cheat. Under this model, therefore, uniquely self-interested, short-term benefits from contractual behaviour are unlikely to prove the determinative guide to conduct.

Contract

The third normative framework of contractual behaviour is constituted by the standards provided by the self-regulation contained in the contract. This frame of reference orients conduct to the identification of rights and obligations established by any formal documents, explicit agreements, and accepted customary standards. It guides the parties in making assertions of rights and correlative claims to obligations to perform or pay compensation. The self-regulation provides another frame of reference by which to judge whether the other party has defaulted or cheated.

Lawyers will often be employed to guide and to articulate the discourse generated by this contractual orientation, so that it may be described as legalistic. But this framework is not exactly the same as how the law thinks about the conduct of the parties. The contractual discourse is not confined to lawyers. The parties to a deal may decide that it would be prudent to iron out the details of a potentially divisive issue in a formal way, not because they expect ever to have a legal dispute, but for the purposes of clarifying the problem and determining the allocation of risks and liabilities in advance.

[6] Telser, L. G., 'A Theory of Self-enforcing Agreements', *Journal of Business* 53 (1980) 27.

This attention to the details of planning is not necessarily connected to the possibility of legal enforcement. For example, in Palay's study of rail freight contracting in the USA, most of the contracts which the parties negotiated were probably unenforceable due to regulations governing interstate commerce, but this lack of enforceability in no way discouraged the parties from committing some complex aspects of the transaction to a written agreement.[7] During performance of a contract as well, the parties may raise points in this legalistic mode. One party may argue that she never agreed to the contract, because she never signed the documents. Another party may point to the small print in the standard form contract in order to rely on an exception clause which absolves him from breach of contract. Indeed, lawyers may have a rather less legalistic approach to detailed points of interpretation than the layman, since they are aware that a court may adopt a rather looser, purposive, or 'common-sense' interpretation of the legal rules and the terms of the contract.[8] How the law thinks about the terms of a contract may therefore differ from the way the layman expounds this contractual framework, even though the layman may believe that he is tracking legal argumentation.

This third framework may be described more accurately therefore as how the contract thinks about the relation between the parties. It emphasizes the autonomous, unsituated obligations constituted by the formal agreement. The formation of the agreement creates a new system of communication between the parties, which is distinct from the communication systems established by the business relation and the economic deal. The way in which the contract thinks about disputes is a framework which isolates the transaction from its economic and social context. The communication system of contract treats the obligations undertaken as absolute undertakings, firm commitments, which cannot be revised except through the process of revising the contract itself by agreement. It is this third framework which describes the discrete communication system represented by the contractual relation.

Competing Norms of Contractual Behaviour

By distinguishing these three dimensions of economic transactions, we can understand many puzzling features of contractual behaviour. Each dimen-

[7] Palay, T. M., n. 2 above.

[8] e.g. Lord Hoffman, *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 898, HL; Lord Wilberforce, *Reardon Smith Ltd v Tngar Hansen Tangen (The Diana Prosperity)* [1976] 1 WLR 989, HL; Sir Robert Goff, 'Commercial Contracts and the Commercial Court', *Lloyds Maritime and Commercial Law Quarterly*, [1984], 382; Lord Steyn, 'Contract Law and the Reasonable Expectations of Honest Men', *Law Quarterly Review* 113 (1997) 433.

sion has its own normative standards by which the parties guide their behaviour. The dimensions can each be described as closed, self-referential communication systems, which have their distinct 'internal point of view' of the rules and standards which are appropriate to processing information and resolving conflict. Conduct can be rational with respect to one set of normative criteria, but irrational with regard to the others. The examples of contractual behaviour given at the beginning of this chapter reveal occasions when one framework has been regarded as determinative, even though it leads to action which is neither optimal nor rational under another criterion. In short, it does not make sense within the other communication systems.

The parties to a transaction are engaged in what appears to be a simple event, such as a sale of apples at the market stall. But their conduct will be guided to some extent by all three frameworks simultaneously. The parties have to steer a way through these competing systems of guidance. Their understanding of the meaning and significance of contractual behaviour differs according to the way in which they constitute a hierarchy between the competing or colliding communication systems.

Consider the simple example of a clear breach of a contractual expectation such as the delivery of goods. The business relation may encourage the disappointed party to ignore the breach of contract for the sake of preserving a harmonious business relation. Similarly, the business relation may encourage the party who has caused disappointment to make amends, even if there is not in fact any legal obligation to do so due to the presence of some exclusion clause in the written contract. In relation to the deal, considerations of economic interest predominate, so that short-term and long-term economic interests will have to be weighed when considering a response to disappointment. Often these calculations will suggest a compromise of interests, a settlement which protects the economic advantages to both parties of the transaction, albeit at a reduced level. When one party fails to deliver the goods on time, the response within the communication system of the deal may be to accept late delivery or to reject the goods entirely according to the calculus of self-interest. The settlement of any dispute will be determined in a way which preserves the economic viability of the deal for both parties by means of a compromise of interests. The normative context of the contract provides the final dimension of the transaction, where the parties assert conflicting rights on the basis of the agreement. These rights do not admit compromise, but the winner takes all. The buyer asserts the right to reject the goods for late delivery, or insists on the right to full and prompt contractual performance. The seller points to the small print of the contract that contains an excuse or limitation of liability.

These distinctions between communication systems explain what is

happening in common observations of contractual behaviour, for the actors may orient themselves towards one normative context to the exclusion of others. In Macaulay's study of business contracts in America, he describes what happened when a regular business customer cancelled an 'order'. The sales representative took no action, and, on inquiry, did not consider that a breach of contract had occurred.[9] Here the sales representative's conduct is oriented principally towards the long-term business relation. This strong orientation towards the preservation of trust excludes the contractual framework from conscious consideration altogether. In addition, there will be the calculation within the business relation that a threat of litigation over the breach of contract might damage the trust which sustains the business relation. The behaviour of the sales representative is also consistent with the repeated game model of the economic deal. Although it is plainly not in the short-term economic interest of the seller to accept a breach of contract without compensation, the prediction of the buyer's response to threats of litigation may be the non-legal sanction of withdrawal of business. With this prediction, it becomes rational for the seller to avoid a claim which might provoke such a response, and to wait until later when this concession may be taken into account in settling a future disagreement.

In another striking example, Beale and Dugdale report on the handling of complaints about defects in products supplied within a business relation. If the complaint is accepted as justified, there will be an offer of repair without charge, or a willingness to reduce prices in future transactions.[10] These responses maintain the value of the particular deal to both parties, and simultaneously seek to preserve the business relation for the future. There was almost certainly a breach of contract in such cases, for which a legal sanction of financial compensation could have been claimed. But this course of action does not seem to have occurred to the actors themselves. Indeed, no money changes hands. Their conduct studiously avoids the contractual orientation towards rights and correlative obligations, but rather awards priority to the business relation, and second place to the business deal.

In these studies also, the subjects observe that appeals to legal rights, or the written documents containing the legal contract, are likely to be regarded as a form of bad faith or betrayal. This interpretation of events occurs because such appeals to legal rights signify the transition to a rival normative context. The norms of the business relation and the calculus of economic interests of the deal are abandoned in favour of the conflictual

[9] Macaulay, S., n. 2 above.

[10] Beale, H., and Dugdale, T., 'Contracts between Businessmen: Planning and the Use of Contractual Remedies', *British Journal of Law and Society* 2 (1975) 45, 59.

assertion of an antipathy of interests and a demand for entitlements without compromise.

In an extended examination of these competing norms of contractual behaviour, Daintith describes the practice of long-term contracts in sales of iron ore to steel mills. This is an international market with few buyers and sellers, where the business relations were for the most part long-term. In the early 1970s the purchasing contracts for iron ore were for a fixed term (perhaps 10 years), a fixed quantity (or a minimum quantity), and a fixed price. But currency fluctuations and the collapse of the steel market rendered such arrangements unworkable. To respond to currency fluctuations, the parties initially agreed an adjustment of prices, and then modified the agreements to an annual negotiation of prices. To respond to the decline in demand, however, for a long time there was no alteration of the minimum quantity specified in the contract. Instead, the sellers merely permitted the buyers to order according to their requirements, though this position was sometimes reflected in a subsequent amendment to the contract to include a tonnage flexibility clause. Although the external crises forced many breaches of contract, there was no resort to litigation or arbitration. These problems were handled by co-operation and flexibility between the businesses. The strict legal entitlements contained in the self-regulation represented by the contract were of far less importance to the behaviour of the parties than the norms derived from the desire to preserve the business relation and the need to make the deal work for both parties. As Daintith observes:

> In most cases, today, the parties are performing a relationship different from that written in the contract, in which non-contractual norms, like fairness in quantity reductions, may be more important than contractual ones.[11]

The vestigial adherence to the old formal contract, even though it did not in practice determine the conduct of the parties, can perhaps be explained by the symbolic importance of maintaining the express commitment to long-term business relations.

Within larger business organizations, we may observe that different departments of the firm may select rival normative contexts. Whereas the sales representative may regard the business relation as pre-eminent, the legal department may read the events within the contractual framework as a breach of contract against which legal action should be taken. The general manager may view the same event through an economic perspective, making a calculation of short- and long-term economic interest in determining the appropriate response to a breach of contract. The

[11] Daintith, T., 'The Design and Performance of Long-term Contracts', in T. Daintith and G. Teubner (eds.), *Contract and Organisation* (Berlin: Walter de Gruyter, 1986) 164, 186.

production division will focus on the technical specifications, the time-scale for delivery, and whether satisfactory performance was ever practicable. The presence of these rival perspectives within a collective actor such as a firm may explain sudden shifts in the dominant normative orientation during a dispute.[12]

As well as these studies of commercial contracts, we can point to the competing norms of contractual behaviour in the context of consumer purchases. When a consumer complains to a shop that recently purchased goods are faulty, the normative framework adopted by most retailers is directed towards the business relation and the deal. The legal rights of the parties are rarely introduced into the conversation. For example, in a questionnaire directed to retailers in Edmonton, Alberta, no retailers mentioned that legal rights and obligations were relevant to their approach to the handling of the complaint. The important factors were business reputation and the desire to preserve the long-term business relation through repeat purchases. Indeed, most of the returns of goods in some shops had no legal basis at all, as when the customer decided that she did not like the colour of the item, but that did not alter the retailer's policy of accepting the goods back.[13]

Apparently puzzling contractual behaviour therefore becomes comprehensible once we recognize that the parties may be orienting their action towards competing norms of contractual behaviour. Studies of business practice reveal that the frames of reference provided by the relation and the deal are likely to carry greater weight than the strict contractual point of view. The position becomes reversed, however, once the parties perceive that the business relation itself has broken down and that the deal cannot be retrieved by compromise of interests. A premature assertion of the contractual perspective by pointing to strict entitlements under the contract is regarded as a hostile act, for it conveys the message that the business relation is no longer valued, and that a compromise of interests is no longer possible.

The 'Non-Use' of Contracts

An interpretation that has been placed upon these empirical studies of contractual behaviour is that contracts are not used by businessmen, or that the contract is irrelevant in business dealings, or even that contracts actually impede business deals. This interpretation of the non-use of

[12] Macaulay, S., n. 2 above, 66.

[13] Ramsay, I., 'Consumer Redress Mechanisms for Poor-Quality and Defective Products', *University of Toronto Law Journal* 31 (1981) 117, 129.

contracts by businessmen has been presented most powerfully by Macaulay himself:

> Most businessmen have an attitude towards contracts that can best be described as indifferent or even hostile . . . They remark 'contracts are a waste of time; we've never had any trouble because we know our customers and our suppliers; if we needed a contract with a man we wouldn't deal with him. Lawyers just get in the way.'[14]

This interpretation of the attitude of businessmen seems to me to be confusing and misleading.

One problem with this interpretation is the confusion between the contractual frame of reference and the use of the law in order to enforce rights. It is certainly true that the legal system is rarely employed to enforce self-regulation by contract, but this does not mean that the self-regulation contained in the contractual agreement is unimportant in guiding contractual behaviour. The reasons for the absence of litigation range broadly over such matters as cost, calculations of the risk of failure, and the damage to business reputation and long-term business relations. In many instances legal enforcement may simply not be viable because of the weak financial position of the debtor. It is quite possible, therefore, for the self-regulation established by the contract to comprise the key normative orientation for the parties, even though they rarely have any intention to use the legal system to enforce that regulation. They use the contract as a point of reference during negotiations towards a settlement of a dispute, even though they have no intention of resorting to law.

A more fundamental problem with the claim that the empirical studies reveal the non-use of contract lies in its failure to appreciate the presence of all three normative frameworks in all contractual contexts. The parties to the contract will be conducting their discourse within each system of thought, but in many instances one discourse will take priority over the others. The contractual framework does not disappear when the injured party prefers to ignore the breach of contract and to emphasize instead the norms derived from the business relation or economic interest. The contractual framework may be invoked at any time. It will be resuscitated if the parties perceive that the long-term relation is about to terminate or the considerations of economic self-interest now point in the direction of strict contractual enforcement of a discrete transaction. In the absence of these conditions, however, which will normally represent the situation in successful trading relations, we should expect the contractual framework to be

[14] Macaulay, S., 'The Use and Non-use of Contracts in the Manufacturing Industry', *Practical Lawyer* 9(7) (1963) 13, 14. The significance of this theme in the sociology of contractual behaviour is considered in Campbell, D. 'Socio-Legal Analysis of Contract', in P. A. Thomas (ed.), *Socio-Legal Studies* (Aldershot: Dartmouth, 1997) 239.

temporarily occluded. The important point to remember is that all three frameworks will normally be available as a discursive resource through which the parties may negotiate improvements to their position.

We can discover, however, good evidence in these surveys of business practice of calculated decisions to avoid the creation of a legally enforceable contract or at least a formal contractual document, so that it cannot provide the basis for an alternative discourse for negotiations and disputes. Here the 'non-use' of contract, at least in the sense of using detailed written contracts and orders, has the purpose of foreclosing arguments about entitlements. The record of an interview with the Vice President in Charge of Sales of a manufacturer of paper explains why the company has no written contracts with any of its customers despite the high values involved:

> Practically, the contracts [used previously] were all one sided. They bound us but provided nothing in return. We could not make the publishers or printers eat the excess paper and take it when they could not use it. Moreover, when a publisher or printer cancels an order for paper, he has just lost a big order or his magazine is in trouble. He is a difficult man to hold for damages then. On the other hand, we do not need contracts with our big accounts—they will take the paper and pay for it. Thus a contract gives us nothing but reduces our flexibility in allocating paper to customers we want to favor.[15]

The final sentence reveals the determinative purpose of avoiding formal contractual documents: it permits flexibility in addressing the needs and interests of all customers, so that valued customers can be given preferential treatment and these business relations reinforced.

Another objection to the claim about the non-use of contracts is that the findings of the original studies in the context of American industry in the 1950s and 1960s cannot be generalized. Times have changed, the post-war boom is over, and so it is probable that under the pressure of global competition the behaviour of businesses towards contracts has altered. Such pressures might account for the apparent proliferation of lawyers in the USA, their heavy involvement in hammering out major deals, and indeed their invasion as a profession of all forms of regulation of business and dispute resolution.[16] Furthermore, it may be doubted whether the attitudes of American businessmen will be replicated in other cultures such as Germany or Japan. Do these studies only provide us with a partial view, perhaps emphasizing manufacturing industry at the expense of construction and service industries such as banking and professional

[15] Macaulay, S., *et al.*, *Contracts: Law in Action* (Michie Co., Charlottesville, 1995), 415.

[16] Dezalay, Y., 'Between the State, Law, and the Market: The Social and Professional Stakes in the Construction and Definition of a Regulatory Arena', in W. Bratton, *et al.*, *International Regulatory Competition and Coordination* (Oxford: Clarendon Press, 1996) 59, 64.

services, where the contracts may be the dominant normative framework for contractual behaviour? My own view is, however, that once Macaulay's thesis about the non-use of contracts is interpreted in the way I have suggested, then the evidence tends to support its generalization across markets and across time.

Later studies of business behaviour seem to me largely to confirm the earlier descriptions of the presence of competing normative frameworks. We still find that the vast majority of businesses across a broad range of industrial sectors are willing to accept substantial contract modifications on the basis of trade practice, long-term business relations, or in order to support a particular deal.[17] It is true that the questionnaires in the surveys are now completed by corporate counsel rather than a business manager, perhaps signifying the widespread insertion of lawyers into management systems, but these counsel seem to behave in the same way as their predecessors. They deny hotly the suggestion that they are more likely to focus on legal rights than other non-lawyer executives.[18] This finding seems plausible to me; lawyers are especially capable of performing a contractual discourse, but they have always been deal-makers and fixers, perfectly competent to grasp and deploy the alternative rationalities. To be a lawyer does not mean that you think like a lawyer all the time. Even a lawyer can shift between the competing norms of contractual behaviour.

There are suggestions of some variations in business cultures, but also the discovery of considerable similarity.[19] In Germany, there is evidence suggesting that the formal contractual undertakings are viewed more centrally in constituting the business deal, so that greater attention will be paid by businessmen to the documents.[20] On the other hand, the contractual document will not necessarily be regarded as limiting the commitments, so that flexibility in settlements and adjustment of undertakings can be expected in the light of the business relation and the working of the deal. In contrast, in Japan there is a concern expressed (often by foreign commentators) about a lack of 'contract consciousness', where the business relation and the deal are believed to eclipse the contractual norms. But surveys designed to test this suggestion appear to discover no significant difference, with perhaps only a slightly greater emphasis on business

[17] Weintraub, R. J, 'A Survey of Contract Practice and Policy', *Wisconsin Law Review* (1992), 1, 19.

[18] Ibid., 26.

[19] Blegvad, B., 'Commercial Relations, Contract, and Litigation in Denmark: A Discussion of Macaulay's Theories', *Law and Society Review* 24 (1990) 397; Macaulay, S., 'Elegant Models, Empirical Pictures, and the Complexities of Contract', *Law and Society Review* 11 (1977) 507.

[20] Arrighetti, A., *et al.*, 'Contract Law, Social Norms and Inter-Firm Co-operation', *Cambridge Journal of Economics* 21 (1997) 171.

considerations over contractual entitlements in Japan.[21] Perhaps the only real difference is the greater involvement of lawyers in the formation of contracts in common law countries compared to Japan, which in turn may reflect the greater complexity of private law regulation.[22] A better interpretation of contractual behaviour in Japan would emphasize the greater significance of non-legal sanctions, such as harm to reputation, which would then tend to displace the significance of contractual terms and legal sanctions. There is also evidence that the Japanese courts are more alert to these dimensions of the business relation, so that the legal process is more designed to reinforce normative standards based upon the continuation of the business relation than their Western counterparts.[23]

My interpretation of the alleged 'non-use' of contracts is therefore that the contractual frame of reference is used whenever it is rational to do so. In the series of repeated games that represents most trading relations, however, it is rarely rational to invoke the contractual discourse. By switching away from the construction of trust within the long-term business relation and from the desire to make the deal work for both parties, the contractual discourse normally threatens both immediate and long-term economic interests. The non-use of contracts is not fuelled by an irrational hatred of lawyers, nor a blinkered incompetence in business planning, but guided by good business sense.

Relational and Discrete Contracts

In an influential series of works, Ian Macneil has argued that classical legal doctrine understands contractual relations from a particular perspective, that of the discrete transaction. How the private law of contract thinks about action is to measure it against the precise express obligations contained in the contract. The classical law assumes that the terms of the contract (supplemented by implicit understandings between the parties) provide a comprehensive normative framework by which to guide and judge the conduct of the parties. Macneil suggests, however, that this classical law model has proved an unsatisfactory tool for the regulation of what he calls 'relational contracts'. These contracts have the features

[21] Nottage, L., 'Bargaining in the Shadow of the Law and the Law in the Light of Bargaining: Contract Planning and Renegotiation in the US, New Zealand and Japan,' in Feest, J., and Gessner, V. (eds.), *Interaction of Legal Cultures* (Onati: Onati International Institute of Sociology of Law, 1997).

[22] Kitagawa, Z., 'Use and Non-Use of Contracts in Japanese Business Relations: A Comparative Analysis', in H. Baum (ed.), *Japan: Economic Success and Legal System* (Berlin/New York: Walter de Gruyter,1997) 145, 148.

[23] Haley, J. O., 'Relational Contracting: Does Community Count?', in H. Baum (ed.), n. 22 above, 167, 169.

that performance persists over a period of time and that the contract provides an incomplete specification of the obligations. For these relational contracts, the assumption of the classical law that the contractual terms provide complete self-regulation (or as Macneil says 'presentiation') is plainly untenable.[24]

Legal doctrine has in response sought to adapt its regulation to suit relational contracts. The principal requirement of this adaptation is to introduce a greater degree of regulation of the content of contract in order to address the problem of incomplete self-regulation. The content of this regulation also needs to be tailored to the long-term nature of the economic relation. We examine this problem of the legal response to incomplete planning in the next chapter. We also consider the extent to which these alterations in the approach to regulation of contracts represent a transformation of the classical law of contract in the subsequent chapter. Here we address the preliminary issue concerning the idea of a relational contract as an explanation of contractual behaviour.

The contrast between discrete and relational contracts presents a possible explanation of puzzling contractual behaviour. It suggests that in discrete contracts, that is, isolated, brief transactions, such as purchase of petrol from a service station, contractual behaviour will be governed by sharply defined commitments and entitlements. In contrast, in relational contracts, such as a long-term requirements contract or a major construction project, then contractual behaviour will be oriented towards the long-term business objectives of the parties, and it will recognize the need for co-operation and adjustment in order to achieve those objectives. This comparison between discrete and relational contracts does throw some light on differences in contractual behaviour. Yet it is implicit in my earlier analysis that the contrast between relational and discrete contracts tends unfortunately to obscure the most important distinctions in the analysis of contractual behaviour. The comparison elides the three frameworks of reference, and, by so doing, obstructs a complete explanation of the rationality of contractual behaviour, which in turn may lead to unsatisfactory regulatory conclusions. The contrast between discrete and relational contracts proves inadequate as a tool of analysis, because of its implication that these dimensions present oppositions.

My contention is rather that all three dimensions are always present in contractual relations, though contractual behaviour may attribute a dominant position to one or the other in any particular case. Consider, for

[24] Macneil, I, 'Contracts: Adjustment of Long-term Economic Relations under Classical, Neoclassical, and Relational Contract Law', *Northwestern University Law Review* 72 (1978), 854; Macneil, I. R., *The New Social Contract: An Inquiry Into Modern Contractual Relations* (New Haven: Yale University Press, 1980); Macneil, I., 'Values in Contract: Internal and External', *Northwestern University Law Review* 78 (1983) 340.

example, the weekly purchase of groceries from a supermarket. This transaction has the three dimensions or points of reference which orient contractual behaviour. As a business relation, the expectation and hope of the supermarket is that the consumer will return to the same store every week. It invests considerably in the business relation by trying to provide a pleasant atmosphere in which to shop, efficient and friendly customer service, loyalty cards for discounts, and a willingness to accept the return of goods by the consumer without the need to demonstrate any defects. The transaction also represents a deal, in which the customer seeks competitive prices, and the supermarket needs to secure a profit margin, not necessarily in a particular week, but over a series of contracts. There is also the contract, a sale of goods as a discrete transaction, in which each item is sold for a fixed price, and default rules supplement this self-regulation by standards of product quality. We can neither characterize this transaction as discrete nor relational, for both dimensions are present: the contractual form may be discrete, an isolated exchange, but probably the dominant orientation of the contractual behaviour of the supermarket is towards the relational aspect. For a dispute about the price of an item, probably the contractual framework will provide the dominant frame of reference, so that the parties will agree that the correct price is the price that was offered by a sign on the shelves or the goods themselves. For a dispute about quality, the supermarket is likely to orient its conduct towards the business relation in order to maintain trust, and towards the long-term profitability of a series of deals with that consumer. My analysis suggests, therefore, that all transactions have both discrete and relational dimensions, and that these classifications obscure the importance of variables along three different dimensions of normative orientation.

My analysis also suggests that the length of time during which performance of a contract is likely to occur should not be regarded as significant for the purpose of the analysis of contractual behaviour. A long-term contract may have the precise, complete self-regulation of a discrete contract in its contractual terms. The contract may specify, for example, exact quantities, quality, and prices of goods to be delivered over a number of years. The significance of this contractual dimension in orienting the conduct of the parties will depend on its relative dominance compared to the other dimensions of the deal and the long-term business relation. In Daintith's study of the long-term iron ore contracts, the original contracts conformed to the pattern of complete self-regulation, and so apart from the period of time over which deliveries were to be made, were similar to an isolated sale of goods. His study reveals, however, that the business deal aspect of the normative framework predominated when the parties had to adapt to a change in circumstances, so that the preservation of a profitable business relation for both sides to the transaction governed their conduct at

the expense of the normative framework provided by the contract. Equally, in a short-term, isolated transaction, such as the purchase of petrol from a service station, although the law may supply a complete system of presentation through its regulation of sale of goods contracts, the contractual behaviour at least of the service station is likely to be oriented heavily towards the business relation and the benefits of a long-term sequence of contracts. The brand name and its business reputation will be important to secure trust, and the long-term repeated game dimension of the deal will encourage the service station to suppress thinking about the transaction as a precise set of entitlements and favour instead the relational dimension of good customer relations.

Insofar as the contrast between discrete and relational contracts purports to be a tool for the analysis of contractual behaviour, my contention is that it proves unhelpful. The source of the difficulty lies in its attempt to link patterns of contractual behaviour to real phenomena, that is, types of transaction. My approach links contractual behaviour rather to communication systems, that is to the normative points of reference that guide behaviour. The different communication systems steer behaviour in divergent directions in many instances. These divergences may be more intense in relational contracts, where the business relation system of communication may be thinking about behaviour in the opposite way to the direction indicated by the contractual frame of reference. But I have suggested that all three communication systems will always be present in contractual relations, and that all three will be required to provide an adequate explanation of the rationality of contractual behaviour in every instance.

Reasonable Expectations

Does this explanation of the rationality of contractual behaviour have any implications for the legal regulation of contracts? We have already observed that the way the law thinks about contractual relations is closely analogous to the contractual system of communication. The understanding of rights and entitlements presented by the contractual framework can be translated almost effortlessly by the law into its own self-referential discourse. The buyer's complaint that the goods supplied were defective becomes in law the similar allegation that the seller has broken the express or implied term of the contract to supply goods of satisfactory quality. Moreover, similar closure rules apply to the contractual framework and the legal analysis. The facts that are relevant to the contractual framework, such as the terms of the contract and the performance which has been supplied, will usually be the same facts as those examined in the legal

enquiry. This coincidence is, of course, not accidental: the legal system observes contractual practices, and parties to contracts observe legal reasoning. There is cross-fertilization and mimicking of argumentative strategies and closure rules.

The principal effect of this coincidence is that legal reasoning tends to reinforce the contractual framework and at the same time subvert the other discourses of the business relation and the deal. Does this impact of the law on contractual behaviour matter? Does this analysis of the tension between legal regulation and the dimensions of contractual behaviour described as the business relation and the deal suggest that private law discourse is fundamentally misconceived in its approach to regulation of market practices? Should legal regulation be reoriented towards a capacity to understand the competing normative impulses in contractual behaviour? Armed with this capacity, legal regulation would then adjudicate on the collision between the discourses, in some instances favouring strict contractual entitlements, but in others favouring implicit obligations based upon the deal or the business relation. If legal regulation took on this task, then we would have to know how it should develop criteria for adjudication between the competing normative frameworks.

We can explore these rather abstract questions in the context of a particular case. In *Williams v Roffey Bros and Nicholls (Contractors) Ltd*,[25] the plaintiff carpenter agreed with the defendant building contractor to perform work on the refurbishment of twenty-seven flats in return for a fixed sum of £20,000. The plaintiff fell behind schedule in the work. This delay concerned the defendant because under the main contract for the building works a clause reduced payment for late completion of the refurbishment. The defendant promised to pay the plaintiff an extra amount of £10,300, at the rate of £575 per completed flat as an inducement to speed up the work. The defendant also realized that the original price had proved too low for the transaction to be commercially viable for the plaintiff. The plaintiff completed work on eight flats, but the defendant only paid £1,500 more. The plaintiff then sued for the balance due under the modified agreement.

The legal report of the case does not disclose the nature of the prior business relation between the parties. This information is irrelevant under the closure rules of the legal analysis. We may surmise, however, that participants in the construction business in a locality are likely to be familiar with each other. The empirical studies indicate that, despite the practice of competitive tendering, contracts are usually awarded only to those sub-contractors who have had prior dealings with the main

[25] [1991] 1 QB 1, [1990] 1 All ER 512, CA.

contractor.[26] We can infer, therefore, that an on-going business relation was likely to be influential in steering the behaviour of the parties. The principal effect of this consideration on the facts was to discourage the parties from rupturing the relation by breaking away from the contractual undertaking.

At the same time, it is apparent from the history of the events that the business deal was an important consideration in the minds of the parties. The reasons for the modification of the original fixed price contract were premised on the need to ensure that the transaction remained commercially viable for both parties. The main contractor needed to complete the transaction on time, in order to avoid the reduction of profits that was threatened by the penalty for delays. At the same time the sub-contractor needed to receive an adequate reward for its work, for otherwise it would be tempted to concentrate on other more profitable jobs. The solution was to agree a modification that restored the commercial viability of the deal for both parties.

This combination of the business relation and the deal steered the behaviour of the contracting parties up to the point when litigation commenced. Until that moment the original contractual arrangement for a fixed price had little practical significance. It did not affect the speed of the carpenter's work or the amount of payment that the main contractor expected to make in fact. Once the dispute over the extra payment entered the realm of legal reasoning, however, suddenly the contractual framework became paramount. The defendant insisted that the original agreement for a fixed price was binding, and that any subsequent modification was invalid on the technical ground of the absence of fresh consideration. There was allegedly no fresh consideration for the modification, because the sub-contractor had merely promised to do what it was already contractually bound to do for the defendant. In other words, this was an opportunistic price increase that a court should not enforce. The plaintiff countered that the modification was binding as a valid revision or variation of the contractual relation. The dispute therefore focused on two competing versions of the contractual framework, and the considerations of the deal and the business relation that formerly motivated the parties were forgotten or ignored.

One view of how the law ought to approach the regulation of such disputes insists that it is appropriate for legal discourse to concentrate exclusively on the contractual framework. Legal regulation should support the authority of the contract as normative framework to guide action. It would be a mistake on this view to deviate from this straight path. It is

[26] Eccles, R., 'The Quasifirm in the Construction Industry', *Journal of Economic Behaviour and Organization* 2 (1981) 335.

better that the parties themselves should by mutual agreement decide to shift their normative orientation in the light of how they view the circumstances. If they decide that preservation of the relation or the deal is more important to them than an insistence upon the contractual framework of the terms of the contract, we should assume that this is rational self-interested action and leave them to do so by accepting the legal validity of any compromises or adjustments. It would be dangerous, however, for the law to substitute its own judgement for when the contractual framework should be modified by reference to the other normative frameworks, for this move runs a high degree of risk of error in making assessments of what is in the best interests of the parties. A court may feel, for instance, that one party should not insist upon its strict contractual rights in the light of the change of circumstances or fresh information. Yet the court should not be tempted to substitute its own judgement for that of the parties, since it may thereby force on at least one of the parties, and possibly both, a less than optimal outcome. In other words, legal regulation should forge exclusive links between the contractual framework and its own self-referential reasoning and closure rules. The law should not seek to achieve direct understanding of the other communication systems present in the social relation of the transaction.

The opposite view criticizes this decontextualization of legal discourse. It objects to the exclusive reference to the contractual framework. It is the business relation and the deal that do most to constitute and sustain business relations. To use self-referential discourses and closure rules that deliberately exclude all this information about the environment of a business dispute is a recipe for poor regulation. The law will inevitably obstruct rational contractual behaviour whenever that rationality is based upon the normative frameworks of the business relation and the deal. On this view, the law needs to become more sophisticated in its examination of contractual practices. It should not remain fixated on the information about the contractual framework, but should revise its closure rules in order to incorporate into its reasoning an assessment of the need for support for rational contractual behaviour based upon the business relation or the deal. This revision can be achieved by inserting into the legal discourse a broader or open-textured standard for gathering information about normative expectations.

Such a broader standard might be described as 'reasonable expectations'. Instead of the legal discourse determining entitlements by reference solely to the contractual framework contained in documents and express agreements, the standard of 'reasonable expectation' is calculated to expand the range of information that will describe the standards governing the contractual arrangement. It may be a reasonable expectation, for instance, that despite the presence of a fixed price contract, the parties will anticipate

a price adjustment in the event of either mistaken assumptions about costs or unforeseen contingencies. If the legal system is to be supportive of markets in order to overcome problems of distrust, then it should, on this second view, try to be responsive to the alternative normative orientations that represent the whole range of the expectations of the parties. A legal system which fails to support those reasonable expectations will inevitably undermine its contribution to the constitution of markets.

If this second strategy were adopted by legal regulation, it would be hard for legal regulation to understand the communications between the parties concerning the establishment of trust in the business relation and economic self-interest in the deal. These sources of expectations would have to be inserted into the discourse of legal regulation by techniques such as open-ended standards which inevitably reduce the predictability of legal outcomes. For example, the law might adjust its regulation to require performance of contracts, not according to the letter of the contract, but according to a standard of good faith or co-operation. This adjustment would then permit a court to assess whether the expectations of the parties to the contract included the standard that a change of circumstances would require alterations such as additional obligations in the expected performance.

Compared to the stark evidence of the written contract, however, the court will encounter difficulty in abstracting from the conduct of the parties the content of their normative standards based upon the deal or the business relation. The best evidence is likely to be found in past conduct, such as previous dealings or deviations from the contractual self-regulation in practice. But even this evidence is always open to different interpretations. The fact that one party did not insist upon payment on the exact date specified but rather accepted late payment on one occasion provides ambiguous indications of the content of the normative standards. It might be argued that this waiver of breach should be interpreted as an isolated event without implications for future expectations, or that it signalled an agreed revision of the standards applicable to the transaction based upon the business relation or the economic self-interest of the deal.

These two views define the terms of a central debate among contract lawyers. On the one side, those who favour certainty and predictability in legal regulation insist that legal regulation should track the contractual framework as closely as possible, whilst of course leaving the contracting parties free through their discretion of self-enforcement to release each other from the legal obligations. On the other side are those who favour a contextualized approach to legal reasoning, which incorporates into legal reasoning information about all three normative standards that guide rational contractual behaviour. The task of legal reasoning on this latter view is to determine the hierarchy of normative contexts in relation to each particular contractual dispute.

In my view, however, this debate hinges on what appears to be on closer inspection a false dilemma. If we look again at *Williams v Roffey Bros*, both parties were compelled by the traditional legal discourse to present their argument in terms of the contractual framework. The dispute centred on two different versions of the contractual framework, the original fixed price contract, and the informal modification at a higher price with incentives. Legal disputes invariably take this form because the self-referential discourse of the law requires this style of presentation. The assertions of the parties always have to be couched in the language of contractual entitlement, based upon narrow closure rules about the content of the agreement. The interesting question is how the court resolves these conflicts. Unless the court reaches the conclusion that one version of the contractual framework is without foundation in the evidence, then it has to select between them on some other criterion. In this case the Court of Appeal decided that the modified contract contained the definitive statement of the contractual entitlements. It favoured the revised contract on the ground that the defendant had secured commercial benefits (and therefore, dubiously, fresh consideration) from agreeing to the price increase. These benefits included changing work practices, so that at least some of the flats were completed on time in order to avoid the penalty, and the avoidance of the cost of having to make alternative contractual relations. These considerations plainly bring aspects of the normative framework of the deal into the legal discourse in order to resolve the conflict between the competing versions of the contractual framework.

In my view, therefore, the private law system is inevitably drawn into a broader examination of the normative frameworks that guide rational contractual behaviour. The courts cannot resolve disputes solely by reference to the contractual framework unless one version of the contract has no evidential foundation. It is true that the discourses of private law regulation are reluctant to acknowledge the need to drop their tight closure rules by adopting open-ended standards that ostentatiously incorporate other normative frameworks. An assessment of the advantages and disadvantages of a more explicit expansion of normative reference points by the reformulation of legal doctrine into open-ended standards such as 'reasonable expectations' requires more detailed examination in relation to particular regulatory issues. In the next chapter, we examine one problem for the traditional approach, which is the priority it tends to attach to written statements of the contractual framework. In the subsequent chapter, we tackle the most divisive issue of whether considerations of economic efficiency support the traditional exclusive emphasis in legal discourse upon the contractual framework.