

Summer 2003

Contract Lore

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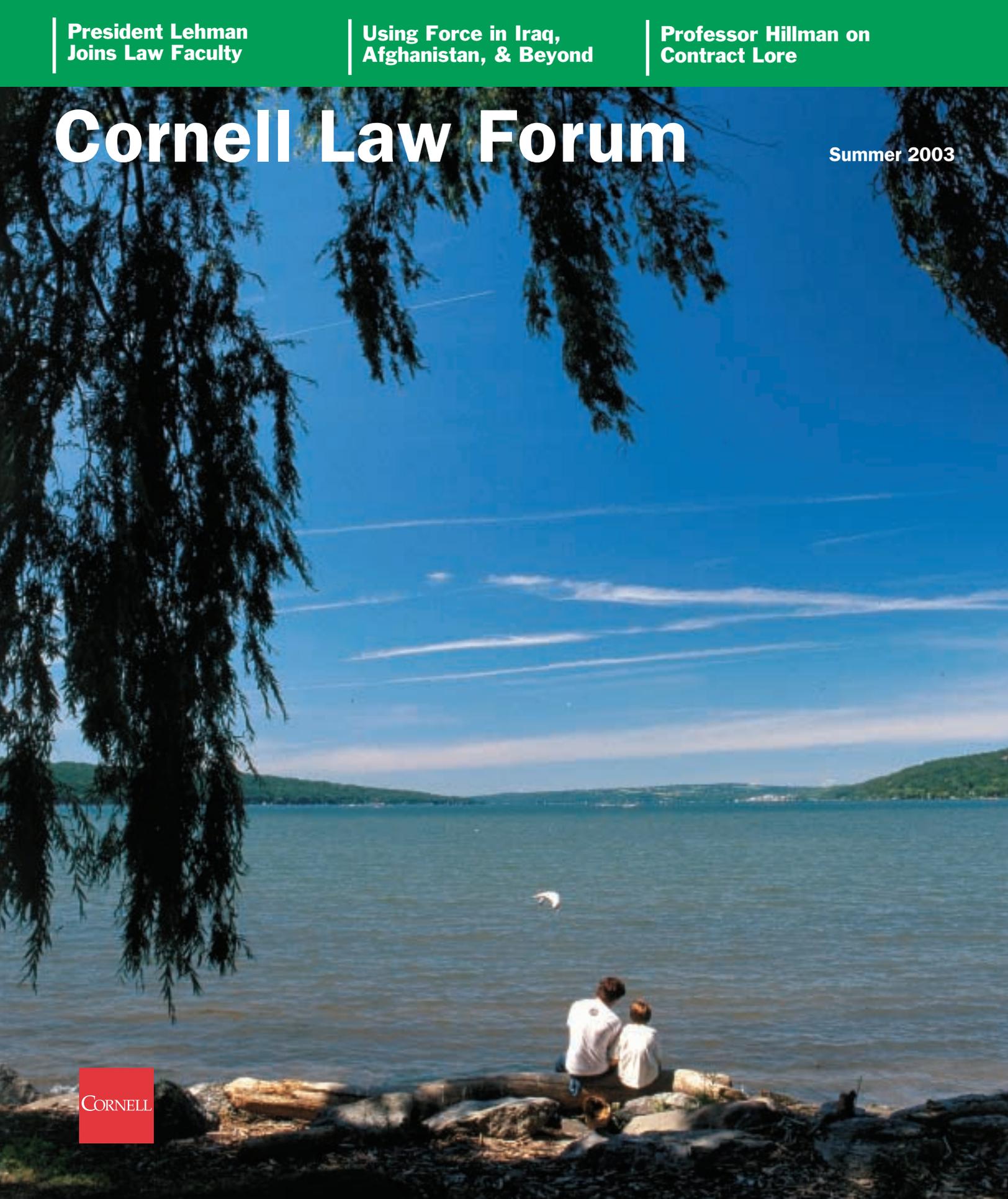
President Lehman
Joins Law Faculty

Using Force in Iraq,
Afghanistan, & Beyond

Professor Hillman on
Contract Lore

Cornell Law Forum

Summer 2003

A scenic photograph of a large body of water, likely a lake, under a clear blue sky. In the foreground, two people are sitting on a log on the rocky shore, looking out at the water. A white bird is flying in the middle ground. The sky is filled with wispy clouds and several thin, white contrails. The water is a deep blue-green color. The background shows rolling green hills. The overall mood is peaceful and serene.

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Changing the Legal Regime: Using Force in Iraq, Afghanistan, and Beyond	1
<i>David Wippman</i>	
Contract Lore	8
<i>Robert A. Hillman</i>	
News	15
President Lehman Joins Law Faculty	15
Dean Search Update	15
Conference on Asian Financial Markets	17
Dean Lukingbeal Elected to National Law Placement Board	20
Minorities in the Law Conference	20
The Class of 2003	21
New Records for Reunion Fund-Raising	22
Scholarship Established in Memory of Prof. Oberer	22
Faculty Notes	23
Profiles	33
Leslie G. Landau '83	33
Paramjeet "Tony" Sammi '98	34
Lynne Campbell Soutter '03	35
James Sahngwon Yoon '03	37
Alumni	38
Highlights and Photos of Reunion 2003	38
Alumni Events in NYC and Washington, D.C.	40
Class Notes	41

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 CORNELL LAW SCHOOL

Contract Lore

Robert A. Hillman

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First, let me explain the title of this essay. Folklore constitutes “the traditional beliefs, legends, customs, etc., of a people”¹ and “represents a people’s image of themselves.”² I want to write about some of the “traditional beliefs,” or principles, of contract law that “contracts people”—judges, lawyers, and scholars who apply and write about contract law—employ so routinely and confidently that the principles shed light on how we perceive contract law today. What makes these principles so interesting is that none of them is even close to true; and, when pressed, most contracts people would admit it. I want to investigate why contracts people invoke these “traditional beliefs and legends” even though they are, in reality, nothing more than contract lore.

This essay examines three examples of contract lore. First, contracts people do not hesitate to declare that the purpose of expectancy damages is to “put the injured party in as good a position as if the contract were performed.”³ But the injured party cannot recover prejudgment interest, attorney’s fees, unforeseeable consequential damages, uncertain losses, and so on. Consequently, expectancy damages virtually never put the injured



party in as good a position as if the contract were performed. Second, contracts people maintain that the reasons for a breach, whether willful, negligent, or unavoidable, are irrelevant to the rules of performance and remedies. However, the reasons for a breach matter mightily, including in how courts determine whether a party has materially breached, the formula for determining damages, and the availability of restitutionary relief. Third, contracts people recite how contract formation and interpretation focus on the parties’ actual intentions and assent, despite the fact that contract enforcement does not depend on intention and assent at all. Instead, enforcement focuses on whether a promisee reasonably believed the promisor intended to contract, and on what constitutes a reasonable interpretation of the language of a contract.

My goal here is not to reveal these dichotomies, which constitute open secrets. Nor do I take issue with the explanations for the manner in

Mephistopheles offers a contract for total worldly knowledge in exchange for Faust’s soul. Undated color lithograph illustration from Faust (1808 and 1832) by Goethe.

which contract law actually operates, although this essay does contain some discussion and evaluation of these explanations. My principal aim is to investigate what, in the aggregate, the existence of contract *lore* tells us about the nature of contract *law* in this new century. I posit that a better understanding of contract *lore* leads to a clearer comprehension of contract law.

I. Examples of Contract Lore

EXPECTANCY DAMAGES

The stated goal of expectancy damages is to make the injured party whole. Most analysts explain the expectancy approach as the best method of creating incentives for parties to contract and to rely on their contracts. For example, under an expectancy damages regime, parties can rely on their contracts, believing either that the other party will perform or that compensation for non-performance will put the injured party in the same position as performance. Setting the damages measure any lower than expectancy would undermine this incentive to rely. Granting recoveries greater than expectancy damages, such as punitive damages, would discourage parties from entering contracts in the first place because they would fear having to pay a penalty, even for an inadvertent breach. Such a fine would also constitute an unjust windfall to the injured party.

This (and other) rationale for expectancy damages is subject to debate. Whatever the reasons behind the expectancy approach, contracts people continue to affirm that the goal of expectancy damages is to make injured parties whole. The reality is dramatically different. A large set of remedial rules limits the recovery of injured parties, often to well below expectancy. For example, in our legal system, parties usually must pay their own lawyers and can rarely recover pre-

judgment interest. These impediments, of course, are the costs of litigation and apply to all areas of the law. More specific to contract law, injured parties cannot recover unforeseeable or difficult-to-prove damages, even though these are often real and large. In addition, courts typically compute damages objectively, thereby ignoring a party's special circumstances, including emotional distress and sentimental value.

The failure of expectancy damages to make injured parties whole is not the world's best-kept secret; many theorists have recognized this reality and have adduced reasons to explain it. One obvious reason is that the expectancy goal runs into institutional counter-policies. We do not want to discourage parties from exercising their right to a day in court by making them liable for the other party's legal fees. We do not want to license courts to award baseless recoveries, so we require injured parties to prove their damages with some precision.

Another reason is the existence of contradictory substantive policies. For example, we want to avoid discouraging people from making contracts because they have a fear (rational or not) of inordinate liability. We also want to encourage promisees to disclose special circumstances, so we deny them consequential damages when the breaching promisor could not foresee a particular loss and the injured promisee did not disclose its possibility.

These and other reasons undoubtedly contribute to the real failure of expectancy damages. My pur-

Injured parties cannot recover unforeseeable or difficult-to-prove damages, even though these are often real and large.

pose here is not so much to take stock of these reasons, but to figure out why so many contracts people persist in pronouncing that expectancy damages make injured parties whole when the secret is out that expectancy damages do no such thing.

CONDUCT OF THE BREACHING PARTY

Contracts people unhesitatingly proclaim that the reasons for a breach, whether willful, negligent, or unavoidable, have no bearing on determining the rights of the contracting parties. Contract liability is said to be “strict,” meaning that the reasons for a breach are irrelevant. The goal is to make the injured party whole, not to punish contract-breakers.

But a host of exceptions swallows up the rule, so much so that most theorists, if pressed, concede that the true “rule” is that the breacher’s conduct matters a lot. For example, in construction contracts, the degree of willfulness of a contractor’s breach helps courts determine whether to grant expectancy damages measured by the cost of repair, or by the diminution in value caused by the breach. Deliberateness also constitutes an express factor in determining the materiality of a promisor’s breach and whether the promisee is excused from the contract. Even after being excused from performance, a promisee might have to deal further with a contract-breaker to minimize damages, depending on a promisor’s motive for the breach. A promisor might also commit a bad-faith breach of contract and therefore trigger rights in favor of the promisee that are not expressly set forth in the contract. Finally, courts have created “independent torts” that arise in the contract setting, including when a party misrepresents facts during negotiations and recklessly performs a contract.

None of these rules should be surprising or even very controversial. Fairness principles, such as the “rule of reciprocity,” dictate that one should not try to increase one’s gains at the expense of the other party. Moreover, on moral grounds, people should keep their promises, and unintentional breaches deserve less moral approbation than intentional ones. Counting the deliberateness of a breach makes sense on instrumental grounds, as well.

Courts should deter a promisor from taking advantage of the promisee’s reliance on an expected performance or of changed circumstances that back the promisee into a corner. By deterring such “opportunistic breaches,” contract law encourages contracting and thwarts useless wealth transfers from an innocent party to a wrongdoer. Perhaps most obviously, judges and juries are human beings who cannot help but be influenced by the degree of nastiness and inconsiderateness of a breach. So it should not be a mystery why courts account for the willfulness of a breach. The enigma I want to address is not why judges pay attention to a promisor’s conduct, but why more contracts people cannot bring themselves to repudiate the dictum that the reasons for a breach do not matter.

Judges and juries are human beings who cannot help but be influenced by the degree of nastiness and inconsiderateness of a breach.

CONTRACT FORMATION AND INTERPRETATION

Judicial decisions almost inevitably contain language suggesting the primacy of the parties’ intentions and the importance of enforcing their actual agreements. This should not be surprising. The understood purpose of contract law is to facilitate people’s freely-made private exchange transactions.

In reality, however, actual intentions and agreements hardly matter in cases that get to court.⁴ Instead, courts apply an objective theory of formation and interpretation that enforces contracts based on apparent, not real, intentions. If a promisee reasonably and honestly believed the promisor intended to contract, the promisor may be bound even though the promisor did not intend to contract. Moreover, a court may enforce the reasonable meaning of a contract term even though the promisor actually understood the term

differently. Judge Learned Hand saw this as early as the turn of the last century:

A contract has, strictly speaking, nothing to do with the personal, or individual, intent of the parties. ... If ... it were proved by twenty bishops that either party, when he used the words, intended something else than the usual meaning which the law imposes on them, he would still be held, unless there were mutual mistake, or something else of the sort.⁵

Notwithstanding the staying-power of Judge Hand's prose, most decisions are chock-full of "intent of the parties" language. Most courts say one thing about individual intentions and do another.

The objective approach to contract formation and interpretation is not hard to explain. It protects a promisee's reasonable reliance on the promisor's manifestation of intent. If a promisor jokingly, mistakenly, or insincerely creates the impression that she intends to contract according to particular terms and her conduct induces the promisee to rely on those terms to her detriment, contract law protects the promisee.

What still needs explaining is why so many contracts people persist in presenting contract law as if subjective intentions and actual agreements matter, when they do not. We now turn to this question, as well as to why contracts people persist in pronouncing other instances of contract lore.

II. The Meaning of Contract Lore

Contract law does not make injured parties whole. It punishes deliberate contract-breakers and it enforces contracts that a party did not intend to make. Why do contracts people persist in saying otherwise?

Contract law does not make injured parties whole. It punishes deliberate contract-breakers and it enforces contracts that a party did not intend to make.

UNSATISFACTORY EXPLANATIONS

There are many unsatisfactory explanations for the existence of contract lore. First, Part I shows that we cannot explain contract lore on the basis that the pronouncements are generally true but subject to a series of exceptions. For example, expectancy damages virtually never make an injured party whole, so it would be difficult to maintain that, as a general rule, they do, and that they do not only when an exception applies. In addition, to establish liability, contract law never *requires* an actual intent to contract, so we cannot argue that contract law requires intent except in certain circumstances.

Moreover, we cannot simply say that contract lore is holdover dicta from a time when it was true, before a series of exceptions effectively swallowed up the rule. For example, I would wager that deliberate breaches have always had ramifications and expectancy damages have never made the injured party whole.

Contract lore also constitutes more than a clever use of legal fictions, at least according to the common use of that term. "Legal fiction" usually denotes a judicial assumption made consciously to facilitate the development of a legal principle designed to achieve a particular instrumental goal. Judges employ legal fictions to achieve ends in order to maintain the law's stability and certainty.

In this sense, claims that expectancy damages make an injured party whole, that the reasons for breach do not matter, and that contract law enforces the parties' intentions do not constitute legal fictions because these precepts do not help develop subsidiary coherent legal principles for the purpose of achieving an end. Moreover, lawmakers typically pronounce legal fictions with the under-

standing that they are not based in reality, whereas people invoke contract lore most often with the view that it is an accurate description of current contract law.

In fact, because most contracts people appear to believe in the veracity of contract lore (at least until reminded otherwise), we can rule out another instrumental explanation for contract lore. Contracts people are not deliberately attempting to create a chasm between the perception of contracting parties of the governing rules (“I will be made whole if the other party breaches”) and judicial decision-making norms (“Judges can limit the remedy to achieve a just result”) for the purpose of achieving greater certainty in the law without sacrificing individual justice. Further, contract lore does not always lend itself to certain results and contract law is not always consistent with fairer decision-making. For example, the value of a promise is not always easy to measure, so the contract lore that injured parties can recover the value of their expectancy does not necessarily clearly guide transactors. Nor does a contract-law principle, such as denying emotional distress damages, always lead to fairer results.

Because contract lore is not always certain in application and often constitutes poor advice to contracting parties, I also doubt that we can explain it as a set of heuristics or shortcuts developed by transactional lawyers to simplify their advice to their clients. Because the reasons for breach matter, for example, lawyers advising otherwise would jeopardize their clients’ interests (recall that a willful breacher may be liable for greater damages or even an independent tort), not to mention possibly commit legal malpractice.

Finally, with respect to what contract lore is not, I do not believe it constitutes evidence of a conspiracy among contract “elites” to favor one class of

contractors over another. The problem with a conspiracy explanation for contract lore is the difficulty of detecting a unitary instrumental pattern to the various pronouncements. Decisions applying the expectancy damages formula but failing to make the injured party whole, or declaring a refusal to “punish” a contract-breaker but taking into account the reasons for a breach, or calling for a “meeting of the minds” but ultimately applying an objective test of assent, do not over time uniformly appear to favor one class of parties

In an ideal world of freedom and justice, a legal approach to exchange transactions would enforce parties’ actual agreements freely made by parties with equal bargaining power and information.

over another.⁶ A conspiracy in these circumstances would be hard to prove.

A MORE SATISFACTORY EXPLANATION

So what *is* going on here? In my view, contract lore represents contracts people’s aspirations—their strong preference for how contract law should operate if realities did not preclude it. In an ideal world of freedom and justice, a legal approach to exchange transactions would enforce parties’ actual agreements freely made by parties with equal bargaining power and information. People would not inadvertently become obligated under a contract. Injured promisees of enforceable contracts would receive performance or its equivalent in damages. The reasons for breach would be irrelevant because injured parties would be made whole. Liability for expectancy damages would be a sufficient punishment for nasty contract breakers. But the real world, filled with practical and substantive hurdles, does not allow for this model of contract law.

The chasm between aspirations and reality is, of course, not unusual. Political candidates include in

their platforms many campaign pledges that the realities of governing make impossible to keep. Sales people puff their products' quality despite the reality that the goods are less than perfect. Contracts people also portray a version of contract law that differs from reality because they are describing our aspirations for contract law, not the hard truths. But the motive for the pronouncements of politicians and sales personnel is, at least in part, personal gain, which sets them apart from the creators of contract lore. Unlike politicians and salespeople, contracts people are not trying to "sell" the system for direct or indirect personal gain by encouraging prospective contractors to place too much faith in contract law.

The psychological phenomenon most implicated in what I am describing is cognitive dissonance. People have a tendency to strive for a consistency of beliefs, which often leads them to believe things that are not true and to avoid conflicting information. This tendency may be especially strong concerning people's "core values."⁷ When people detect a dissonance between their values and reality, they try to suppress the inconsistency and the urge to do so is very strong.

No less a figure than Freud saw the relationship between this tendency and a people's folklore: "In the origin of the traditions and folklore of a people, care must be taken to eliminate from memory such a motive as would be painful to the national feeling."⁸

Lon Fuller, in his description of the judicial construct of "apologetic or merciful fictions"⁹ (different than the "legal fiction" discussed above), also addressed the urge of people to suppress inconsistencies. He saw in the criminal-law fiction that "everyone knows the law" an effort to "apologize" for the difficult reality that the law often punishes people who do not understand they are breaking the law.¹⁰



"Signed, Sealed, and Delivered"

As we can see from Fuller's criminal-law example (and is otherwise obvious), aspirational descriptions of legal principles that gain legitimacy over time are not peculiar to contract law. But cognitive dissonance may be especially strong in this realm because the ideals of freedom of contract and economic liberty are fundamental American values, and exchange constitutes the core element of our economy. The realities of implementing a contract legal system deter us from achieving these goals, but we want to believe that we have achieved them. And thinking and writing about these aspirations reinforces our belief in their truth. As a Critical Legal Studies writer once pointed out, "Once we decide ... that we should ordinarily bolster a private sphere of free action ... we come to believe that we will find such a sphere out in the world."¹¹ In short, contract lore, as with other folklore, constitutes an "escape mechanism" that allows legal thinkers and lawmakers to envision a better system than exists in reality.¹²

III. Ramifications

What are the ramifications of the prevalence of contract lore? Some extant theories of contract law, such as efficient breach, must be rethought because they are based on contract lore, not contract law. According to the efficient breach theory, contract law should encourage breach when the breacher can gain enough from breaching to pay the injured party expectancy damages and still come out ahead. A fundamental premise of the efficient breach theory, however, is that the expectancy measure of recovery makes the injured party whole. If this is not true, the theory falls with it.

The chasm between contract law and lore has practical implications as well. As already noted, if the reasons for breach matter, lawyers should carefully reconsider the nature of the advice they dole out to clients concerning whether and when to breach a contract. If people can be held contractually liable without intending to contract, lawyers should also carefully explain to their clients the kinds of bargaining and negotiation tactics that might lead to contractual liability, regardless of their intent to contract. More fundamentally, lawmakers should review the efficacy of rule-of-law norms as applied to exchange transactions, such as certainty and clarity of law, to consider whether more needs to be done to ensure that contract law is not misleading.

Most important, reformers should resist the urge to believe, based on the prevalence of contract lore, that we already have an ideal contract-law system. Instead, to improve contract law, contracts people should rethink the relationship of internal contract rules and principles to each other and the relationship of contract principles to external rules. Questions such as whether injured parties should recover emotional distress damages; whether the requisites for consequential damages recoveries of

certainty and foreseeability should be relaxed; whether the willfulness of breach should play a greater or lesser role in contract doctrine; whether contract damages should better reflect the objective reasons for enforcing a contract; and whether contracting parties should continue to pay their own legal fees, should not be cast aside on the misleading assumption that contract law has already satisfactorily resolved these issues. In short, the paramount danger of the complacent acceptance of contract lore is that it licenses lawmakers to escape unpleasant realities that require attention.

1. *The Random House Dictionary of the English Language*, 744 (2nd ed. 1987).
2. Alan Dundes, *Interpreting Folklore*, viii (1980).
3. See, e.g., *Sullivan v. O'Connor*, 296 N.E. 2nd 183, 186 (Mass. 1973).
4. It is important to distinguish the fact that many, if not most, contracts do in fact constitute actual agreements between the parties, from the legal necessities for enforcement, which do not require actual agreement.
5. *Hotchkiss v. Nat'l City Bank of New York*, 200 F. 287, 293 (S.D.N.Y. 1911), aff'd, 201 F. 664 (2nd Cir. 1912, aff'd, 231 U.S. 50 [1913]).
6. See generally Robert A. Hillman, "The 'New Conservatism' in Contract Law and the Process of Legal Change," 40 *Boston College Law Review* 879 (1999).
7. Steven Hartwell, "Legal Processes and Hierarchical Tangles," 8 *Clinical Law Review* 315, 371 n.117 (2002).
8. Sigmund Freud, *The Basic Writings of Sigmund Freud*, 104 (1938).
9. Lon L. Fuller, *Legal Fictions*, 84 (1967).
10. *Ibid.*
11. Mark Kelman, *A Guide to Critical Legal Studies*, 291 (1987).
12. Dundes, *supra*, note 2 at 36.



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