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ESSAY

Relational Contract Theory and the Concept of Exchange

PAUL J. GUDEL†

This Essay is an introduction to the importance of Relational Contract Theory and the controversy it has created within contract law scholarship. In examining why the theory is especially important and controversial today, the Essay explores specific current areas of inquiry within Relational Contract Theory and suggests the direction in which the theory leads contract law. Relational Contract Theory provides an alternative to common, even standard, ways of thinking about contract law. In presenting the alternative that the theory offers, the Essay begins with the narrowly legal, moves to the economic, and finishes with the broadly philosophical. Finally, the Essay considers some implications of Relational Contract Theory for the role of law in regulating contracting activity.

I. LAW

Ian Macneil is the contracts scholar most responsible

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for the concept of relational contract. His work demonstrates that one can arrange all exchange between humans on a continuum, from the most discrete exchange at one end to the most relational on the other end. A discrete contract, as the name implies, is a transaction "of short duration, involving limited personal interactions, and with precise party measurements of easily measured objects of exchange," such as money and some easily quantifiable good. Macneil says that in such transactions, the complete future of the deal, to the extent that it has any at all, is "presentiated"—that is, the parties bring the future wholly into the present and treat it as present through complete planning of the transaction, planning which then binds the parties. In a purely discrete transaction, there is nothing that binds the parties together or connects them with each other, except this fully articulated planning for a single, mutually beneficial exchange.

A completely discrete transaction is an impossibility, but Oliver Williamson gives an example of a transaction that is about as close to pure discreetness as one can get: a purchase of a bottle of local spirits from a shopkeeper in a remote area of a foreign country who one never expects to visit again nor to recommend to one's friends. I might add that the transaction would be even more discrete if the buyer did not speak the shopkeeper's language but had to


2. MACNEIL, CONTRACTS, supra note 1, at 12.

3. See Macneil, Long-Term Economic Relations, supra note 1, at 863.

4. See id. at 856, 857 n.10.

use sign language, and did not use the local currency but bartered a personal possession.

Relational contracts, conversely, are characterized by long duration, personal involvement by the parties and the exchange, at least in part, of things difficult to monetize or otherwise measure. The beginning and end of relations tend to be gradual and incremental, rather than, as Macneil says in regard to discrete transactions, "sharp in, sharp out." Finally, again in Macneil's words, "the participants never intend or expect to see the whole future of the relation as presented at any single time, but view the relation as an ongoing integration of behavior to grow and vary with events in a largely unforeseeable future...." It follows that planning for relational contracts is often tentative rather than entirely binding and often involves not simply the substance of the exchange, as in discrete transactions, but also planning of structures and processes to govern the relation in the future. Like a purely discrete transaction, a purely relational contract is probably impossible. But toward the relational end of the exchange spectrum we find such things as franchise arrangements, long-term employment, professional partnerships, labor-management relations and, quintessentially, marriage.

Macneil also recognized that discrete contracts alone cannot come close to satisfying the need of modern industrial society, with its dependence on massive capital investment, for a combination of the stability provided by long-range planning and the flexibility to deal with continuously changing circumstances. The result is that relational contracts predominate; even the most discrete transaction is embedded in heavily relational patterns.

6. Macneil, Futures of Contracts, supra note 1, at 750.
7. See MACNEIL, CONTRACTS, supra note 1, at 13.
8. This does not mean that there is still not a great deal of discrete planning in modern economic life. The complexity of economic activity demands a great deal of detailed, discrete planning. The point is that this planning takes place in relational structures. Macneil says that sometimes the best response of the legal system to a dispute over an exchange will be to give this discrete planning its full effect. "But those solutions will be 'best' because the overall relational circumstances so indicate, not because of the general dominance of jurisprudential systems based on enhancing discreteness and presentation." MACNEIL, Long-Term Economic Relations, supra note 1, at 886 n.101.
9. Macneil has argued that discrete transactions work well as a means of exchanging certain kinds of goods and services, but that the production of goods and services (a much larger part of economic activity) is carried out through
Part of the immediate impact in legal scholarship of Macneil's discrete/relational scheme was that it provided a powerful means of criticizing existing contract law.\(^{10}\) It quickly became apparent that the doctrines of what are called classical and neo-classical contract law are largely based on the assumption that all contracts are discrete. Contract law was and is relatively well adapted to dealing with discrete transactions. However, it was and is ill-equipped to deal with problems arising out of contract relations. To put it another way, contract law had a powerful bias in favor of discreteness, and discrete legal doctrines applied to relational contracts often produced results that were intuitively unfair.

A quick example from the high period of classical contract law is *Missouri Furnace Co. v. Cochran.*\(^{11}\) Missouri Furnace (the buyer) contracted with Cochran (the seller) for a year's supply of coal, to be delivered in installments on every working day of the year. The contract price was $1.20 per ton. Shortly into the year, the price of coal rose to $4.00 per ton and Cochran told Missouri Furnace that it was repudiating the contract. Missouri Furnace then "covered"—it contracted with another seller for the remainder of the year at the then-market price of $4.00 per ton. It then sued Cochran for standard contract damages, the difference between $4.00 and $1.20 per ton.\(^{12}\)

Unfortunately for Missouri Furnace, shortly after it

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In the very heyday of laissez-faire, wherever there were sales of wheat in markets, there were banks financing every step from the fields themselves to final delivery, family farms growing the wheat, harvester teams harvesting it, private companies or cooperatives storing it, railroads and carters moving it, mills milling it, and baking companies and families baking it. All these carried on their operations in internal patterns of relational exchange . . . .

*Id.* at 490-91.


11. 8 F. 463 (C.C. W.D. Pa. 1881).

12. *Id.* at 464.
entered into the second contract the price of coal dropped back to the range of $1.30 per ton. The court ruled that the measure of damages for breach of such a contract is the difference between $1.20 per ton and the value of coal at the time each delivery would have been made. Thus Missouri Furnace could collect as damages only the difference, if any, between the contract price with Cochran, $1.20, and the market price of coal for every day coal was delivered to it for the remainder of the year. Yet no matter what the daily market price of coal, Missouri Furnace was still committed to paying $4.00 a ton for coal pursuant to its forward contract with second seller. In essence, Missouri Furnace was punished for entering into a contract to cover, even though the price of coal under that contract was completely reasonable when the contract was entered into. The court would rather force Missouri Furnace to buy replacement coal on the spot market every day; saying, "As the [buyer] was not bound to enter into the new forward contract, it seems to me it did so at its own risk ...." This horrifying result comes from the court’s treatment of a one-year-long contract as if it were a year-long series of identical (except for price) daily contracts and illustrates a bias in favor of discreetness in the starkest way possible.

Today, happily, *Missouri Furnace* would come out differently under Article 2 of the Uniform Commercial Code, governing sales contracts. But there are many contemporary instances of the lack of fit between a contract law oriented toward discreetness and the realities of relational contracts. In particular, criticism of existing law by relational contract theorists has centered on one persistent tendency of classical contract law—namely, its attempt to locate the entire content of the parties’ agreement, and thus the entire source of their obligation to one another, in an initial moment of agreement which contracts treatises describe as the “meeting of the minds.” Correspondingly, courts have been extremely reluctant to

13. *Id.*

14. *Id.* at 467. In other words, the court held that Missouri Furnace violated the principle of mitigation of damages. It could not recover the damages it claimed because they were reasonably avoidable.

15. Section 2-712 of the U.C.C. provides that after a breach by a seller, a buyer may recover the difference between the cover price and the contract price. This section further defines "cover" as "any reasonable purchase of or contract to purchase goods in substitution for those due from the seller" (emphasis added).
intervene in any contract if that intervention cannot be justified by reference, albeit fictional, to this magic moment of agreement.

The case of *Air Terminal Servs., Inc. v. United States* provides another quick illustration. Air Terminal contracted with the United States to operate parking lots at Washington’s National Airport for three years. One year later the United States built a large number of metered parking spaces near the airport terminal. As a result, Air Terminal’s revenues from short-term parking dropped dramatically. Air Terminal sued, claiming that by installing the parking meters the United States had breached its contract with Air Terminal. The court reasoned that the United States had never promised that it would not install parking meters. A warranty of this type was not part of the original agreement. In fact, the court noted, the official regulations of the Civil Aeronautics Administration, buried deep somewhere in the Federal Register, reserved to the Director of the Airport the right to control traffic on the streets and roads of the airport. As such, Air Terminal had “at least constructive knowledge” that there was no agreement that parking meters wouldn’t be installed. Air Terminal was thus denied relief, and its petition was dismissed.

This decision would probably come out differently today. A court would likely find that in installing the meters, the United States had violated the covenant of good faith that the law implies into every contract. The covenant of good faith requires that no party to a contract shall do anything to impair another party’s ability to receive the benefits of the contract. Yet that is exactly what the United States did in *Air Terminal*. The United States violated a provision of the contract, one that came into being at the moment of agreement, even if only impliedly as a matter of law. In other words, today a court would justify

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17. *Id.* at 974-77.
18. *Id.* at 977.
19. *Id.* at 980.

intervention in *Air Terminal* by referring back to the original moment of agreement after all. The only alternative approach available to courts is to rewrite the parties' contract. The idea that courts might rewrite the contract of the parties is anathema to the legal mind, and contract law has been dominated by this dichotomized way of organizing and thinking about legal responses to contract: implementing the original intent of the parties versus writing a contract for them. This approach overlooks the theory in relational contracts that there is no simple “intent of the parties,” that the parties themselves are continually engaged in “rewriting the contract” and that a legal approach which looks back to intent at the moment of initial agreement in effect does rewrite the contract by ignoring the reality of the parties’ developed relation.

These considerations are relevant to the real question that Relational Contract Theory raises for contract law: what is the source of binding contractual obligation? Is it solely the initial agreement of the parties at the time of contracting? Relational Contract Theory suggests that obligations evolve in the course of long-term relations, that contractual obligations cannot always be derived from an originary act of initial agreement, and that they may derive from norms other than the express (or even implied) consent of the parties. Clearly this is an “alternative approach to contracting,” distinct from the basic legal definition of “contract” that every first year law student learns: a promise or a set of promises for the breach of which the

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21. One example can illustrate how far this dichotomy can be taken. In *Wilhelm Lubrication Co. v. Brattrud*, 268 N.W. 634, 634 (Minn. 1936), the parties contracted for the sale of a fixed quantity of motor oil. Under the contract, the buyer was to specify at a later date the SAE weights he wanted; the price of the oil varied according to the weight. *Id.* at 634-35. The buyer then repudiated the contract without ever having specified the weights he wanted, and the seller sued. *Id.* at 634. In this situation, fairness and common sense dictate that damages could be calculated based on the cheapest oil weight, since the buyer had contracted for at least this much. Instead, the court held for the buyer and denied all recovery, on the ground that since the contract price could not be determined without the buyer having specified the weights, it was impossible to measure damages. *Id.* at 635. The court said it could not “be allowed to speculate as to the measure of damages, and there is no sound authority for taking an average or an arbitrary price as the contract price in a case of this kind.” *Id.* This is refusing to write a contract for the parties taken to the point of paranoia.
law will give a remedy. A promise is a manifestation of intent to act in a certain way in the future. Relational Contract Theory departs from this promise-centered theory of contract. Macneil, for example, defines contract as "the projection of exchange into the future." This means that an expectation arises out of on-going exchange relations that future exchanges will continue and will be "entirely free of all other coercion or ordering." This expectation emerges from and accounts for the fact that relationships characterized by ongoing exchange are often defined by particular traditions, customs, habits, status, kinship, command or religious obligations.

The legal system has been slow to account for the realities of relational contracts. The constant attempt to force relational wine into discrete bottles, as with the covenant of good faith and fair dealing discussed above, 

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22. See Restatement (Second) of Contracts § 1 (1979).
23. See id. § 2.
26. In Presentation, supra note 1, Macneil provides one example of how the law attempts to formulate rules that are responsive to the relational character of exchange. The example is the Restatement (Second) of Contracts § 267 (Tentative Draft No. 8, 1973), which sets forth the following factors for determining materiality of breach:

1. Extent to which the injured party will be deprived of the benefit which he reasonably expected;
2. Extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
3. Extent to which the party failing to perform or to offer to perform will suffer forfeiture;
4. Likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;
5. Extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing;
6. Extent to which it reasonably appears to the injured party that delay may prevent or hinder him in making reasonable substitute ar-
has hindered the progress of Relational Contract Theory. Today, for example, one area of controversy in contract law concerns the extent to which the law should restrict the parties' ability to terminate so-called "contracts terminable at will." It has long been the rule in American law that contracts that do not specify a duration, that lack a set termination date, are contracts terminable by either party at any time. In recent years there has been a movement to impose limits on the more powerful party's ability to terminate, even though there was no initial promise or agreement to limit that party's ability to terminate. For example, consider the following scenario. A candy company fired an at-will employee who had worked for the company for thirty-two years, had risen from pot washer to vice-president, had always received favorable performance evaluations and had been assured that his job was secure if he did his work and remained loyal to the company. The California Court of Appeals in Pugh v. See's Candies, Inc.

Macneil believes these factors, which Comment (a) to this section labeled "imprecise and flexible," capture just the "impression essential to the operation of ongoing relations." Macneil, Presentation, supra note 1, at 608. In the final version of the RESTATEMENT (SECOND) OF CONTRACTS (1979), the above factors were divided into two sections: § 241, CIRCUMSTANCES SIGNIFICANT IN DETERMINING WHETHER A FAILURE IS MATERIAL (which incorporates the first five factors), and § 242, CIRCUMSTANCES SIGNIFICANT IN DETERMINING WHEN REMAINING DUTIES ARE DISCHARGED (which adds the last two factors).


held that in this scenario, the company had an implied obligation to fire the employee only for good cause, even though the company had never made an explicit promise to the employee, much less made one at the outset of the employment relation.\(^29\)

Law addresses not only descriptive but also normative problems. That is, courts must base their judgments not only on descriptive analysis but also normative principles. For example, the result in See's Candies is consistent with a description from organizational theory which maintains that employees of a firm generally have a closer relationship to the firm than its shareholders.\(^30\) The California Court of Appeals, however, could not base its decision solely on this description from organizational theory. The law poses a normative requirement to justify applying the state's coercive power to enforce a duty not to terminate the vice-president except for good cause. For centuries contract law has justified using state coercion by looking to the principle of assent:\(^31\) the law only enforces

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29. See Pugh v. See's Candies, Inc., 171 Cal. Rptr. 917 (Cal. Ct. App. 1981). Peter Linzer argues that the nature of the modern employment relation generates obligations on the part of the employer to the employee that cannot be wholly liquidated in "a salary or other compensation that can terminate at the will of the owner." Linzer, supra note 27, at 426.

30. Orthodox legal analysis characterizes an employer-employee relation as a master-slave relationship. Yet this "ignores the undoubted fact that the employees are members of the company for which they work to a far greater extent than are the shareholders whom the law persists on regarding as its proprietors." See L.C.B. GOWER, MODERN COMPANY LAW 10-11 (3d ed. 1969). See also Clyde W. Summers, Co-determination in the United States: A Projection of Problems and Potentials, 4 J. COMP. CORP. L. & SEC. REG. 155, 169 (1982) ("[T]he employees who provide the labor are as much members of the enterprise as the shareholders who provide the capital.").


As articulated by earlier scholars such as Mill, and contemporary scholars such as Hayek, Friedman, Nozick, and Fried, individual autonomy is seen as a paramount social value and a central precondition to individual freedom. Private ordering is most compatible with this value because it minimizes the extent to which individuals are subjected to externally imposed forms of coercion or socially ordained forms of status. Private ordering is the quintessential form of government with the consent of the governed.
obligations the parties have voluntarily assumed. Yet in *See's Candies* the employer never agreed to terminate its employee only for good cause. If we remove the concept of promise as the moral ground of contract enforcement, with what do we replace it? Do we say that, in cases such as this one, we are not enforcing a private agreement or a voluntarily assumed responsibility, but rather a general social standard of acceptable behavior in contractual relations, thus pushing contract law in the direction of tort? Or do we say that our notion of assent itself needs to be broadened, that it no longer can be identified with the discrete notion of promise?

This approach holds not that recent developments in contract show a "decline of assent," but a decline of assent discretely understood. Consider the following homely example. About a year after our son was born, I found that I was the one getting up to feed him at two in the morning. This turned into an obligation and, although I had never explicitly assented to it, there is no sense in considering it other than a voluntarily assumed obligation. This understanding, reflective of Relational Contract Theory, entails a profound rethinking of some of the central concepts of contract law, such as intention, acceptance and agreement.

The case of *Local 1330, United Steel Workers v. United States Steel Co.* demonstrates the central shift in perspective that a Relational Contract Theory analysis demands. In the late 1970s, U.S. Steel closed two steel plants in the Youngstown, Ohio area on grounds of obsolescence. The workers sued to prevent the plant closures. The court was extremely sympathetic to their plight, saying:

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*Id.* at 8.


Everything that has happened in the Mahoning Valley has been happening for many years because of steel. Schools have been built, roads have been built. Expansion that has taken place is because of steel. And to accommodate that industry, lives and destinies of the inhabitants of that community were based and planned on the basis of that institution: steel.\textsuperscript{34}

The trial court even suggested that the lengthy employment relation had vested the workers with a property interest in the plant.\textsuperscript{35} Yet in the end, the workers lost their case simply because they could not prove the technical elements of breach of contract or promissory estoppel.\textsuperscript{36} From the alternative perspective of Relational Contract Theory, a court could have found that the steel company had assented not to close the plant without adequate notice. This conclusion, however, requires an understanding that the discrete notions of "promise" and "bargain" do not exhaust the definition of "voluntarily assumed responsibilities."

II. ECONOMICS

In addition to challenging traditional legal understanding of concepts such as the notion of assent, Relational Contract Theory also breaks with an understanding of contracts strongly promoted by the law and economics movement. Using the above example of the closed steel plant, economists would ask why we would even want to extend the notion of assent to find the steel company liable to the employees when simply giving the steel company the right to close the plants whenever it wants is the most efficient rule. Yet as an alternative approach to contracting, Relational Contract Theory suggests that just as the discrete notion of assent is no longer adequate to ground the enforcement of contracts, so too a discrete notion of efficiency is equally inadequate.

Here a bit of background, necessarily very crude, is required. The influence of economic thinking on law is a recent phenomenon, dating basically from R.H. Coase's 1960 article \textit{The Problem of Social Cost}\textsuperscript{37} and the

\textsuperscript{34} \textit{Local 1330}, 631 F.2d at 1265.
\textsuperscript{35} \textit{Id.} at 1279-80.
\textsuperscript{36} \textit{Id.} at 1269-79.
publication of the first edition of Richard Posner's influential *Economic Analysis of Law* in 1973. Posner popularized for a legal audience the Coase Theorem, which says that if transaction costs are zero, resources will "naturally" and inevitably gravitate to their most efficient allocation regardless of how property rights are initially assigned.\(^{38}\) The Coase Theorem seemed dramatic to lawyers because it said that if there are no transaction costs, then the law doesn't affect the allocative efficiency of resource use by assigning legal rights or liabilities to one party or another. Moreover, Coase seemed to show that if bargaining is costless, it will not only allocate goods but costs as well, so that parties will always come to an agreement that minimizes the costs or harm resulting from incompatible uses of property.\(^{39}\)

Economically minded lawyers tended to draw this moral: the purpose of the law is twofold. First, adopt whatever legal arrangement lowers transaction costs; it is socially desirable to keep transaction costs low, because this promotes efficient allocation through exchange. Second, in any given area, such as the law of torts, in which transaction costs prevent bargaining, resolve legal disputes by allocating rights to the party which would have bargained for them if transaction costs were zero.\(^{40}\) In other words, law should "mimic the market." All this implicitly assumes that the ideal world, though practically unobtainable, has no transaction costs.

The notion of bargaining in this classical microeconomic model is extremely discrete. Long ago Victor Goldberg convincingly argued, in work that surprisingly has not had a large impact on legal scholarship, that "[i]f transaction costs truly are zero, then only a very small subset of desirable transactions will take place."\(^{41}\) This is because the commitment that one binds oneself to when contracting is itself the establishment of transaction costs that affect one's future behavior. As Goldberg put it, "Enforceable promises, the very essence of classical contract theory, require that

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some transaction costs be positive."\textsuperscript{42} The "bargain model" relied on by Coase assumes that parties are able to allocate all relevant risks at the time of contracting.\textsuperscript{43} On the other hand transaction costs theorists "assume that uncertainty and complexity often \textit{prevent} parties from accurately allocating all relevant risks at the time of contracting."\textsuperscript{44} Transaction costs theorists thus study efficiency strategies that parties create to encourage cooperation in complex relational contracts that do not and cannot resemble the "sale with a time lag"\textsuperscript{45} of neoclassical microeconomic theory.

Yet Relational Contract Theory is an alternative even to the transaction costs approach to contracting. It embodies a different philosophical picture of human beings. Economists assume that humans are rational wealth maximizers, inherently selfish. Even in transaction costs economics, the primary, if not the sole, value is efficiency. In Oliver Williamson's work, for example, the essential problem of complex contract governance is opportunism—the subduing of an inevitable and inherent selfishness within the confines of larger (but still efficiency-oriented) governance structures.\textsuperscript{46} Macneil's analysis of contracts rests on a profoundly different conception of human nature. In Macneil's own words:

As students of man in society, we are faced with an illogicality. Man is both an entirely selfish and an entirely social creature, in that man puts the interests of his fellows ahead of his own interests \textit{at the same time} that he puts his own interests first....

\textsuperscript{42} Id. at 46-47.
\textsuperscript{44} Id.
\textsuperscript{45} Macneil, \textit{Economic Analyses of Contractual Relations}, supra note 1, at 1020.
\textsuperscript{46} "The 'transaction-cost' economics of Oliver Williamson and his school represents exactly such an assimilation of 'relational' insights to the liberal model of social relations as the products of rational individual choices: solidarity and hierarchy are explained as institutional governance forms chosen for the purpose of realizing efficiency gains." Robert W. Gordon, \textit{MacAuley, Macneil, and the Discovery of Solidarity and Power in Contract Law}, 1985 Wis. L. REV. 565, 575 n.27. Macneil has said that "the transactions costs approach is far too unrelational a starting point in analyzing relational contract." Ian R. Macneil, \textit{Relational Contract: What We Do and Do Not Know}, 1985 WISC. L. REV. 483, 495 n.45
Two principles of behavior are essential to the survival of such a creature: solidarity and reciprocity. Getting something back for something given neatly releases, or at least reduces, the tension in a creature desiring to be both selfish and social at the same time, and solidarity—a belief in being able to depend on another—permits the projection of reciprocity through time. 

Based on this picture of human nature, Macneil postulates that our interest in exchange is not captured by the idea that it increases our ability to maximize individual utility. We have as much interest in solidarity as we do in capturing for ourselves as much of the exchange surplus as we can. Our interest is in sustaining the proper combination of solidarity and reciprocity. Utility maximization is not the only human motivation that functions in exchange relations. Macneil says:

It is thus a mistake to think of “net utilitarian advantage” in its outside-of-society context involving fictional maximizers of individual utility, equally powerful or not. In the real world there are only enhancers of individual utility immersed in relations creating countless countermotives. Exchange is virtually always relational exchange, that is, exchange carried on within relations having significant impact on its goals, conduct and effect.

If contractual relations are controlled by norms other than utility maximization, what are they? Macneil suggests ten norms: (1) role integrity (behaving consistently within one’s role within a contractual relation, and managing conflicts between and within roles); (2) reciprocity (the problem of getting something back for something given); (3) implementation of planning; (4) effectuation of consent; (5) flexibility; (6) contractual solidarity (which includes the norm of preservation of the relation); (7) protection of the restitution, reliance and expectation interests; (8) creation and restraint of power; (9) propriety of means (using only appropriate means to gain any end); and (10) harmonization with the social matrix. Macneil argues that

47. Macneil, Values in Contract, supra note 1, at 348-49.
49. See Macneil, Values in Contract, supra note 1, at 347; see also MACNEIL, NEW SOCIAL CONTRACT, supra note 1, at 40; Ian R. Macneil, Relational Contract Theory as Sociology, 143 J. INSTITUTIONAL & THEORETICAL ECON. 272, 274-76 (1987). Macneil does not claim that this list is necessarily complete or exhaustive. See Macneil, Values in Contract, supra note 1, at 343 n.5.
all these norms are essential elements of contract behavior and therefore constitute the immanent values of such behavior, in the sense that if any of these norms begin to deteriorate within a contractual relation, that relation will begin to fail.\(^5\) Constantly reinforcing these norms will allow the institution of contract to remain healthy and robust and so perform its job of satisfying both the selfish and social sides of human beings.\(^6\)

Certainly Macneil did not get these “internal values”\(^5\) of contract from classical and neoclassical contract law, with their discrete and utilitarian biases. One of Macneil’s significant contributions to legal scholarship has been his reminding us of what had been, surprisingly, almost forgotten in law—namely, the inclusive nature of contractual relations. In a world of relational contracts, a dysfunctionally discrete body of contract law cannot survive for very long. One way contract law has adapted to relational contracts is through creating, on a rather ad hoc basis, doctrines and exceptions to doctrines that avoid some of the worst results of a purely discrete law. Another way has been to “spin off” areas of relational contract law into specialty areas.\(^5\)

Consider the highly relational contracting structure of labor/management relations, for example. Federal courts, interpreting the National Labor Relations Act and subsequent related statutes, have developed a body of law that is much more explicitly relational than common law contract law.\(^5\) Yet few, if any, first year contracts courses in

50. “The common contract norms are essential to any behavior we might be willing to call contractual . . . .” Id. at 346. “Contractual relations fall along a ‘success spectrum.’ Those contractual relations operating effectively will reveal the common contract norms in robust condition, while those in varying degrees of trouble will reveal the common contract norms in varying degrees of disarray . . . .” Id. at 351-52.

51. Macneil posits that extremely discrete transactions are obtained by a “great magnification of two of the common contract norms: implementation of planning and effectuation of consent.” MACNEIL, NEW SOCIAL CONTRACT, supra note 1, at 59-60.

52. Macneil, Values in Contract, supra note 1, at 345-47.


54. Macneil provides a revealing example of what occurs when a “spun off” area of relational law rubs up against traditional contract law. It is black letter contract law that, in a third party beneficiary situation, a breach by the promisor is a defense by the promisee against the third party beneficiary. If I am having my paycheck made out to my son, and then stop teaching altogether
in mid-semester, the school can stop sending the checks to my son. This familiar rule is embodied in RESTATEMENT (SECOND) OF CONTRACTS § 140 (1979).

Lewis v. Benedict Coal Corp., 361 U.S. 459, 259-62 (1960), involves just this rule. In Benedict Coal, the United Mine Workers (UMW) had entered into a collective bargaining agreement with a multi-employer bargaining association. Among other things, the agreement required Benedict Coal, a member of the association, to pay a royalty on every ton of coal produced to the Trustees of the UMW Welfare and Retirement Fund. The UMW struck Benedict Coal in violation of the agreement. Benedict Coal withheld royalties from the Trustees on coal produced during the course of this strike. After the strike ended, the Trustees sued to get the royalties on that coal.

Benedict Coal presents a classic third party beneficiary situation. The Trustees are third party beneficiaries of the UMW/Benedict Coal contract which UMW breached. It seems clear that this breach should be a defense against the Trustee's suit. Yet the Supreme Court noted that the contract was "not a typical third party beneficiary contract," and held for the Trustees. Id. at 468. The Court noted four reasons for its decision. First, the union and the industry had jointly created a fund to care not only for employees, but also their families and any retirees. Without such a joint fund, corporations generally provide these benefits independently. The Court held that "[t]he promisor's interest in the third party here goes far beyond the mere performance of its promise to that third party .... In a very real sense Benedict's interest in the soundness of the fund and its management is no way less than that of the promisee union." Id. at 468-69. Second, Benedict was not the only promisor. If Benedict failed to pay royalties, other coal companies might feel pressured to make up the short fall so as to maintain the planned benefit schedule. The Court was not willing "to assume that the other coal operators ... were willing to risk the threat of diminution of the fund in order to protect those of their number who might have become involved in local labor difficulties." Id. at 469. Third, Benedict could not claim that it could recoup losses from the UMW's strike by garnishing the wages of individual employees. Yet because pension payments are a form of deferred compensation, that is precisely what Benedict attempted. Id. at 468-69. Fourth, the Taft-Hartley Act states that suits against a union are enforceable only against the union, not its members—indicating a congressional intent that members not be made held accountable for the union's wrongs. Id. at 470. See 29 U.S.C. § 185(b) (1994).

This is a good example of a marvelously relational decision. The way in which this is not, as the Court said, a "typical third party beneficiary contract" is precisely that it is not one in which an isolated promisor, promisee and beneficiary stand in a purely discrete transaction. The Court addresses the actual complexity and "thickness" of the relation by drawing in all the other relations intermeshed with this one—that is, relations with employees, families, retirees, the other coal companies. (Justice Frankfurter dissented on the ground that the old time religion was good enough for him. "There is no reason for jettisoning principles of fairness and justice that are as relevant to the law's attitude in the enforcement of collective bargaining agreements as they are to contracts dealing with other affairs ...." Id. at 475-76 (Frankfurter, J., dissenting)).

Illustration 10 of § 140 of the RESTATEMENT (SECOND) OF CONTRACTS (Tentative Draft No. 8, 1973), is based on Benedict Coal. Illustration 10 states:

A collective bargaining agreement between A, a labor union, and many coal operators, including B, provides that each operator will pay 40
law school discuss labor relations. It is an elective taken by relatively few students. Indeed even most law professors would be shocked by the idea that family law is just a somewhat specialized course in contracts. This is partly because we think of contract law as implementing and enforcing the world of private agreements, while labor law and family law are statutorily based public law, permeated and informed by public policies imposed on these relations by the body politic acting through its representatives. Macneil's work has opened up a whole new area of legal inquiry into the existence and nature of contract norms common to the entire spectrum of contract behavior. This inquiry leads to the further question of the extent to which public law is concerned not with imposing external social standards on private arrangements, but with attempting to facilitate reciprocity, solidarity and the other contract norms within certain types of private arrangements that have completely outgrown the straitjacket of "contract law." Macneil's attempt to identify the most fundamental common contract norms is a beginning to these inquiries.

Comparing relational Contract Theory to two other

cents to C, trustee of a welfare fund for coal miners, for each ton of coal mined. In violation of the agreement A calls a strike of B's employees. B is not entitled to deduct the resulting damage from the payments due to C.

This Illustration flatly contradicts the rule of § 140, as well as the preceding Illustration 9. The Restatement gives no explanation for this discrepancy whatsoever. As Macneil notes, "apparently the vague language 'considerations of fairness or public policy' set out in the comment is the explanation for this inconsistency." Macneil, Presentation, supra note 1, at 600 (footnote omitted). See infra notes 61-63 and accompanying text (discussing notions of fairness). In the final version of the Restatement (Second) of Contracts, § 140 of Tentative Draft Number 8 appears as § 309(2). Illustration 10 remains unchanged. See Restatement (Second) of Contracts § 309(2) (1979).

55. In recent years, a number of legal scholars, largely from the standpoint of critical legal studies or other "left" perspectives, have criticized those who distinguish between "public" and "private" realms. They submit that these worlds are not mutually exclusive, that the private realm is not removed from state coercion and power. Instead, certain persons or classes of persons in the private realm assume and exercise state power against others. These scholars' main point is that the "free" private realm is permeated by public power. See Matthew H. Kramer, Critical Legal Theory and the Challenge of Feminism 243-47 (1995); see generally Symposium on the Public/Private Distinction, 130 U. Pa. L. Rev. 1289 (1982). Macneil's work likewise undermines the private/public distinction, but from a different direction. His concern is with the extent to which the public realm exists not to implement its own norms but to strengthen and implement the norms of private relations.
common ways of thinking about contracts—that of law and economics as well as traditional liberalism of the Rawls/Dworkin variety—further clarifies the alternative it presents to familiar notions of contracting. Richard Posner, Andrew Rosenfield and Charles Fried have written on the perennial problem in contract law of when to excuse a contractual obligation on grounds that the duty has become too onerous due to the occurrence of an event for which the parties' agreement did not plan. The law deals with this question through the doctrines of impossibility, impracticability, frustration of purpose and mistake. Both economists Posner and Rosenfield and liberal theorist Fried agree on the basic approach to this issue: a court confronted with this problem is confronted with a problem of allocating to one of the parties a risk that the parties did not at the time of agreement allocate themselves. They maintain that courts should do this by asking what the parties would have done at the time of agreement had they allocated the risk. At this point, their respective analyses diverge radically.

Posner and Rosenfield believe that courts should place the risk of loss on the cheaper risk bearer while Fried believes that parties should share the losses caused by unallocated risk. Their analyses diverge because determining how reasonable parties would have allocated risk necessarily involves assumptions about human nature and motivation. Posner and Rosenfield assume that humans are purely self-interested:

If the purpose of the law of contracts is to effectuate the desires of the contracting parties, then the proper criterion for evaluating the rules of contract law is surely that of economic efficiency. Since the object of most voluntary exchanges is to increase value or efficiency, contracting parties may be assumed to desire a set of


57. Posner and Rosenfield preface their discussion by noting: “A second purpose [of contract law], central to our subject, is to reduce the costs of contract negotiation by supplying contract terms that the parties would probably have adopted explicitly had they negotiated over them.” Posner & Rosenfield, supra note 56, at 88. Fried maintains that, “Since actual intent is (by hypothesis) missing, a court respects the autonomy of the parties so far as possible by construing an allocation of burdens and benefits that reasonable persons would have made in this kind of arrangement.” Fried, supra note 56, at 73.

58. See Posner & Rosenfield, supra note 56, at 90; Fried, supra note 56, at 71.
contract terms that will maximize the value of the exchange.\textsuperscript{59}

Fried, on the other hand, says that to ask what the parties would have done is "an inquiry with unavoidably normative elements: 'reasonable' parties do not merely seek to accomplish rational objectives; they do so constrained by norms of fairness and honesty."\textsuperscript{60} In Macneil's work, neither pure self-interest nor abstract moral considerations like fairness generally govern the contracting parties' behavior. Instead, something in between—more particularized norms generated by the contractual relation itself and related to the relation in a functional way—govern contracting behavior.\textsuperscript{61} This is not to say that considerations of fairness are not a component of the contract norms. The norms of reciprocity and propriety of means, just to take two, obviously invoke fairness concerns. But abstract fairness here takes its concrete sense from within the relation itself. It is one element among others and, because norms sometimes conflict, it may be subordinated to others (as may the norm of effectuating consent).\textsuperscript{62} Recognizing the multiplicity and complex

\textsuperscript{59} Posner & Rosenfield, supra note 56, at 89.
\textsuperscript{60} Fried, supra note 56, at 73.
\textsuperscript{61} Concerning this "mid-level" aspect of exchange relations, Macneil has said:
The level of values I have been discussing—values of contract behavior and of internal principles and rules—is an extremely important one. It is also one too often partially or entirely overlooked in contract scholarship, which tends to focus either on the next level—the response, especially the legal response, of external society to contract—or on only the discrete transactional aspects of this level. The importance stems from the fact that this is the real operating level—the real life level of exchange relations. Consequently, this is the level at which implementation of values undoubtedly has by far the greatest impact upon the lives of the participants and everyone affected by their activities.


\textsuperscript{62} Macneil argues that notions of fairness "are far too narrow to encompass such basic relational norms as role integrity, reciprocity, contractual solidarity, balancing power in acceptable ways, propriety of means (doing things the right way), and harmonizing the relations with the external social matrix in which they occur." Ian R. Macneil, \textit{Relational Contract: What We Do and Do Not Know}, supra note 46, at 503. Recall Macneil's comment that only a vague reference to "fairness and public policy" allows one to explain the conflict between \textit{Restatement (Second) of Contracts} § 309(2) (1979) and its Illustration 10, based on the \textit{Benedict Coal} decision. Such vague references do little to help one understand the \textit{Benedict Coal} holding, or to apply its reasoning to other cases involving relational contracts generally. \textit{See generally supra note
interaction of contract norms, Macneil calls for a "rich classificatory apparatus" to analyze contracts—as opposed specifically to the economic emphasis on efficiency and impliedly to the liberal emphasis on "fairness." Note that "effectuation of consent" (which under classical contract theory might be the only recognized contract norm) and "implementation of planning" are only two out of ten contract norms. It appears that some authority outside the parties to the contract imposes the other eight norms—by definition norms not related to consent. Here, again, Relational Contract Theory challenges our received way of thinking about contractual obligation. Macneil tries to bridge the traditional dichotomy by means of the notion of "consent to a relation":

Liberal society has always recognized numerous legitimate relations into which entry is by consent, but the content of which is largely unknown at the time the consent was given. This is the idea of joining a relation. We can join a law firm or a university faculty...; we can join the army; we can join a corporation by buying its shares; we can join in holy matrimony. In each instance we can do so in spite of large-scale ignorance about the restraints we are accepting. In spite of our ignorance liberal society will bind us to those unknown restraints.

54. See Macneil, Economic Analysis of Contractual Relations, supra note 1, at 1062-63.

63. See Macneil, Bureaucracy and Contracts of Adhesion, 22 OSGOOD HALL L.J. 5, 20-21 (1984). The examples Macneil gives in this passage are somewhat misleading because they all involve "sharp" moments of establishing the relation (taking the oath of enlistment, participating in a wedding ceremony, buying shares of stock). Many relations evolve slowly over time. A one-shot purchase of goods may over months or years lead to an elaborate commercial relation between a buyer and a seller, a relation which may or may not be embodied in formal contractual terms. This aspect of Macneil's thought is the target of Randy Barnett's critique of Macneil's work. See Randy E. Barnett, Conflicting Visions: A Critique of Ian Macneil's Relational Theory of Contract, 78 VA. L. REV. 1175 (1992). Barnett's main point is that by cutting out of contract theory the discrete notion of consent embodied in the doctrine of agreement, Macneil has made it too difficult to tell when one has entered into a relationship that has legal consequences—that is, to which the contract law will be applied.

The liberal conception of the rule of law is based on the notion that persons need access to knowledge of when they will be subjected to legal sanctions and when they will not... It does persons who would contemplate engaging in Macneilian contractual exchanges little good to be told that maybe legal sanctions will be used to "reinforce" your
To put it another way, consent to a relation entails consent to being bound by the norms of the relation, even if those norms ultimately turn out to conflict with elements of the initial consent. But does this mean that these norms are imposed non-consensually? Clearly, the authority of these norms fits neatly into neither of the two liberal sources of authority for binding rules: consent of the parties and promulgation by the consensually selected representatives of the citizenry. The seeming paradox of Relational Contract Theory is in its assertion that one can have consented to the application of norms that may override the terms of one's explicit consent.

Macneil's treatment of liquidated damages and penalty relationship, but maybe not. Ask us again after you exchange.

Id. at 1191 (footnote omitted). Yet given Stewart Macauley's research into the role legal rules and sanctions actually play in commercial practice, it is not clear just how tremendously important it is that persons have access to this knowledge. That they do need it may be a position itself based on and assuming a discrete view of contracts and of human action, and so cannot be used to defend that view. (Recall Macneil's praise of the acknowledged "imprecision and flexibility" inherent in Restatement (Second) Contracts § 241 (1979), on materiality of breach. See generally supra note 26.) As Macneil says, it is a characteristic of discrete contract law that "as much as possible of the content of the relation... is forced into a pattern of material assent expressed at some instantaneous point of time," and any content "which cannot sensibly be rationalized into a pattern of instantaneous material assent, will be supplied eo instante by the legal system in a form as precisely predictable as possible." Macneil, Presentation, supra note 1, at 593-94. A second answer is that given by Robert Gordon:

I am always a bit taken aback to hear lawyers argue, as they sometimes do, that for all its faults the old formal-classical system of rules had the virtues of predictability and administrative convenience; its results might be sometimes arbitrary or unjust but at least one knew where one stood. I should have thought if there was one proof the Realists critics had managed to nail down for good it was that of the manipulability and contextual variability of the old rule-system. If the rules are stable and predictable in particular practice settings—as of course they usually are, at least in the short-to-medium term—that stability derives from well-accepted conventions within the community of regular interpreters of the rule.

Gordon, supra note 46, at 566 n.1.

65. Macneil notes that in the political theory of the liberal state, only two justifications exist for applying rules to anyone, both grounded on consent. One is individual or contractual consent, whereby individual manifestation of a willingness to be bound in relatively specific ways constitutes submissions to rules (sometimes hereafter called "liberal contract"). The other is collective consent, whereby democratic state processes yield the application of rules by the sovereign. See Macneil, Bureaucracy and Contracts of Adhesion, supra note 64, at 5.
clauses illustrates how this aspect of the theory works. A basic rule of contract law is that the parties to a contract may provide by agreement what the damages will be in the event of a breach of the contract. However, the doctrine of the penalty clause limits this ability. A penalty clause is a provision that provides for liquidated damages, but in an amount unreasonably large in relation to the actual damages caused by the breach. Such provisions will not be enforced. The doctrine of penalty clauses has always been a bit of a problem in contract law, since it is unclear why a voluntary agreement as to damages should not be enforced. For Richard Posner, in particular, the refusal to enforce provisions denominated as penalties is an anomaly in the otherwise efficient common law of contracts.

Macneil argues that the legal hostility to penalty clauses is explained by the fact that consent can conflict with, and be overridden by, another contract norm—that of limiting unilateral power in contractual relations. What does Macneil gain by referring to a norm of limiting unilateral power instead of to Fried-like notions of fairness? First, it establishes connections between things that might otherwise just seem to be disparate elements of contract law—for example penalty clauses, the limited nature of contract remedies in general, unconscionability and good faith, and Title VII of the Civil Rights Act of 1964.

67. See, e.g., MARVIN A. CHIRELSTEIN, CONCEPTS AND CASE ANALYSIS IN THE LAW OF CONTRACTS 173-77 (2d ed. 1993) (“There may be instances in which liquidated damage provisions are so extreme as to shock one’s conscience, but by and large such instances are likely to involve individual consumers . . . and are probably best dealt with through an application of the unconscionability doctrine.”)
68. See POSNER, supra note 38, at 115-17; Richard A. Posner, Some Uses and Abuses of Economics in Law, 46 U. CHI. L. REV. 281, 290 (1979). See also Lake River Corp. v. Carborundum Co., 769 F.2d 1284 (7th Cir. 1985), in which now Judge Posner writes an opinion severely criticizing the penalty clause doctrine, then strikes one down in obedience to controlling Illinois law.
69. See Macneil, Economic Analysis of Contractual Relations, supra note 1, at 1054-62.
70. See id. at 1059; MACNEIL, NEW SOCIAL CONTRACT, supra note 1, at 56-57.
71. See Macneil, Economic Analysis of Contractual Relations, supra note 1, at 1060.
72. See Macneil, Values in Contract, supra note 1, at 376 (“[E]mployment law provides a good example of sovereign imposition of the power norm.”). Macneil has put forth the hypothesis that “American legal rules . . . tend toward limiting (as well as creating) unilateral power in contractual relations of all
Second, it inquires into the ways in which this norm is not just an application of a generalized moral principle of fairness applied to the contract from outside, but is functionally related to sustaining healthy contractual relations which satisfy the often contradictory needs of human beings.  

Finally we must consider whether application of the norm of restraint of unilateral power is consensual or non-consensual. Relational Contract Theory teaches that when committing to a relation, we cannot specify all the obligations and responsibilities that relation will entail. But it also suggests that we do commit ourselves to the norms necessary to maintain the health of that relation. The theory then challenges us to develop a more expansive non-discrete notion of commitment and consent.

III. PHILOSOPHY

Ultimately Macneil's departure from utilitarianism may not be radical enough. Macneil recognizes that humans are both selfish and social but still conceives of their selfish side in utilitarian terms—as the acquisition of something from an exchange. In other words, the pay-off of the exchange is

kinds" and he has argued that his hypothesis is just as empirically testable, and just as true, as Posner's hypothesis that common law rules tend to promote economic efficiency. See Macneil, Economic Analysis of Contractual Relations, supra note 1, at 1056-62. For a statement of Posner's position, see Richard A. Posner, Some Uses and Abuses of Economics in Law, 46 U. Chi. L. Rev. 281 (1979).

73. Macneil's emphasis on the functional relation between the contract norms and flourishing contractual relations has led his theory to be criticized as inherently conservative in an ideological sense. The crux of the criticism is that Macneil views the role of law as one restoring the "harmony" of society in the face of conflict, which is always seen as a bad thing. "The state as an instrument of class domination and control, or as a bureaucratic organization resting on legitimated domination are theories pushed to one side." Ken Foster, Book Review, 9 J.L. & Soc'y 144, 147 (1982) (reviewing IAN R. MACNEIL, THE NEW SOCIAL CONTRACT). Macneil does point out that relational contract theory is not incompatible with a high degree of conflict, and he does not view conflict as always dysfunctional. See Macneil, Values in Contract, supra note 1, at 352-53. For a more sympathetic view of Macneil's work from a politically left perspective, see generally Gordon, supra note 46.

74. This does not mean that contractual relations should never end. Of course they can and do. But it means that this termination—its timing, its motivation, its manner, its processes—must itself be in accord with the contract norms, just as was the life of the relation.

75. This is to say, Macneil tends to conceive of exchange as purely "the
separate from the exchange itself. Indeed, contracts scholars largely think of contracts as beneficial in so far as, and because, one gets something from them. Aristotle, however, long ago distinguished between actions performed for the sake of a product (which Aristotle called "productive") and actions performed for the value of the action itself.

Consider a person catching a fish. For the commercial fisherman, his work is a means to an end—a haul of fish—without which his labor is lost. If the fisherman were to inherit a fortune, he would no longer fish for a living. Compare him to the sport fisher who may go through many of the same motions as the commercial fisher. Aristotle would say the sport fisher achieves his purpose "in action" rather than in its outcome. His day is not spoiled if the big one gets away. It is true that catching fish is his object—giving to his activity intensity, focus and seriousness it would otherwise lack. But he may, for example, go after trout with a light rod because they are harder and more fun to catch that way. Intentionally making it hard would be irrational for the commercial fisher, but it is perfectly understandable if the amateur does not only this but also gives his entire catch to his neighbor. It was not the fish he wanted, but the activity of catching them.

Note that in the difference between the two fisherman, means and ends change places. For the commercial fisher, fishing is the means toward which the fish are the end; for the sport fisher, they are reversed. Aristotle taught that the only thing that is truly good in itself is activity performed for its own sake; productive actions have only derivative value. Crudely put, making tennis rackets is of no value if giving up of something in return for receiving something else." Macneil, Exchange Revisited, supra note 1, at 567.

77. This discussion is deeply indebted to Warner A. Wick, The Rat and the Squirrel, 82 ETHICS 21 (1971).
78. For aristotle practical intellect means reason in the service of the human desire for the good.

[Practical intellect] rules the productive intellect [reason in the service of making of things such as technology] as well, since every one who makes for an end, and that which is made is not an end in the unqualified sense . . . . - only that which is done is that; for good action is an end, and desire aims at this.

See ARISTOTLE, supra note 76, at ¶ 1139b1-4, 1098b9-1099b8.
at least some people do not simply enjoy playing tennis. The Greeks customarily regarded most productive activities as servile, because nobody would do them for their own sakes but would assign them to a slave if possible. Free persons concerned themselves with activities that were called “free” because they were subservient to nothing outside them. This is quite different from our modern way of thinking, which tends to regard all serious activity as productive, while non-productive activity is recreation, leisure or consumption.

The discrete/relational distinction forms a striking continuum from contracts done for the sake of a product on one end to those done for the sake of the activity of maintaining the contractual relation on the other end. The point of a discrete sale of goods is, of course, to possess the goods or money that one gets from the exchange. But towards the relational end of the continuum, possession of any exchange surplus begins to share equal time with the satisfaction gained from the activity of the relation itself. At the far end of the relational continuum is the family, which some theorists describe simply as an institution for exchanging the products of labor specialization. Yet certainly the decision to enter into family relations is motivated by more than just a desire for low cost products. Indeed in discrete transactions, contracting takes place for the sake of the exchange, while in relational contracts the exchange is for the sake of the contractual relation itself.

How does the distinction between productive activities and activities chosen for their own sake help clarify issues of contract law? In Foley v. Interactive Data Corp., the defendant had fired the plaintiff who sued for breach of an implied contract not to terminate his employment except for good cause, similar to the discussion above in See's Candies. He also sued for the tort of breach of the covenant of good faith and fair dealing. This tort cause of

80. See POSNER, supra note 38, at 127-29.
81. Posner tries to account for this aspect of marriage by saying that marriage includes elements of altruism, which he describes as “a cheap and efficacious substitute for (formal) contracting.” Id. at 129.
82. 765 P.2d 373 (Cal. 1988).
83. See supra note 29 and accompanying text.
84. Foley, 765 P.2d at 374.
action originated in a line of insurance cases.\textsuperscript{85} If an insurance company wrongfully denies a valid claim under a policy, that is a breach of the insurance contract. But if an insurance company wrongfully denies a claim with full knowledge that it is a good claim, courts hold this to be not only a simple breach of contract but also a punishable tort. This, of course, gives the insured the possibility of greatly enhanced damages, including punitive damages.

Courts created this insurers' tort partly because they felt that when an insured suffers a loss, a conflict of interest arises between the insured and insurer which is not present in other types of contracts.\textsuperscript{86} The result is that the insurer has an incentive to breach that only the larger threat of tort damages will deter. Additionally, courts felt there is a "special relationship" between insurer and insured that takes such contracts out of the category of purely "commercial contracts." That is, the purpose of the insured in entering the contract is not to secure profit or advantage, but security or peace of mind.\textsuperscript{87}

Should courts extend the tort of bad faith breach of from the insurance context to the employment context? Put another way, should the employee's interest in his job be reducible to the pure economic benefits he gets from it? That was the question the California Supreme Court faced. In a 4-3 decision, the Foley court held the extension was not warranted. Contrast the relevant language from the majority and vigorous dissenting opinions. The majority opinion maintained:

[A] breach in the employment context does not place the employee in the same economic dilemma that an insured faces when an insurer in bad faith refuses to pay a claim . . . . [T]he insured cannot turn to the marketplace to find another insurance company willing to pay for the loss already incurred. The wrongfully


\textsuperscript{87} See Foley, 765 P.2d at 390.
terminated employee... can and must... make reasonable efforts to seek alternative employment. Moreover, the role of the employer differs from that of the "quasi-public" insurance company with whom individuals contract specifically in order to obtain protection from potential... economic harm. The employer does not similarly "sell" protection to its employees; it is not providing a public service. Nor do we find convincing the idea that the employee is necessarily seeking a different kind of financial security than those entering a typical commercial contract. If a small dealer contracts for goods from a large supplier and those goods are vital to the small dealer's business, a breach by the supplier may have financial significance for individuals employed by the dealer or to the dealer himself. Permitting only contract damages in such a situation has ramifications no different from a similar limitation in the direct employer-employee relationship.

Justices Broussard stated in dissent: "A man or a woman does not enter into employment solely for the money; a job is status, reputation, a way of defining one's self-worth and worth in the community.... In short, 'in a modern industrialized economy employment is central to one's existence and dignity.'" Justice Kaufman argued in his dissenting opinion:

It is, at best, naive to believe that the availability of the "marketplace," or that a supposed "alignment of interests," renders the employment relationship less special or less subject to abuse than the relationship between insurer and insured. Indeed, I can think of no relationship in which one party, the employee, places more reliance upon the other, is more dependent upon the other, or is more vulnerable to abuse by the other, than the relationship between employer and employee. And, ironically, the relative imbalance of economic power between employer and employee tends to increase rather than diminish the longer that relationship continues. Whatever bargaining strength and marketability the employee may have at the moment of hiring, diminishes rapidly thereafter. Marketplace? What market is there for the factory worker laid off after 25 years of labor in the same plant, or for the middle-aged executive fired after 25 years with the same firm? Financial security? Can anyone seriously dispute that employment is generally sought, at least in part, for financial security and all that implies: food on the table, shelter, clothing, medical care, education for one's children.... Peace of mind? One's work obviously involves more than just earning a living. It defines for

88. Id. at 396 (citations omitted).
89. Id. at 407-08 (Broussard, J., dissenting) (citations omitted).
RELATIONAL CONTRACT THEORY

many people their identity, their sense of self-worth, their sense of belonging. The wrongful and malicious destruction of one's employment is far more certain to result in serious emotional distress than any wrongful denial of an insurance claim.\textsuperscript{90}

It might help to think about the opposition between the majority and dissenting opinions in this way: the majority regards employment as a relation that only has value in the separable economic "products" that the employee gets out of it, while the dissenters think about employment as a relation that has an inherent, non-commercial value for the employee. The dissenters suggest that employees find value in the activity of the job itself, thus making the relation seem, at least partly, more like the non-commercial insurance contract.

If Relational Contract Theory is to have an impact in the world of actual legal decision-making rather than just in legal academia, it will be in helping the legal profession to think about how cases like the Youngstown steel workers and Mr. Foley should come out, freed from the hypnotic sway of the discrete transaction. In developing Relational Contract Theory, one of the most important things lawyers and law professors can do, ill-suited perhaps as they are to do it, is to return to philosophical questions of the motivation of human action, its natural ends and goals and its distinctive virtue and characteristic excellence,\textsuperscript{91} as the Greeks would have said. Without this understanding, we

\textsuperscript{90} Id. at 414-15 (Kaufman, J., dissenting).
\textsuperscript{91} It has become increasingly common today to deny that this is even doable because humans have no distinctive virtues. This large philosophical issue is beyond the scope of this Essay, but for an argument that the task suggested here is both possible and necessary, see Martha C. Nussbaum, \textit{Human Functioning and Social Justice}, 20 POLITICAL THEORY 202 (1992); Martha Nussbaum, \textit{Non-Relative Virtues: An Aristotelian Approach}, in \textit{THE QUALITY OF LIFE} 242, 242-69 (Martha Nussbaum & Amartya Sen eds., 1993). Indeed Macneil has said that "the basis in nature of relational contract theory... suggests a value in seeking further knowledge about the fundamental nature or natures of man." Macneil, \textit{Values in Contract, supra} note 1, at 412. Macneil seems to think that this idea leads to "social, psychological, and biological investigation of various kinds." \textit{Id.} Another large question, again beyond the scope of this Essay, is the extent to which inquiries into the nature of man—based on the techniques of modern science or social science—contribute to a complete understanding of human nature, and to what extent they encourage us to lose sight of that nature. For a provocative discussion, see \textit{ALLAN BLOOM, THE CLOSING OF THE AMERICAN MIND} 173-79, 356-80 (1987).
cannot construct theoretical models that will adequately reflect humans' interests and commitments in contracting behavior.\textsuperscript{92}

**CONCLUSION**

I want to close on a cautionary note. Since Relational Contract Theory resides within the discipline of law, there is a real question as to the extent that law as an institution can promote the norms of relational contracts. Let me start again with a few examples.

Section 2-607 of the Uniform Commercial Code, dealing with sales of goods, provides that a buyer of goods cannot sue for breach in any case in which the buyer has accepted the goods unless the buyer has provided notice of breach. This provision has a perfectly good relational purpose. When the buyer accepts goods, the seller is likely to think that the transaction is satisfactory to the buyer. \textsuperscript{79}U.C.C. § 2-607 prevents the buyer from surprising the seller with a law suit. It gives the seller and the buyer a chance to work out the buyer's dissatisfaction informally. It opens the way for settlement and negotiation, and it eliminates the harsh, and discrete, common law rule that acceptance of goods by a buyer waived all legal remedies.

But what constitutes adequate "notice of breach?" In *Eastern Air Lines v. McDonnell Douglas Corp.*,\textsuperscript{93} the U.S. Court of Appeals held that it was insufficient for the buyer

\textsuperscript{92} Another area of Macneil's work that shades into major philosophical issues is in asking why has the legal community exhibited such a distorting bias in favor of discreteness. Macneil has suggested that the bias stems from a commitment to rationality for the sake of rationality. "Man has an immense desire for order and consistency," and, more, for control over a shifting and uncertain existence. Macneil, *Values in Contract*, supra note 1, at 393-94. Even more, "the very nature of reason has been transformed in bureaucratic structures, with wisdom stripped out, leaving nothing but 'functionality or calculability.' " Ian R. Macneil, *Bureaucracy, Liberalism and Community—American Style*, 79 NW. U.L. REV. 900, 902 (1984) [hereinafter Macneil, *Bureaucracy, Liberalism and Community*]. Macneil even suggests that human reason is now engaged in the attempt "to liberate itself from all else that makes us human." \textit{Id.} at 901. Here Macneil joins hands with the work of Stanley Cavell. Cavell maintains that human obsession with reason and with knowledge, with knowing the world as our primary access to it, is an attempt to escape the conditions of human existence and thus threatens loss of what Kant calls our human finitude. \textit{See generally} Stanley Cavell, *The Claim of Reason* (1979).

\textsuperscript{93} 532 F.2d 957 (5th Cir. 1976).
just to express some kind of dissatisfaction with the goods or the transaction—that was inadequate to keep the seller from being later surprised by a lawsuit. Rather, the court said that the notice must “inform the seller that the transaction is claimed to involve a breach.”94 This comes close to saying that the seller must threaten a lawsuit in order to maintain its ability to file one. This legal rule seems contrary to the goal of smoothing contractual relations and encouraging amicable resolution of disputes. Professor Stewart Macaulay, whose groundbreaking research into contract behavior is also one of the wellsprings of Relational Contract Theory, found that business persons not only rarely assert legal rights, but understand such assertions as an expression of distrust.95

Another brief example is the trend in employment law today to recognize employee handbooks and personnel manuals as contractually binding on employers. But once courts recognized that these handbooks create contractual obligations, they had to recognize that employers could contractually avoid these obligations, for example by adding prominent disclaimers. Because courts strictly construe these disclaimers, they must be prominent and explicit. Here is an example of a handbook disclaimer a Michigan appellate court approved and enforced:

The contents of this handbook are presented as a matter of information only. While [Employer] believes wholeheartedly in the plans, policies and procedures described here, they are not conditions of employment. [Employer] reserves the right to modify, revoke, suspend, terminate or change any or all such plans, policies or procedures, in whole or in part, at any time, with or without notice. The language used in this handbook is not intended to create, nor is it to be construed to constitute, a contract between [Employer] and any one or all of its employees.96

This language was italicized and outlined in red in the handbook. When I practiced employment law, one of my

94. Id. at 976.
jobs was to see that every one of our clients' handbooks contained such a disclaimer. Employers resisted including the disclaimers because the language seemed to undermine the handbook's partial goal of improving employer/employee relations. To many clients a handbook with such a prominent disclaimer seemed worse than no handbook at all. Yet given the expense of even unsuccessful litigation, employers are almost forced to incorporate these disclaimers.

One can argue that justice demands judicial recognition of handbooks as contracts, that it appears unfair to allow employers to ignore their own enunciated norms and that employees deserve protection from such arbitrary employer abuse of power. But it is a real question as to which regime was better for employees: one in which there was no legal enforcement of handbooks and there were occasional abuses, or one in which the law enforces handbooks as contracts. The issue here is not which regime was fairer, but rather which regime was more conducive to flourishing contractual relations with high levels of solidarity and reciprocity. (Naturally, fairness, as captured in norms like restraint of unilateral power and propriety of means, is subsumed in this analysis.) Of course there would be no problem if it were costless to treat employee handbooks as conferring contractual rights. Then employees would have both a belt and suspenders; the immanent norms of contractual relations would protect most employees from abuse while the enforcement of handbook statements as contracts would rein in those employers who engaged in abusive, arbitrary behavior. But what if the enforcement of legal rights tended to undermine contractual norms, as if wearing suspenders caused one's belt to atrophy?

One thing Relational Contract Theory has taught us is that the threat of legal sanction is not a very effective tool to fight abuse of power and opportunism in contracts.  

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97. This does not mean, of course, that law is wholly useless or could be dispensed with. Macneil says the institution of law has several functions. It is an institution generally providing social solidarity. It also functions as "a back-up system seldom used actively, but always used passively." MACNEIL, NEW SOCIAL CONTRACT, supra note 1, at 94. Finally, it functions "as a relatively precise expression—an index if you will—of the great underlying and diffuse sea of custom and social practices in which human affairs are conducted. This function of law is to tell society what is most important among its customs and practices." Id. at 93-94.
Stewart Macaulay’s pioneering research showed (and in the 1960s shocked contracts professors) that business persons ranked legal sanctions extremely low on the scale of reasons for keeping contracts. It is not, as Richard Epstein has argued, that there is a competitive market for labor where employees can vote with their feet and the forces of competition do not simply weed abusive employers out of the market. Rather, in highly relational contracts there are myriad motivations at work beyond gain maximization. Relational Contract Theory accounts for behavioral norms that are not reducible to efficiency. This does not mean that something like McDonnell-Douglas is a bad decision. It may be about as good an interpretation of UCC § 2-607 as can be given. But as Macneil has said:

Lawyers often forget that imposed procedural regularity is needed and useful only when good faith and trust decline below certain levels. They forget that it in turn breeds distrust.... The rise of procedural regularity respecting student-university relations is often hailed as a great step toward equality and justice. It can just as well be viewed as the result of a vast decline in trust and perceptions about an absence of good faith. So viewed it is a huge step backward.

98. See generally Macaulay, Non-Contractual Relations in Business, supra note 95.
101. See supra note 93 and accompanying text.
102. MACNEIL, NEW SOCIAL CONTRACT, supra note 1, at 68. This very issue was recently raised by political columnist E.J. Dionne, Jr., in the context of the U.S. Air Force’s move to court martial Lt. Kelly Flinn for adultery, under vague regulations forbidding conduct harmful to military “good order and discipline.” The threatened court martial set off a public controversy over the extent to which the military should enforce codes of appropriate sexual behavior. Dionne wrote:

Defense Secretary William Cohen has set up panels to study these issues. The unpleasant fact they face is this: What’s required are not fewer rules, but more rules, more explicitly stated. You can do with a short rule book and a lot of flexibility when there’s consensus and people basically trust the system. Right now, there is no consensus and limited trust.
When the legal system applies from without the same norm as is internally generated in a relationship, imposing the norm from the outside transforms the norm and gives it different practical consequences. A duty of good faith bargaining imposed on unions and employers by the National Labor Relations Act is profoundly different than actual good faith bargaining between the two.

Lawyers have been slow to realize not only just how limited law is as a tool of social engineering, but also how complex are its effects. This is in large part because they have narrow, discrete views of social norms. Law is rights-oriented and adjudicative, is backward looking rather than forward looking and tends to focus on the narrow dispute before it as opposed to considering the effect of its decision on the future of the parties. Professor Gideon Gottlieb

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104. See Macneil, Values in Contract, supra note 1, at 369-82 (discussing generally the effect of sovereign imposition of contract norms).
105. Indeed in Foley v. Interactive Data Corp., 765 P.2d 373 (1988), the only practical difference between the majority and dissenting views was the amount of money Mr. Foley was to receive.
points out that adjudication is to a contractual relation as radical surgery is to a patient,\textsuperscript{106} although an autopsy may be a better metaphor. Legal training is partly to blame. Law schools, especially in the first year, generally use the case method where students read almost nothing but appellate decisions in which parties sitting in the ruins of dead relations fight over the allocation of spoils and losses. A dawning realization of the limitedness of legal techniques has led to the current growing legal interest in alternative dispute resolution, mediation and counseling, and the awareness that such modes of dispute resolution are concerned with articulating and extending the norms of a relationship, not just with giving structure and order to a clash of power. The major inquiry remaining for relational contract theorists, then, concerns how to make law a more effective instrument for reinforcing contract norms, given our new understanding of the complexity and multi-dimensionality of those norms.
