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Implicit Dimensions of Contract

Discrete, Relational and Network Contracts

Edited by
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2

Discovering the Implicit Dimensions of Contracts

DAVID CAMPBELL AND
HUGH COLLINS

LAWYERS APPRECIATE THAT there is more to contractual relationships than agreement and consideration. They understand that there are other dimensions to commercial transactions, such as fair dealing, good faith and co-operation. It is now generally acknowledged that the practice of entering into contracts relies upon the presence of trust, implicit understandings and shared conventions established by trade practice. Without using our tacit knowledge of these implicit understandings and expectations, we would not be able to differentiate in social life between taking and trading, and between trading and the exchange of gifts.[1] Despite lawyers' awareness of these implicit dimensions of contracts, legal reasoning has developed only a weak capacity to incorporate these dimensions into its analysis of contracting and into the assistance legal reasoning offers in the resolution of disputes about contracts.

This apparent defect of legal reasoning is a recurrent theme of critiques of the 'classical law of contract'. The classical law, by which is meant the elegant constructions of legal doctrine by jurists and judges of the nineteenth century, is thought by many modern writers to be an inadequate form of legal reasoning about contractual relationships. The classical law's doctrines facilitated an understanding of contracts as a disembedded association between individuals. These doctrines thus marked a break with the legal understanding of economic relationships as being based upon status, loyalty and tradition. They corresponded to the description of the system of economic relationships as a market in which 'faceless buyers and sellers . . . meet . . . for an instant

[1] M Weber, *Critique of Stammler* (New York, The Free Press, 1977) 109; IR Macneil, *The New Social Contract* (New Haven, Yale University Press, 1980) 1.

to exchange standardised goods at equilibrium prices'.[2] In its abstraction from social context, the classical law of contract assumes a 'social' interaction between unsituated individuals who bind themselves to a wholly discrete set of obligations by choosing to employ the legal institution of contract. At its most extreme, the classical law claims that the foundations of markets in individual rational choice, agreement and private property are immutable features of human society.[3]

Many criticisms have been launched against the powerful and seductive doctrines of the classical law of contract. As we say, one persistent theme of those criticisms is that the classical law could not incorporate an adequate acknowledgement of the implicit dimensions of contracts. For example, we see this theme in the contrast drawn between discrete and relational contracts. Relational contracts are different, it is argued, because they rely for their wealth-enhancing properties on a set of diffuse implicit obligations that are not, and cannot be, expressed by formal contractual undertakings.[4] A similar theme emerges in discussions of 'long-term' contracts, which, it is argued, depend upon diffuse obligations of co-operation for their efficiency.[5] In making these criticisms of the classical law, legal scholars make their contribution to a broader criticism of liberal political theory: the classical law of contract reproduces the principal structural contradiction of bourgeois society—a society which has at its heart a denial of its social character.[6]

As we shall argue in detail below, the classical law of contract does not exclude implicit dimensions of contracts from its reasoning altogether. References to implicit dimensions can be inserted by a variety of devices: such as rules that invalidate consent on grounds of misrepresentation and undue influence, the technique of supplementing express terms by implied terms and rules such as mitigation that determine the quantification of damages as a remedy. Our argument, therefore, is not that the classical law could not recognise implicit dimensions of contractual relationships, but rather that its techniques

[2] Y Ben-Porath, 'The F-connection: Families, Friends and Firms and the Organisation of Exchange' (1980) 6 *Population Development Review* 1.

[3] A Supiot, 'The Dogmatic Foundations of the Market' (2000) 29 *Industrial Law Journal* 321, 324.

[4] V Goldberg, *Readings in the Economics of Contract Law* (Cambridge, Cambridge University Press, 1989).

[5] D Campbell and D Harris, 'Flexibility in Long-term Contractual Relationships: The Role of Co-operation' (1993) 20 *Journal of Law and Society* 166, 173.

[6] GWF Hegel, *Philosophy of Right* (Oxford, Oxford University Press, 1956) ss 182–229.

for instantiating these implicit dimensions frequently proved inadequate. The framework of the classical analysis always commences with the assumption that legal reasoning need not incorporate reference to implicit dimensions. As the reasoning proceeds, however, exceptions and qualifications creep in to subvert the exclusive emphasis on the explicit, discrete contractual relationship through references to its social context and the implicit understandings generated by that context. But these insertions of implicit dimensions must always be marginalised or minimised by the classical legal doctrine, for they represent 'dangerous supplements'[7] to classical reasoning, in the sense that an acknowledgement of the pertinence of implicit dimensions threatens the collapse of an analysis that holds itself out as being an instrument of explicit, rational choices. In other words, to be fully operational and to achieve closure in legal reasoning, the manipulation of the classical rules frequently requires reference to the implicit dimensions of contractual relationships, yet these references always threaten to undermine the integrity of the classical discourse.[8]

Before elaborating upon these claims, we need to address the question of why, if this critique of legal reasoning about contracts is correct, it should be a matter of concern to lawyers and others? For some people, the concern may be with the disfunction of the law. If the law seeks to protect and enforce contractual agreements, the recognition that it has a partial and incomplete understanding of those agreements suggests that it fails in many instances to achieve its goals by enforcing not the agreement of the parties in all its relevant dimensions but a truncated perception of that agreement. From another functional perspective, the law of contract promotes and controls the social practice of entering self-regulated transactions, and misunderstandings of this practice create the risk that legal regulation will either fail adequately to support the practice when required or misdirect its controls so that they are ineffective. For others, the concern may be that the law's

[7] For an explanation of the use of this term used by Jacques Derrida in connection with contract law, see H Collins, 'The Decline of Privacy in Private Law' (1987) 14 *Journal of Law and Society* 91.

[8] On the strategies the classical law has used to try to rein in the implications of these dangerous supplements see D Campbell, 'The Undeath of Contract: A Study in the Degeneration of a Research Programme' (1992) 22 *The Hong Kong Law Journal* 20. Ian Macneil has long argued that the law actually used in practice and actually envisaged by competent scholars is 'neo-classical' rather than classical: IR Macneil, 'Contracts: Adjustment of Long-term Economic Relations Under Classical, Neo-classical and Relational Contract Law' (1978) 72 *Northwestern University Law Review* 854.

misunderstanding of contractual agreements causes it to promote inefficient (ie not Pareto optimal) outcomes. Most lawyers would be content with voicing the concern that one is not doing justice if the law frustrates the reasonable expectations of honest men.[9]

Our general aim in this essay is to map out many of the occasions when the traditional doctrines of the law of contract require legal reasoning to take into account an understanding of implicit dimensions of contractual relationships that cannot be discovered in the express words or terms of the agreement. Our discussion ranges over the conventional categories of formation of contracts, the content of obligations, and remedies for breach of contract. Our further purpose is to reveal how the need to incorporate recognition of the implicit dimensions of contracts into legal reasoning is at once essential to, but disruptive of, traditional contract law doctrine. This disruptive tendency is revealed both by silences when legal reasoning avoids any reference to implicit dimensions yet depends upon them to produce an intelligible outcome, and by attempts to confine by arbitrary lines the extent to which implicit dimensions should be considered.

FORMATION OF CONTRACTS

The legal requirements for the formation of contracts that there should be a bargain (consideration and intention to create legal relations) produced by voluntary consent (agreement) focus attention on the explicit dimensions of the contractual relationship. Have the parties both expressed the wish to enter into the same transaction, and does their express agreement satisfy the criterion that both parties expect to enhance their wealth by its performance? In addition, further rules concerning fraud and coercion determine the validity of consent to the contract.

Within all these legal rules, it is the equitable controls over the validity of consent which refer most openly to the implicit dimensions of contractual relationships, and we hazard the suggestion that this openness is a characteristic feature of equitable interventions in the law of contract. The doctrine of undue influence permits the court to examine the prior social relationship between the parties to discover whether

[9] Lord Steyn, 'Contract Law and the Reasonable Expectations of Honest Men' (1997) 113 *Law Quarterly Review* 433.

one party has exercised unfairly some kind of dominant influence over the other. Although there are many kinds of undue influence, a frequent element comprises the abuse of a prior relationship of confidence, which is a situation where the weaker party reposes trust in the other to the extent of being guided about the merits of entering transactions. A court relies on a finding of a relationship of confidence to conclude that this implicit dimension created the risk that the explicit contract was not a wealth-enhancing transaction for the weaker party.

Similarly, the equitable technique of invalidating express agreements for 'innocent misrepresentation' demands an appreciation of the implicit dimensions of the relationship. In order to distinguish false statements of fact, which permit the weaker party to avoid the contract, from statements of opinion, which do not, the court has to place the statement in its context. If the misrepresentor is in a better position to have complete information and has superior expertise in evaluating that information, a statement is more likely to be regarded as one of fact rather than opinion. In other words, it is the quality of the relationship within which the contract is made and the existence of dependence that determines whether false statements trigger the legal response of invalidating the express agreement. Once equity opens the door to an examination of the relationship between the parties, however, the crucial problem becomes how to prevent this exploration of implicit dimensions from threatening to disrupt the enforcement of a wide range of contracts that satisfy the formal common law requirements. How can the courts both respond to the social reality of relationships of dependence on expertise and relationships of confidence and avoid the conclusion that ordinary consumers in their dealings with large businesses such as banks must be protected against any disadvantage or disappointment? The solution lies in the attempt to draw arbitrary lines between different situations, such as those instances where a presumption of undue influence applies; but this solution invariably breaks down when confronted by the variety of possible relationships that might be abused.

Although equitable techniques provide fairly transparent methods for inserting the implicit dimensions of contracts into legal reasoning, the common law rules regarding formation of contracts also depend at least in some instances on unacknowledged references to implicit dimensions of contracts. Consider, for instance, the problem of knowing whether the parties have reached an agreement and the objective test that is employed for the resolution of disputes.

> If, whatever a man's real intention may be, he so conducts himself that a reasonable man would believe that he was assenting to the terms proposed by the other party, and that the other party upon that belief enters into the contract with him, the man thus conducting himself would be equally bound as if he had intended to agree to the other party's terms.[10]

When there seems no real 'meeting of the minds', though at least one party believes the parties have entered a contract, the classical law appeals to the reasonable man's perception of the other's actions. Conduct which can reasonably be interpreted by reference to conventional understandings as signifying consent will be regarded as consent to a contract, even if there was in fact no subjective intention to make an agreement. The use of the word 'reasonable' in the quotation requires the court to consider not what the promisee actually believed, but rather what a person might think about the conduct viewed in its context. This man is reasonable because he is aware of the context of the transaction, the typical expectations of the traders and their implicit understandings. The reasonable man interprets the other's conduct as a series of signs, which have that particular meaning owing to the context of social conventions and practices surrounding the contractual behaviour. The objective test of agreement is not merely an evidentiary rule, but rather a switch from a search for the individual preferences of the parties, when the failure of the individual to meet social standards of clarity leaves those preferences equivocal, to an examination of conduct and its significance in the light of implicit understandings and expectations.

We can detect a similar concealed reliance on implicit dimensions of contractual relationships in the operation of the doctrine of consideration. In those cases which prove troublesome because it is unclear whether what was envisaged was an exchange or merely some form of conditional donative promise, the doctrine of consideration can operate as a test of legal enforceability only by incorporating reference to the implicit dimensions of the relationship between the parties. The courts delve into the implicit dimensions of the relationship between the parties in order to determine whether to imply a request for something in exchange for the promise. In *Combe v Combe*,[11] for instance, the issue was whether a husband's promise to pay an annuity to his wife on their separation was binding. The husband had not explicitly

[10] Blackburn J, *Smith v Hughes* (1871) LR 6 QB 597.
[11] [1951] 2 KB 215, CA.

requested that the wife should refrain from claiming her legal entitlement to maintenance in return for the annuity. The question was whether that request could be implied in the circumstances. The trial court found such an implicit understanding, but the Court of Appeal reversed this conclusion. Either view depends upon an interpretation of the parties' unarticulated expectations about the present and future nature of their relationship. The fact that the wife was wealthy seems to have tipped the Court of Appeal towards an interpretation of the relationship as being one in which there was no firm expectation of continuing economic support from the husband, since the wife could live comfortably on her independent means.

Shadwell v Shadwell[12] provides another illustration of how the doctrine of consideration achieves closure only by resorting to implicit understandings. An uncle promised his nephew, in view of his forthcoming marriage, a regular income until he prospered at the Bar. The evidence disclosed no explicit request to marry or to pursue a career at the Bar in return for the money. At the explicit level of contractual relationships, there was therefore no consideration to support the uncle's promise. At an implicit level, however, we can discern the operation of a convention that wealthy relatives might seek to encourage young men to marry and settle down by making it financially possible or even advantageous for them to do so. With this convention in mind, the court (by a majority) could understand that the uncle had made an implicit request, a request that could remain silent because the social convention was understood; and, indeed, the request perhaps *needed* to remain silent in order to suppress any explicit acknowledgement of the commercial character of the bourgeois marriage. This implicit dimension of social convention (and hypocrisy about that convention) seems to have been the crucial element in the determination of the legal outcome in favour of the nephew.

One last example of the use of implicit dimensions of contractual relationships in order to resolve basic questions concerning the formation of obligations takes us outside a strict definition of contracts. When neither party can seriously contend that an express agreement was reached, perhaps because negotiations were continuing, the classical law insisted that no contractual obligations could have arisen. Any claim for a remedy for breach of an obligation in these circumstances had to be presented through such doctrines as equitable estoppel for

[12] (1860) 9 CBNS 159.

misplaced detrimental reliance or restitution for benefits conferred. The classical law drove out notions of implied contracts or quasi-contracts because such devices contradicted its insistence upon express choices of explicit bargains as the foundation of and justification for contractual obligations. Leaving this field of pre-contractual negotiations to be handled by doctrines of equitable estoppel and restitution produced the unfortunate consequence that legal reasoning failed to direct its attention to the most important source of the claim for compensation, namely the existence (or otherwise) of implicit understandings between the parties to the negotiations that obligations had arisen as a result of their interaction.

The implicit dimension of mutual understandings and expectations can be inserted back into legal reasoning, but only with difficulty. In equitable estoppel, the issue of whether there was an implicit agreement or tacit understanding has to be dealt with as the question of whether the detrimental reliance was reasonable. In restitutionary claims, the enquiry into an implicit understanding is truncated into the question of whether the goods or services were freely accepted. Once it is appreciated how much the classical law relating to the formation of contracts depends upon unacknowledged reference to the implicit dimensions of contractual relationships, this doctrinal analysis of pre-contractual negotiations that distances itself from any reference to these dimensions appears unsatisfactory. The law absolutely requires cognitive openness to the presence of the implicit understandings that are the necessary context of any contractual obligations. Although the doctrinal path may be too embedded to be overturned, our argument suggests that a doctrinal analysis framed in terms of implied contracts may offer a better approach to the field of pre-contractual negotiations, one which appreciates the significance of the implicit understandings of the parties in generating obligations.

CONTENT OF CONTRACTUAL OBLIGATIONS

Our central argument that legal reasoning about contracts must engage with the implicit dimensions of contractual relationships despite any protestations to the contrary is perhaps less controversial in connection with the law's assessment of the content of contractual obligations. In many cases, recent cases in particular, the courts openly acknowledge that in order to interpret a written document they must examine these

implicit dimensions of the relationship, that is the 'matrix of fact'.[13] Similarly, the insertion of implied terms into contracts frequently relies upon references to implicit understandings and expectations. Terms implied in fact search for the implicit understandings that guided the formal expression of the contract. Terms implied by reference to custom and usage place the agreement in its normal business context, inserting a conventional rule or expectation of the particular trade or business. Terms implied by law represent a generalisation about the normal expectations of the parties when making a standard type of contractual agreement. On all these occasions, legal reasoning restores the context that was supposed to be excluded by the classical law's emphasis on the express agreement.

Much the same effect is achieved in other legal systems through the use of general clauses in the civil codes. General clauses are typically stated in normative language, such as a general principle of good faith to which the parties ought to conform. At first sight, the articulation of such a principle might be regarded as the imposition of external moral ideals. But we think that this would be to misunderstand the operation of general clauses. Although the general principle may be coloured by the moral ideals of the society at large, in its detailed application the general clause inserts the implicit understandings and expectations of the parties' specific epistemic community into the binding contractual undertakings. Teubner argues persuasively, for instance, that the good faith clause in the German Civil Code permits courts to insert business custom and convention into express agreements, thus qualifying or supplementing contracts by reference to what already was implicit in the business relationship.[14]

Interpretation

Many of the subsequent essays in this volume examine the role of implicit expectations in the interpretation of contracts. Without trespassing excessively on their territory, we can briefly state that our argument includes the contention that in any interpretation of contracts, whether they are discrete bilateral contracts, relational

[13] Lord Wilberforce, *Reardon Smith Line Ltd v Hansen-Tangen* [1976] 1 WLR 989, Hl.

[14] G Teubner, 'Legal Irritants: Good Faith in British Law or How Unifying Law Ends Up in New Divergences' (1998) 61 *Modern Law Review* 11, 25.

contracts, or networks of contracts that form a productive organisation, legal reasoning must engage with the implicit dimensions of the relationship in order to make sense of the express contractual agreement. In other words, the option of sticking to the literal meaning of the contract except in some cases such as ambiguity, which is sometimes described as formalism,[15] is not, we would argue, in reality available. Thus the 'new contextualism' associated with recent judgments of Lord Hoffmann[16] is, we contend, nothing new, but merely an explicit recognition of a legal method for interpretation that has often been suppressed. There are two, rather different, kinds of argument to support that contention.

The first argument relies on theories of meaning and Wittgenstein's concept of a language game. It is the same argument used by Lon Fuller against HLA Hart in their famous debate about vehicles in the park. The point of the analysis of language games is that the meaning of words depends upon how they are used in different kinds of communication exercise. The question is what kind of language game is represented by a written contract? We might regard the document as a record or description of the reciprocal undertakings of the parties. If so, this description should be interpreted according to the ordinary uses of words, that is the conventional or dictionary definitions, because this kind of language game relies upon those meanings for the purposes of description. Thus, for controversies about the word 'vehicle', we should resort to the dictionary to settle the dispute. In contrast, if we regard the document as a record of instructions to each party, designed to implement a purpose such as the completion of a sale of goods, the language game changes into one that determines meaning by reference to purpose. The meaning of a word like vehicle then depends upon the intention, purpose, or expectation of the parties to the contract. If the parties were engaged in a transaction for the hire of a car, the word vehicle should be interpreted to mean a car and nothing else. Fuller argued, convincingly in our view, that for the purpose of statutory interpretation, this latter approach was the appropriate language game. The same conclusion should apply to the construction of contractual documents, for they represent an attempt at self-regulation by the parties. But in order to use this language game of examining the

[15] See the essay by Macaulay in this volume.

[16] *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896, H; *Mannai Investments Co Ltd v Eagle Star Life Assurance Co* [1997] AC 749, HL; see the essay by Brownsword in this volume.

purpose of the parties to the contract, it is essential to place the formal agreement in the context of the implicit understandings surrounding the scope and purpose of the agreement. Thus, this first argument insists that meaning can be correctly attributed to contractual documents only by reference to the purpose of those documents, which necessarily relies upon the implicit dimensions of contracts. To rely upon literal meaning, that is conventional dictionary definitions, is to misunderstand the language game or communication system employed in written contracts.

A second argument for supporting the claim that interpretation of contracts requires reference to the implicit dimensions of contracts is that a careful observation of the practice of the courts reveals that they invariably resort to references to implicit understandings. We might label an approach that purports to eschew the implicit dimensions 'the literal approach' to construction, for it claims merely to look at the words used by the parties in the documents and nothing else. An approach that examines implicit understandings could be labelled, in contrast, the 'intentions of the parties' approach, for it acknowledges that it must discover those intentions from the context of the relationship as well as the formal document. What we find on close examination of the legal reasoning is that neither approach is used on its own. Judges always invoke the other method of interpretation as qualifiers, or, perhaps more accurately, as dangerous supplements. When a court adopts the literal approach, the dictionary definition of words will be confined by reference to the absurdity of the result, which seems to be an invocation of the presumed intentions of the parties to rule out certain meanings. The purposive method of interpretation places limits on meaning by reference to conventional limits on the meaning of words, which are ascertained by asking what a reasonable promisee would have understood the words to mean.

The reason why these qualifications represent dangerous supplements is that, if taken to their logical conclusion, each qualifier (ie absurdity or reasonable promisee) would in fact destroy the foundations of the method. Thus, a literal method that chooses between available meanings by reference to the intentions of the parties could be said in fact to collapse into a purposive approach. Similarly, a purposive approach that purports to follow the joint intentions of the parties, but then proceeds to rule out possible intentions by reference to conventional meanings, could be said to collapse into a literal approach.

The presence of these dangerous supplements, requiring the employment of different language games to deal with them, suggests that when interpreting contracts the courts appreciate that they should not deracinate the formal written document from the implicit undertakings that arise from the context of entering into a transaction. The problem is rather one of playing off explicit and implicit understandings against each other; explicit understandings must be qualified by implicit understandings, and vice-versa. Methods of interpretation of contracts provide procedures or arguments for handling this process, but never produce a method for terminating the process. The meaning of explicit undertakings must depend upon implicit undertakings, and implicit undertakings have to be understood by reference to explicit undertakings.

If this 'critical' analysis of the practice of interpretation of contracts seems too quick with the vast judicial learning on the subject, it may be worth looking at some more concrete examples of the dangerous supplements at work. For example, judges often commence the process by asserting that their task is to ascertain the 'joint intention' of the parties. This principle of construction invokes a purposive approach which permits implicit understandings to be incorporated. But then two further moves are immediately made which undercut the purposive approach. The first is to assert that the actual intentions of the parties, if not communicated, should be ignored—that is the objective approach to interpretation, which returns priority to explicit undertakings interpreted by conventional meanings. The second is to say that the court must discover the common or joint intentions, and since these may well have been at odds, the court must ascertain these intentions from the words of the contract, which amounts to a reversion to a literal interpretation.

If, on the other hand, judges launch the enquiry into the meaning of a contract with an assertion that the task is to interpret the words used by the parties in the contract, which is an invocation of a literal approach, we find two similar moves designed to reinsert the implicit dimension. The first move is to invoke the understanding of the reasonable man familiar with the context:

> The fact that the words are capable of a literal application is no obstacle to evidence which demonstrates what a reasonable person with knowledge of the background would have understood the parties to mean, even if this compels one to say that they used the wrong words.[17]

[17] Lord Hoffmann, *Mannai Investments Co Ltd v Eagle Star Life Assurance Co* [1997] AC 749, 779.

The second move is to discount 'unreasonable results' produced by the literal meaning, the unreasonableness depending, of course, on an interpretation of the implicit understanding:

> The fact that a particular construction leads to a very unreasonable result must be a relevant consideration. The more unreasonable the result the more unlikely it is that the parties can have intended it, and if they do intend it the more necessary it is that they should make that intention abundantly clear.[18]

If either of these arguments for asserting that the process of interpretation of formal contractual documents necessarily relies upon the implicit dimensions of contracts is correct, we have established that legal reasoning cannot avoid reference to the implicit dimensions of contracts for the purpose of construing formal contracts. To seek to avoid implicit dimensions, a court would either have to misunderstand the language game of self-regulation through contractual documents, or to deviate from the normal practice of interpretation in which a literal approach is always harnessed to the dangerous supplement of purposive interpretation.

Planning Documents

Given this view that implicit dimensions of contractual relationships provide an essential ingredient in the interpretation of contracts, a deeper question arises for legal reasoning about written contracts, namely how much significance should be attached to a written contract, ie the planning documents, or what Macaulay calls the 'paper deal'?[19] How far does the recognition of implicit dimensions of contractual relationships lead one down the road of diminishing the significance of the planning documents to the legal enquiry about the content of contractual obligations?

The written contract is usually produced by lawyers for the parties to a transaction. It serves the evidentiary function of recording the explicitly negotiated aspects of the deal. It also serves a cautionary function in the sense that the parties may be induced to reflect carefully on their commitments before signing a written contract. But the parties to the contract will have already agreed these elements of the transaction at

[18] Lord Reid, *Wickman Machine Tools Sales Ltd v L Schuler AG* [1974] AC 235, 251.

[19] See the essay by Macaulay in this volume.

least in outline. What the formal contractual document adds to the transaction, which the parties may not have discussed in any detail, is the allocation of risks, together with specification of remedial devices in the event of breach of contract. In other words, what the lawyer typically adds to the transaction is detailed planning with respect to contingencies and remedies for breach. This view of the formal contract as a planning document opens up the possibility of two sources of divergence between the express terms and implicit understandings.

The first potential source of divergence concerns the primary obligations or commitments under the contract. The formal contract records the main elements of the proposed economic transaction, such as the price and the goods or services required. But the formal contract is unlikely to record every point of detail of the expectations of the parties with respect to the transaction. The law can often insert these expectations by the device of terms implied in fact; without such a term the contract would lack business efficacy. On the sale of a particular car, the formal contract records the price and describes the car, but the formal document is unlikely to specify explicitly that the seller should also deliver at least one set of keys to the car. Without such an obligation, however, the transaction loses its economic point; few people buy a car just to observe it from the outside, with no intention of driving it. The law can insert the obligation to deliver a set of keys as an implied term.

Beyond simple cases of this kind, however, the formal contract may not record explicitly other kinds of conventions or expectations which at least one party presupposed in reaching the economic deal. As in *Sagar v Ridehalgh and Son Ltd*,[20] an employer might hire a worker to produce goods on a piece-work basis, assuming that the employer's practice of refusing to pay for defective goods applies to the transaction, though without recording that rule in the formal contract or communicating it to the worker. If the worker objects to deductions from his wages for defective pieces, which version of the economic transaction should apply: the employer's implicit understanding or the formal agreement? In this case, the transaction has business efficacy on either version, so it is necessary to adopt a different method of reasoning in order to resolve the dispute. Either the legal system can refuse to look beyond the formal agreement, or it can try to situate the agreement in the context or social practice. If the latter is chosen, the

[20] [1930] 2 Ch 117.

law faces the difficulties of discovering the practice accurately, and of deciding whether or not it may be used to qualify the express agreement.

The second source of potential divergence between the planning documents and the implicit understandings of the parties are in the terms governing risk allocation and remedies. Here it seems much less likely that the parties will have actively considered these issues in detail. In bargaining about the transaction, they concentrate on such matters as price and quality, not on what will happen if things go wrong. We may then observe a divergence between what the formal contract states should happen if some contingency occurs, and what the parties actually expect to happen when it does. For example, the formal contract may precisely allocate the entire risk of late delivery of goods to the seller, so that the buyer is entitled to terminate the contract the moment that the due date has passed. The expectation of the seller and the buyer, however, may be rather that some leeway will be given, that some contingencies may provide an excuse, or that the obligation of the seller is confined to the payment of compensation for any reliance losses (in the form of a reduction of the price). The divergence between formal agreement and implicit expectations arises in this instance because the parties to the contract have not ensured that the formal document (in the small print at the end expressed in lawyers' jargon, eg time is of the essence) precisely corresponds to their expectations, no doubt for the very good reason that they do not expect such problems to arise. Perhaps even more significantly, the parties may also have an implicit expectation that neither will rely upon the small print of the contract in any case, but rather try to work out a mutually satisfactory solution. An example of this behaviour in found in *Mitchell (George) (Chesterhall) Ltd v Finney Lock Seeds Ltd*, where it was found that, when dealing with regular customers, the seed merchant rarely insisted upon the limitation clause in the written contract.[21] Here the problem of divergence is not simply that the planning document does not accurately record all the expectations of the parties, but also that it actually inserts provisions to which the parties have not really agreed despite their formal signatures on the document.

These two sources of potential divergence between planning documents and the implicit understandings of the parties thus pose rather different problems for the legal system. In the case of the former, the

[21] [1983] 2 AC 803.

planning documents are arguably incomplete in their specification of the commitments. The problem is whether to *supplement* the formal agreement, and if so, by reference to what other kinds of sources of obligations. In the case of the latter source of divergence, the planning documents are arguably inaccurate in their expression of the commitments. The problem now is whether to *override* or *qualify* the formal agreement, and if so, by reference to what sources of implicit understandings.

In response to both of these types of problem there is always strong support among lawyers for giving priority to the planning documents and for discounting the significance of any implicit understandings. In favour of this attitude it can be said that the planning documents provide relatively clear guidance about the content of the obligations of the parties, and this facilitates dispute resolution. In addition, if the law discounts other evidence about the content of the obligations, it provides an incentive for the parties to say what they mean, which may avoid disagreements in the future. In the long run this policy might not only avoid the cost of disputes, but also lead to more optimal transactions in the sense that, as a result of spelling out the details of the transaction, the price can more accurately reflect the value of the deal to the parties.

A more controversial argument in favour of giving the planning documents an exclusive role in determining contractual obligations is to insist that the purpose of the law is not to enforce the intentions or expectations of the parties, which in any case may conflict or be indeterminate, but rather to enforce the self-regulation of the parties, which is contained in the planning documents. This argument is possibly supported by the 'objective' approach of the common law to the determination of the existence and content of contractual obligations; it is not the intention of the parties that matters, but how a reasonable person would interpret their words and conduct. A reasonable person, it might be urged, could place significant weight on the planning documents, but could not reasonably attach much significance to the other party's unexpressed intentions. And an objective approach rules out reliance upon one's own unexpressed expectations and understandings. The objective approach to the interpretation of contracts tends to protect reasonable reliance rather than the joint intention of the parties. Emphasising the role of contract law as supporting self-regulation through planning documents also tends to emphasise the protection of reasonable reliance at the expense of the will of the parties.

We can make several points which weigh against these considerations. First, the pressure on parties to business transactions to record everything in detail in the planning documents plainly increases the costs of entering into transactions. Secondly, we must doubt whether the parties have the competence to assess whether the planning documents accurately reflect their expectations in every respect, because those documents are often expressed in technical legal terminology. The parties might even need to hire another lawyer to assess whether their lawyers had accurately expressed their intentions in the planning documents, again adding to transaction costs (were it possible at all). Thirdly, we must doubt whether even the most gifted draftsman would be able to reduce the subtlety of some implicit expectations to a form of words or a rule to govern the transaction. There is always likely to be a problem that express terms are too 'coarse' in the sense that their provision for a contingency, though complete in the sense of dealing with the problem, does not reflect all the appropriate qualifications. Thus, the pressure on the parties to increase the complexity of the planning documents will never completely eliminate unwelcome divergence from implicit understandings. Fourthly, if a general aim of the law of contract is to enforce the agreement reached by the parties, we should not ignore evidence about the content of the agreement merely because it was not formally recorded. It may be appropriate in some instances to ignore other evidence, if, for example, the parties have agreed that the written document is their entire agreement. But such deliberate statements indicate a special state of mind, which is unlikely to be present in most transactions. Fifthly, contracts provide a special mechanism through which the parties can augment and qualify obligations owed to other persons, but they are always located in the surrounding pattern of obligations which are presupposed in the transaction. For example, a sale presupposes a system of ownership of goods, and a contract to perform a service is nested in reciprocal duties of care. In the absence of detailed knowledge of the law, the parties to a transaction will not make a sharp distinction between those surrounding obligations which have legal sanctions and those which represent mere social conventions. Another way to make this argument is to suggest that the surrounding obligations describe the extent to which the parties implicitly place reliance upon each other beyond the formal document. To the extent that the law of obligations should aim to protect reasonable reliance, it is important to take into account these other obligations in determining the full scope of the contractual undertakings. To

examine the planning documents in isolation as the determinant of obligations runs the risk of ignoring this surrounding pattern of obligations and their implications for the accurate understanding of what the contractual commitments were between the parties.

These arguments for and against attributing weight to the planning documents do not produce a conclusive result. Instead, our conclusion is that the weight that should be attached to the written record or paper deal must itself ultimately depend on the context and the implicit understandings surrounding the transaction. At one extreme, we may find a complex financial transaction involving a loan and security, where the documents purport to describe exhaustively the undertakings, the allocation of risks, and the remedies available, capping this off with an 'entire agreement' clause. In this context, arguments for legal support for implicit understandings and expectations may be regarded as weak, though not necessarily excluded altogether (eg estoppel by convention, interpretation of technical terms). At the other extreme, the document may be brief, not attempting to be a piece of comprehensive self-regulation, and the context may be a frequent pattern of trading between the parties in the same line of business. In such instances, there seems to be a compelling case for legal recognition of the implicit dimensions of the contract to be discovered in the customs of the trade and the pattern of dealing between the parties. The difference between these contexts lies ultimately in the implicit dimensions of the contractual relationship. We might say that, in effect, in the former context there is an implicit contract that the planning document should have paramount importance, whereas in the latter context the implicit understanding is rather that the paper deal is merely an incomplete memorandum of a transaction that is largely constructed on the basis of implicit expectations. In this latter context, we should also conclude that we should not give too much weight to those clauses in the planning document which have been fabricated by lawyers without the explicit guidance of their clients, since if we were to do so, we would be judging the quality of the lawyers, not supporting the transaction agreed between the parties.

REMEDIES

To complete this outline map of the necessary role played by the implicit dimensions of contractual relationships in legal reasoning, we

turn finally to the body of legal doctrine concerned with remedies for breach of contract. The most important feature of these remedies is that they normally do not insist on the performance of the primary obligations under the contract. Leaving aside the peculiar case of debt, literal enforcement of primary obligations is an unusual remedy available only when the normal remedy, of payment of compensatory or expectation damages when the claimant has a 'duty' to mitigate her or his loss, is judged inadequate. The explanation for this preference for compensatory damages is that, between good faith parties, the purpose of providing a remedy is not the overt one of, as it were, unilateral vindication of the claimant's rights[22] under the contract but the implicit one of co-operating to deal with the effects of the breach according to 'the principle of joint-cost minimisation'.[23] By shifting from the primary obligation to perform to the secondary obligation to provide a remedy, the law gives the defendant the opportunity to choose between different ways of satisfying the claimant's expectation, and, of course, he or she will normally choose the cheapest. But, the crucial point we now wish to emphasise, this can work only if there is an implicit dimension of co-operation by the claimant in the handling of the breach.

As we have discussed the way that the rules about remedies give effect to co-operation at great length elsewhere,[24] we will here discuss only the two legal doctrines which have a particularly important role in inserting consideration of this implicit dimension of co-operation into the handling of breach. The first is the duty to mitigate loss. Joint-cost minimisation works because the mitigation rules give the claimant a great incentive to take reasonable steps to minimise his or her losses because failure to do so will result in the court refusing to award compensation for those avoidable but unavoided, and therefore excessive, losses. The question of what amounts to reasonable steps seems to us to depend heavily on implicit understandings and business conventions. We are fortunate in this context in having available a study by Beale and Dugdale of what are regarded in one line of business as reasonable steps or the implicit conventions of contractual relationships

[22] H Collins, *Regulating Contracts* (Oxford, Oxford University Press, 1999) 330–8.

[23] GJ Goetz and RE Scott, 'The Mitigation Principle' (1983) 69 *Virginia Law Review* 967, 972–3.

[24] H Collins, *The Law of Contract*, 3rd edn (London, Butterworths, 1997) ch 17; D Harris *et al*, *Remedies in Contract and Tort*, 2nd edn (London, Butterworths, 2002) ch 1.

concerning the handling of breach of contract.[25] A common problem was breach through late delivery. In the following quotation we have inserted numbers in square brackets to assist the discussion:

> the buyer is similarly entitled to damages for consequential loss caused by late delivery, but it appeared that such consequential losses were seldom claimed and almost never paid . . . The reason for this general position does not appear to be the difficulty of claiming such losses . . . It seemed that the situation was caused by an interplay of related commercial facts and practices. On the one hand [1] buyers were expected to guard against delay by planning schedules so that deliveries could be late without causing loss; on the other hand [2] sellers were bound by an 'unwritten law' that the buyer must be notified in advance of any likely delay, to enable the buyer to reschedule (only one contract required this). If this could not solve the problem the buyer might well have [3] alternative sources of supply or [4] be able to use other materials. Even if the buyer did suffer a loss it was [5] generally recognised that the seller should not be liable for delays which were not his fault, and it seemed to be the general view that it was [6] far safer to refuse any claim for consequential loss for fear of creating a precedent. Finally [7] in some cases it would not be possible to claim serious consequential losses from a small supplier without the risk of bankrupting him. Thus, although there was potential scope for making a claim in a few cases, it was almost unknown for such a claim to be paid.[26]

Beale and Dugdale describe a repertoire of responses to delay in performance which match in function some aspects of the formal legal remedies but in other respects rely upon implicit understandings that demand co-operation according to implicit conventions. Stages [5] and [6] represent implicit understandings and expectations, which may qualify the express agreement, and certainly depart from strict legal rights. Stages [1], [2], [3] and [4] seem to be equivalent to the position the parties would be left in by the operation of the mitigation rule combined with the unavailability of specific performance, except that what amounts to reasonable steps to minimise loss is rendered more determinate by the 'unwritten laws' of the trade. The further limit on taking action presented by stage [7], the threat of driving the defendant into bankruptcy, is a formal limit on taking contractual action in one sense (the formal rules being those of insolvency), but it is also an implicit understanding about the limits of contractual commitment whatever

[25] H Beale and T Dugdale, 'Contracts Between Businessmen: Planning and the Use of Contractual Remedies' (1975) 2 *British Journal of Law and Society* 45.
[26] *Ibid*, 54.

the terms of the contract. When a court has to decide the question whether the claimant violated the duty to mitigate loss, it is all these factors that are taken into account, with the test of reasonableness allowing the claimant a margin of appreciation with respect to the application of the implicit conventions in the circumstances.

A second technique for inserting implicit understandings into the determination of remedies is the doctrine of remoteness of loss. The courts answer the question whether the defendant should be liable for all the claimant's losses by use of the doctrine of remoteness. A line is drawn on the measure of recovery, so that some losses flowing from the breach of contract are said to be too remote to be recoverable. This result can be restated in the language of risk: the defendant did not accept the risk of certain kinds of losses. If the contract makes no explicit provision about the type of risk under consideration, the court has to infer this allocation of risk from some other material. We suggest that this context is an aspect of the implicit dimensions of the contract.

Attempts to elucidate the meaning of the doctrine of remoteness, and specifically of the phrase 'reasonable contemplation', by abstract speculation on the literal meanings of the words have produced a pointless logomachy in the leading cases.[27] A clearer justification for the limits on recovery may be produced by reference to the implicit understandings and expectations of the parties that may have evolved in a course of dealing or may be set by usage of trade.[28] For example, when a carrier delays delivery of goods to a market where they will be resold, the implicit understanding may be that the carrier should bear the risk of a fall in the market price of the goods, provided that the carrier is aware that the goods are of the kind that will be resold on a market. Whether or not that represents the understanding in the shipping business is in principle a question of fact that could be explored by the court by examining normal compensatory practices. It may be that the lawyers in the higher courts have gained experience in this trade themselves through experience in litigation and settlement, and have become aware of the relevant implicit understandings. In the absence of such knowledge, the problem cannot be solved by resort to general standards of fairness or

[27] *Hadley v Baxendale* [1843–60] All ER 461; *Victoria Laundry v Newman* [1949] 2 KB 528 and *The Heron II* [1969] 1 AC 350.

[28] *Monarch Steamship v Karlshamns Oljefabriker* [1949] AC 196; *British Columbia Saw Mill v Nettleship* (1868) 3 CP 499 and *Montevideo Gas v Clan Line* (1921) 8 Ll LR 192.

the like, for in the allocation of risks in commercial contracts the touchstone is not fairness but the efficient allocation of insurable risks. It would be better for the court to discover evidence of practice, perhaps revealed in the insurance arrangements, in order to determine the application of limitations on recovery of damages.

Many formal contracts make explicit provision for remedies through such devices as deposits, security, liquidated damages and limitation clauses. Although these agreed remedies are normally legally valid, the courts have wide and vague powers to control the exercise of such contractual rights on the basis of standards such as reasonableness and unconscionability. In order to exercise such indeterminate powers and to justify their application, the courts seem to rely to a considerable extent upon an investigation of the implicit dimensions of contracts, that is the implicit expectations and understandings of the parties. For instance, in *Mitchell (George) (Chesterhall) Ltd v Finney Lock Seeds Ltd*,[29] when the seed merchants supplied the farmer with the wrong type of seeds but sought to rely on a limitation of damages clause to defeat a claim for loss of profits, the court held the limitation clause to be unreasonable and unfair. The House of Lords invalidated the limitation clause in part because the admission by the seed merchant that it did not always insist upon its standard form limitation clause suggested that an implicit understanding of the trade was that the defendants would limit compensation, but not to the full extent of the clause, in the light of the circumstances such as the degree of fault of the defendants and whether or not the claimant was a valued customer. We suggest that similar references to implicit dimensions of contractual relationships plays a vital role in the other instances of judicial control of agreed remedies. A forfeiture is 'reasonable' if it conforms to the customs of the trade. A liquidated damages clause is not an invalid penalty if it produces outcomes that conform to the reasonable expectations of the parties about the appropriate level of compensation. The technique for leading the courts to ascertain those implicit understandings is the legal requirement that the contractual estimation of loss should be 'genuine'.

JUSTIFICATION FOR INCORPORATION OF IMPLICIT DIMENSIONS

Our discussion of formation, content and remedies has been directed towards identifying those techniques employed by legal reasoning for

[29] [1983] 2 AC 803.

inserting implicit dimensions of contractual relationships into its determinations. Although the classical law ostensibly eschews these implicit dimensions, we have pointed to many instances where more or less covertly the implicit dimension plays a crucial role in legal reasoning. We noted that at times legal reasoning senses just how subversive of classical orthodoxy can be the judicial reliance on implicit dimensions, yet we also argued that often in those same instances the legal process could not exclude implicit dimensions without lapsing into unfounded decisions or even incoherence. In stressing the significant role played by the implicit dimensions of contractual relationships in legal reasoning, we have touched only briefly on the normative question whether this practice is desirable. The question is whether courts should be encouraged to use legal reasoning that consciously and explicitly inserts implicit dimensions of contract relationships into determinations of contractual disputes.

As a matter of principle, it is argued that the courts are properly reluctant to rewrite contracts in ways that they might regard as more reasonable, or to satisfy what may be regarded as a reasonable expectation which has not been protected by an express contractual agreement. The courts should not exercise such powers because they will interfere with freedom of contract. And freedom of contract in general enhances the utility of contracts as a welfare-enhancing mechanism The reasons why we reject this argument of principle are both that mere or exclusive reliance on the express terms of the contract is not a practical alternative; and, secondly, if, as the principle of freedom of contract maintains, the job of the law is to enforce the agreement of the parties, this task can only be achieved by looking at the 'real deal', which is not necessarily the same as the written contract. Assuming that respect for freedom of contract has the alleged desirable utilitarian consequences or at least ensures respects for individual rights, it does not follow in our view that legal reasoning should eschew reference to the implicit dimensions of contractual relationships. On the contrary, by incorporating implicit dimensions into legal analysis, by recontextualising private law, the legal system can achieve a greater capacity for upholding freedom of contract and its consequent benefits.

We do not subscribe, however, to the view that contract law should be governed by a version of efficiency that places freedom of contract on a pedestal. In many contracts, the need for co-operation and adaptation in order to achieve efficient production and competitiveness can only be met by contracts that are incomplete by design supplemented

by implicit obligations of co-operation and protection of reasonable expectations. These kinds of long-term, relational and network contracts require from time to time legal support to protect against disappointment, and this support must entail giving legal effect to these implicit obligations if it is to help the parties to secure the efficiency gains of their transaction.

As well as arguments of principle for and against the incorporation of implicit dimensions of contractual relationships in legal reasoning, pragmatic considerations about the costs and benefits of this practice need to be considered. The main pragmatic reason to discourage the courts from engaging with the implicit dimensions of contracts is that they do not have ready access to information that might determine what these implicit understandings and expectations may have been. This information can only be discovered by secondhand and conflicting evidence about the state of mind of the parties or investigations of customs of the trade that may be uncertain and far from uniform. Instead of embarking on such a speculative enquiry, a court may be better advised to stick to the letter of the contract and send a warning to the market that parties should look after their own interests more carefully in the formation of contracts. This awareness of the possibility, indeed likelihood, of 'radical judicial error'[30] is currently being made the basis of a strong renewed defence of formalism in contract interpretation.[31] Not only does such a warning seem unlikely to be effective in many contexts, such as consumer standard form contracts and contracts of employment, but also it seems difficult for formalism, even accepting that it can be presented in more sophisticated versions,[32] to avoid dependence on some sort of idea that there is a literal sense available from the wording of a contract, a possibility that we have sought to deny. A correct judicial appreciation of implicit dimensions is certainly not guaranteed, but the option of ignoring those dimensions and confining attention to the express terms of a written contract seems destined to guarantee some judicial mistakes about the bargain that the

[30] EA Posner, 'A Theory of Contract Law Under Conditions of Radical Judicial Error' (2000) 94 *Northwestern University Law Review* 749.

[31] RE Scott, 'The Case for Formalism in Relational Contract' (2000) 94 *Northwestern University Law Review* 847.

[32] TC Grey, 'Langdell's Orthodoxy' (1983) 45 *University of Pittsburgh Law Review* 1 and TC Grey, 'The New Formalism', Stanford Public Law and Legal Theory Working Paper No 4, Stanford Law School, 1999; D Kennedy, *A Critique of Adjudication (fin de siècle)* (Cambridge (USA), Harvard University Press, 1997) 105: Langdellian formalism is a 'theory with no known American proponents'.

parties wanted. These arguments about pragmatism are considered in greater detail in the next essay in this volume by Stewart Macaulay, so we will not pursue them further here.

We therefore defend the proposition that the courts should incorporate examinations of implicit dimensions of contractual relationships on two grounds: there is no alternative intelligible method of legal reasoning, and even if there were, the practice would be justified in any case, subject only to pragmatic considerations of cost, on the basis of welfare-maximisation, efficiency and respect for the rights of individuals. We are conscious that many issues have been left unresolved. How determinate is the notion of implicit dimensions of contracts? At times we have spoken of customs of the trade as an example of implicit dimensions of contracts, but at others the whole social context of the agreement, including conventions of meaning in language, have been invoked as the implicit dimension of contractual relationships. Another question is how we can best analyse these implicit dimensions? Is it helpful to follow economic analysis to try to explain their presence as further agreements (implicit contracts), or does this analysis deprive the social context of what makes it social? Yet a further problem is how can legal reasoning discover the implicit dimensions of contracts. Legal reasoning works best with evidence and proven facts, but the incorporation of implicit dimensions of contracts requires a reliance upon unspoken assumptions, 'unwritten laws' of the trade, and signs which acquire their meaning through unrecorded habits and conventions. To some extent these questions are addressed in the subsequent essays in this book, but no doubt this research agenda leaves much for further discussion on another occasion.