

Research Note: Economic Welfare Implications of Plurality in English Contract Law

Man-ching Fung
University College London

— *Review of* —
**Integrative
Business &
Economics**
— *Research* —

ABSTRACT

This study argues that the plurality-induced tension causes ambiguity and complexity in contract law, which indeed enables the law to better meet people's needs because diversity is businesses' true nature. Court judgements therefore should bring contract law consistent with commercial reality, despite doing so necessitates a compromise between conflicting values and undermine the certainty, predictability, and coherence of contract law. This study devises a theoretical model to illustrate the economic welfare implication of a possible plurality-certainty trade-off and evaluates whether the theoretical implication is consistent with court decisions in practice through legal case analysis. To conclude, court decisions appear to attain a balance between plurality and certainty that enables the law to better serve the needs of individuals who use it at the expense of the law's coherence.

Keywords: Economic Welfare; Plurality; English Contract Law.

Received 15 August 2023 | Revised 19 September 2023 | Accepted 24 September 2023.

1. INTRODUCTION

Judicial precedent under common law dictates the current principles of contract law; judges therefore often play the role of law maker to formulate legal principles that serve peoples' needs in conducting economic and business activities. In other words, to facilitate business transactions and ensure that the free market is well-functioning, court judgments on contract law cases are frequently based on principles including fairness, predictability, and economic efficiency that tend to favour investment and business activities. However, these principles may not correspond with one another. Embracing the plurality of norms and values in contract law for justice and fairness inevitably makes the law ambiguous and complex because of the diverse, or even conflicting, norms and values held by contracting parties within a culturally diverse business community; and such ambiguity and complexity are in conflict with the policy considerations of certainty, predictability, and economic efficiency. This study argues that the plurality-induced tension causes ambiguity and complexity in contract law, which indeed enables the law to better meet people's needs because diversity is businesses' true nature. Court judgements therefore should bring contract law consistent with commercial reality,

despite doing so necessitates a compromise between conflicting values and undermine the certainty, predictability, and coherence of contract law.

The rest of this article is organised as follows. Section 2 elaborates policy considerations in contract law and argues that freedom of contract as an institutional arrangement mediates the free market to reduce uncertainty and achieve economic efficiency. Section 3 proposes a possible trade-off between certainty and plurality of values, and further argues that court judgements should observe this trade-off. Section 4 concludes this article.

2. POLICY CONSIDERATIONS IN CONTRACT LAW - FREEDOM OF CONTRACT, CERTAINTY, AND ECONOMIC EFFICIENCY

2.1 Freedom of contract and economic welfare

An important policy consideration in contract law is freedom of contract that is linked to free markets and economic welfare.¹ Freedom of contract as an institutional arrangement is arguably a “major instrument of economic efficiency” because such liberty without public authority intervention potentially maximises economic welfare through voluntary trade and exchanges that are mediated by intentional and expressive business contracts.² Freedom of contract, and by extension free trade and exchanges, implies that the society’s productive resources are allocated by the free market mechanism, which in theory achieves allocative efficiency and maximises the “social surplus”.³ In other words, freedom of contract as an institutional arrangement mediates a well functioning free market to achieve allocative efficiency.

2.2 Certainty and economic efficiency

Another policy consideration pertinent to economic efficiency is policy certainty which affects the transaction costs of voluntary trade and exchanges (under freedom of contract). Policy certainty is a crucial element of a society's institutional arrangements due to the “public interest in efficient and competitive functioning of the market economy.”⁴ In general, uncertainty in the outcomes of business transactions increases the costs of conducting voluntary trade and exchanges because businesses incur extra costs (i.e., transaction costs) in insuring themselves against such uncertainty (so as to reduce the risks of exchanges and litigation). Excessive transaction costs may cause the free market to fail in achieving allocative efficiency.⁵ In the context of this article, transaction costs are lower if the law governing business transactions is written clearly and its interpretation is predictable. For instance, businesses incur lower transaction costs in terms of securing

¹ PS Atiyah (1995), 5

² PS Atiyah (1995), 2

³ Frank (2017) 175, 207.

⁴ Tan (2021) 547

⁵ Coase (1960) 1, 44

the legal validity of their business contracts to avoid potential disputes if statutes, rules, and regulations governing those contracts are clear, unambiguous, coherent, and predictable. The more unclear and ambiguous the law is, the higher the need for *ex-ante* in-depth legal due diligence (i.e., full scrutiny of the contract's legal risks) and the larger the *ex-ante* provision for possible litigation as a result of dispute, which increases the transaction costs and reduces the economic efficiency of the free market mechanism. Therefore, certainty of the law promotes economic efficiency by lowering the risks of business dispute and litigation, which stimulates market transactions and investment. In other words, freedom of contract is more effective in mediating the market mechanism to achieve allocative efficiency if the law is clear, unambiguous, and predictable.

3. THE CERTAINTY-PLURALITY TRADE-OFF

3.1 Role of Market Mechanism

As the previous section argues, certainty in the law is a cornerstone for the free-market mechanism to promote investment and achieve economic efficiency. However, the business community as a part of human society, by its nature, has diverse norms and values defining a diverse set of commonly acceptable business practices and commercial common sense within a particular context characterised by a specific societal setting. This echoes pluralist theories in acknowledging plurality of values that may or may not be correspondent with one another within a “contractual context”.⁶ As Saprai suggested, for instance, the tension between conventional morality (socially acceptable) and critical (unconventional) morality can be contextually addressed.⁷ Therefore, judges frequently have to weigh conflicting values on a ranking scale to formulate legal principles that meet peoples' needs in conducting business and economic activities. However, incorporating such plurality of values into the law inevitably increases the complexity, ambiguity, and unpredictability of the law governing business transactions. Following the same line of argument from the previous section, a fall in the predictability and coherence of the law makes freedom of contract less effective in mediating the free market to achieve economic efficiency. To facilitate the functioning of the market mechanism on the one hand and to meet the needs of the business community with diverse values on the other, court judgements should observe the trade-off between the economic benefits of certainty and the necessity of plurality in contract law.

As plurality is addressed by contextual reasoning, the certainty-plurality trade-off in the domain of commercial contracts can be illustrated by the polarisation between the literal and contextual approaches to contractual interpretation, which has led to a long-standing judicial debate between which approach should take priority - certainty (the literal approach), or plurality (the contextual approach). Although a majority of recent cases

⁶ Trakman, 1033, 1034

⁷ Saprai (2019) 69

were inclined to the literal approach for the sake of certainty and economic efficiency⁸, voices advocating the pluralistic contextual approach are not uncommon as it gives judges greater discretion to deliver fairness and justice by considering conflicting values and business common sense through contextual reasoning in their judgements.

3.2 Theoretical Model

The welfare implication of the certainty-plurality trade-off can be illustrated by a theoretical model as follows. Let W be the social surplus, which is a measure of economic welfare. Equation (1) configures W as a function of legal certainty (C) and plurality (P):

$$W = W(C, P) \quad (1)$$

It is assumed that $\frac{\partial W}{\partial C} > 0$ and $\frac{\partial W}{\partial P} > 0$ because C increases market efficiency and P delivers greater fairness and justice to the society. The trade-off between C and P is expressed by the following constraint:

$$C + P = A \quad (2)$$

where, A is a constant. Equation (2) requires that a change in C by a certain degree entails a change in P by the same degree but in opposite direction. That is to say, an increase in legal plurality implies a decrease in legal uncertainty. To maximize economic welfare, the court needs to choose levels of C and P such that W is maximized subject to the constraint $C + P = A$. For simplicity, suppose W is additive in C and P . The first order conditions are as follows:

$$\frac{\partial W}{\partial C} - \frac{\partial W}{\partial P} \cdot \frac{\partial P}{\partial C} = 0 \quad (3)$$

$$\frac{\partial W}{\partial P} - \frac{\partial W}{\partial C} \cdot \frac{\partial C}{\partial P} = 0 \quad (4)$$

As a result, the welfare maximizing C and P should satisfy the following condition:

$$\frac{\partial W}{\partial C} = \frac{\partial W}{\partial P} \quad (5)$$

Equation (5) implies that, to maximize economic welfare, the levels of C and P should be chosen such that their marginal benefits to the society are equalized.

3.3 Legal Cases Analysis

⁸ [2009] EWCA Civ 218

The previous section provides a theoretical underpinning for a balance between legal plurality and certainty from the economic welfare perspective. Is the theoretical implication consistent with court decisions in practice? The case of *Arnold v Britton* deserves mention when it comes to comparing the literal and contextual approaches to contractual interpretation⁹. Supporting the literal approach, Lord Neuberger argued that the use of contextual information, in particular “commercial common sense”, should not undermine the importance of the contract’s actual language. Unlike abstract notions like commercial common sense used in the contextual approach, the contracting parties should have freedom of control over the language used in drafting their contracts.¹⁰ He also noted that the Courts should not avoid interpreting a contractual term in the literal way just because it is “imprudent”; the Courts should “identify what the parties have agreed”, not what they ideally should have agreed. Lord Neuberger’s remark emphasising “the contract’s actual language” and “the freedom of control over the language” essentially links the literal approach to the concepts of freedom of contract and certainty. Specifically, certainty is manifested by the contracting parties’ full control over their language in drafting the contract, which gives the largest degree of certainty as the contractual terms are not subject to uncertain interpretations from the public authorities. In other words, the court judgement is more predictable in case of dispute if the Court interprets contractual terms based only on the actual language the contracting parties used in drafting the contract instead of imposing contextual considerations (that are likely to be subjective and uncertain) on the contractual interpretation. As argued in the previous section, the decreased uncertainty and increased predictability as a result of the literal approach lower the transaction costs of voluntary trade and exchanges mediated by contracts.

However, Lord Carnwath’s dissenting view in *Arnold v Britton* advocates the contextual approach, which basically suggests that the more unreasonable or “ill drafted” a contractual term is, the more the Court must rely on the contracting parties’ intention and context underpinning the contract.¹¹ Moreover, in contrast with Lord Neuberger’s judgement, Lord Carnwath agrees with Lord Hoffman in *Chartbrook v Persimmon Homes* that there is no limit to the Court’s discretion in interpreting a contractual term where it is clear that “something has gone wrong with the language”, and that the interpretation must clearly reflect what a “reasonable person” would understand the parties’ original intended meaning.¹² Note that, in the context of this article, what a “reasonable person” would contemplate as commercial common sense varies with norms, values, and contexts. Such plurality of values in contract law is addressed by contextual reasoning.

⁹ [2015] UKSC 36

¹⁰ *Ibid.* at [23]

¹¹ *Ibid.* at [104]

¹² [2009] UKHL 38 at [25]

Further, again in relation to Lord Neuberger's judgement, Lord Carnwath highlights the necessity of contract law "to give business efficacy to the contract", especially when it comes to commercial contracts.¹³ That is to say, it is necessary to consider the consequences of how a contractual term is interpreted, particularly whether the interpretation would "frustrate the apparent business purpose of the parties".¹⁴ This sentiment was reflected in other similar cases, such as *The Antaios* where it was held that if the language of the contract "flouts business common sense", interpretation of the contractual term should prioritise business common sense.¹⁵ From these remarks, one can deduce that the contextual approach favours flexibility and compatibility with the commercial reality that reflects the plurality of values in society and the business community. Thus, the Courts did give effect to the concept of plurality by enforcing a presumption against unreasonable outcomes.¹⁶ This approach places the Courts in a better position to bring fairness and justice to the contracting parties under dispute by exercising its discretion to depart from a direct literal interpretation of contractual terms.

There is no lack of criticism from past cases against the diminished certainty and the loss of the contracting parties' autonomy under the contextual approach despite its flexibility in accommodating plurality. In particular, Lord Sumption argues that "the language of the parties agreement" is the only direct evidence of their intentions; it is the most reliable source, as opposed to their subjective intentions.¹⁷ By giving effect to the language of the contract itself, we are relying directly on the contracting parties' understandings with each other. More importantly, he argues that judges are not necessarily well-placed to assess commercial common sense, since parties will usually have conflicting purposes which "can be most unfair and entirely unreasonable" at the time of formation, whereas court approach with hindsight, with the notion of common sense moulded by ideas of fairness. He added that "The parties are the master of their own agreement, and anything which marginalises the role of words in the process of construction is a direct assault on their autonomy." The terms "conflicting purposes" which "can be unfair and unreasonable" bring us back to the trade-off between certainty and freedom of contract on the one hand, and plurality of values on the other, as this study proposes - incorporating plurality into contract law is complex and the outcome is highly uncertain as what deemed to be reasonable common sense in a particular time and space can be entirely absurd in another. As a reliance on vague concepts is more difficult to predict than a reliance on the actual language of the contract, certainty and thus economic efficiency would be unduly undermined when the Courts shift the balance too much towards contextual information (e.g., business norms) from the actual language used in the contract.

¹³ [2015] UKSC 36 at [112]

¹⁴ Ibid. at [112]

¹⁵ [1985] AC 191 at [201]

¹⁶ [1974] AC 235 at [32]

¹⁷ Sumption (2017)

While advocates of the contextual approach may argue that the literal approach neglects commercial reality and business common sense,¹⁸ Lord Sumption's statements bring out the uncertain nature of the contextual approach relative to the literal approach, which returns to the trade-off between certainty and plurality proposed in this study. Lord Sumption's remark about the contracting parties' autonomy also seems to imply that the contextual approach accommodates plurality at the expense of freedom of contract. If judges are given unlimited discretion to depart from the actual language used in a contract to some conflicting values and ambiguous business common sense, the contextual approach essentially restrains the contracting parties' behaviour with those values and common sense and hence reduces their freedom to negotiate innovative contractual relationships.

In view of the opposing arguments discussed so far, court judgements appear to be able to observe the trade-off between certainty and plurality. Attestations of this trade-off can be seen from past cases. For instance, in *The Mihalis Angelos*¹⁹ the judge opined that certainty and predictability is a fundamental element of the law, while in *Triple Point Technology Inc v. PTT Public Co Ltd*, plurality is implied in the judge's consideration of "duties imposed by the law of tort and also norms of commerce"²⁰. In the face of this trade-off, it is a compromise for the Courts to create a middle-ground between conflicting positions, which allows a certain degree of flexibility to incorporate plurality of values without entirely losing certainty, although doing so reduces the coherence in the law. For instance, an attempt to formulate a compromise between certainty and plurality is observed in *Wood v. Capita Insurance Services Ltd*, where Lord Hodge states that the literal approach and contextual approach to contractual interpretation should not be seen as conflicting values. Instead, they should be used to "assist the court in its task...according to the circumstances of the particular agreement."²¹ Simply speaking, the decision on whether to prioritise certainty versus plurality is made on a case-by-case basis. In general, the balance as manifested in court judgements is expected to shift towards what the members of society tend to desire (e.g., more towards environmental protection in wealthy regions and more towards economic development in poor regions)²². In that sense, it seems reasonable to me why recent case law favours the literal approach in an extremely volatile environment (e.g., war, pandemic, recession, etc.) with a social consensus to return to predictability and certainty.²³ The underlying debate between the literal and contextual approaches is not only an illustration of the certainty-plurality trade-off but also a manifestation of the prevailing socio-economic environment. That is to say, incorporating a plurality of values into contract law enables the law to better meet the needs of the people who use it.

¹⁸ [2014] EWCA Civ 984 at [24]

¹⁹ [1971] 1 QB 164 at [205]

²⁰ [2021] UKSC 29 at [108]

²¹ [2017] UKSC 24 at [13]

²² Slater (1999) 519, 528

²³ Callen (2004) 123,148.

4. CONCLUSION

To conclude, contract law should be built on a solid foundation of certainty that is desirable for economic efficiency. Nonetheless, an examination of diverse case law concerning contractual interpretation reveals that, to deliver fairness and justice, the Courts must also consider a plurality of values. This is mirrored in the certainty-plurality trade-off, in which judges must strike a balance between legal certainty and consideration of competing values. Attaining such a balance enables the law to better serve the needs of individuals who use it at the expense of the law's coherence.

LIST OF LEGAL CASES

Anglo-Continental Educational Group (GB) Ltd v Capital Homes (Southern) Ltd [2009] EWCA Civ 218, [2009] 12 EG 98, [2009] All ER (D) 166 (Mar).

Arnold v Britton [2015] UKSC 36, [2015] AC 1619.

Chartbrook v Persimmon Homes [2009] UKHL 38.

Antaios Cia Naviera SA v. Salen Rederierna AB, The Antaios [1985] AC 191.

Schuler AG v. Wickman Machine Tool Sales [1974] AC 235.

Napier Park European Credit Opportunities Fund Ltd v Harbourmaster Pro-Rata and others [2014] EWCA Civ 984.

Wood v. Capita Insurance Services Ltd [2017] UKSC 24, [2017] AC 1173.

Maredelanto Compania Naviera SA v. Bergbau-Handel GmbH (The Mihalis Angelos) [1971] 1 QB 164.

Triple Point Technology Inc v. PTT Public Co Ltd [2021] UKSC 29, [2021] 3 WLR 521.

ACKNOWLEDGEMENT

The author thanks the anonymous reviewers for their helpful comments and suggestions.

REFERENCES

[1] Atiyah, PS (1995), *An Introduction to the Law of Contract*, 5th ed. Clarendon.

- [2] Callen, M., Isaqzadeh, M., Long, J.D., and Sprenger, C., (2004), "Violence and risk preference: Experimental evidence from Afghanistan", *American Economic Review*, 104(1), 123-148.
- [3] Coase, R.H. (1960), "The Problem of Social Cost". *Journal of Law and Economics* 3(1), 1-44. doi:10.1086/466560. S2CID 222331226.
- [4] Frank, R.H., Bernanke, B.S., Antonovics, K., and Heffetz (2017), *Principles of Economics*, 6th ed. McGraw Hill.
- [5] Lord Sumption (2017), "A Question of Taste: The Supreme Court and the Interpretation of Contracts", Harris Society Annual Lecture, Keble College, Oxford.
- [6] Saprai P. (2019), *Contract Law Without Foundations: Toward a Republican Theory of Contract Law*, Oxford: Oxford University Press.
- [7] Slater, P. (1999), "Environmental law in third world countries: Can it be enforced by other countries?" *Journal of International & Comparative Law*, 5 ILSA 519-528.
- [8] Tan ZX (2021), "The Prospects for Pluralism in Contract Theory", *Legal Studies*, 41.
- [9] Trakman L (2010), "Pluralism in Contract Law", *Buffalo Law Review*, 58.