Chapter 9: The Doctrine of Freedom of Contract

Thou shalt not take the name of the Lord thy God in vain; for the Lord will not hold him guiltless that taketh His name in vain.
— Exodus 20

But governments do not limit their concern with contracts to a simple enforcement. They take upon themselves to determine what contracts are fit to be enforced...There are promises by which it is not for the public good that persons should have the power of binding themselves.
— J. S. Mill

Few who consider dispassionately the facts of social history will be disposed to deny that the exploitation of the weak by the powerful, organised for purposes of economic gain, buttressed by imposing systems of law, and screened by decorous draperies of virtuous sentiment and resounding rhetoric, has been a permanent feature in the life of most communities that the world has yet seen.
— R. H. Tawney

Introduction

Contract law is one of the fundamental institutions that underpin the market system. It is not often understood that the religious and governmental regulations that underpin agreements have a very long history. Therefore, it is not often realised that the above quotation from the Ten Commandments refers not to the uttering of obscenities, but to the process of oath taking in ancient Israel, which—among other things—helped enforce contractual arrangements. A rigid view of contract law in the form of the doctrine of freedom of contract is a central element in economic fundamentalist rhetoric. It is desirable, therefore, for critics of economic fundamentalism to equip themselves with some understanding of the origins of this doctrine and how it emerged and then declined as part of the nineteenth-century view of social theory and laissez-faire economic doctrine. Our account now turns to an examination of the emergence of classical contract law towards the end of the nineteenth century in England and the United States. It will be shown that the doctrine has its origins in the breakdown of medieval ideas regulating social and economic life and the emergence of social contract ideas as a basis for explaining social order and for justifying the property rights of the elite. Natural law, the natural lawyers and the gradual secularising of that tradition also heavily influenced the growth of the doctrine. Consequently, my account parallels the earlier account of the rise of social contract ideas. As we saw then, many philosophers and economists used the concept of a contract as
their fundamental explanatory device in explaining or justifying social order. The doctrine of freedom of contract is therefore central to the conceptual framework within which economists and, in particular, economic fundamentalists operate.

The development of common law and the associated growth of contract law in England and the United States parallel the rise of capitalist society and its adherence to social-contract theory. That law was influenced heavily by the Enlightenment and by its natural-law outlook while English judgements and theorists continued to exercise considerable influence in the United States after the War of Independence.

Chapter 4 pointed to the gradual breakdown in the medieval idea that people owed a wide range of social and religious duties. In that medieval world, relationships were largely customary, but law backed that custom. Indeed, law, custom and morality are not distinguished clearly. In particular, while there were some elements of bargaining and free choice in economic life, that freedom was constrained severely by ethical ideas, which ensured that economic relationships occurred in ways that were thought to be fair and just. The notions of a just price and a just wage were central to medieval economic thought. Custom and law imposed a duty on those exercising authority to enforce those just prices and wages. Any bargain in which one party obviously gained more advantage than the other and used his power to the full was regarded as usurious. Similarly, no one doubted that everybody was entitled to subsistence. As a result, there were repeated attempts to impose price controls on staple items as well as to regulate wages. Until the end of the fifteenth century, all lending at interest was, in theory, prohibited. A sale in which there was a defect in either quantity or quality was sinful and was void. A seller was obliged to reveal a secret flaw in the product being sold. In this world, the doctrine of *caveat emptor*—the companion to the doctrine of freedom of contract—had no standing, while the possession of property involved temporary custodianship and carried duties as well as rights.

The system of justice included the King’s tribunals and local and special courts in which administrative and judicial functions were blended. These functions included a wide range of regulations controlling trade and ensuring an open market, a fair price and good quality. These arrangements became even more formalised as market towns succeeded fairs. As ecclesiastical authority broke down, the secular realm—particularly the Crown—took a larger and larger role in maintaining these fair-trading regulations. By the end of the sixteenth century, the system of justice was shared between the common law, the courts of custom, the liberties of the towns and special tribunals. Importantly, customary law had not yet emerged as the common law.
The above attitudes towards the regulation of economic activities were associated with a view of the law as a body of essentially fixed doctrine, derived from divine and natural law, and to be applied in order to achieve a fair result in particular cases. As a consequence, judges in England, and later in the American states, conceived of their role as merely discovering and applying pre-existing legal rules. This brought with it a strict conception of precedent in which judicial innovation was not permissible. At the same time, statute was conceived of largely as an expression of custom.

With the gradual breakdown of these ideas, the lords and freeholders came to question to some extent the legitimacy and privileges of the Crown and of government more generally. They also began to see themselves as the owners of the land they occupied, while at the same time ideas about the ownership of property become more absolute. Similarly, ideas about freedom also became more absolute. The breakdown of central government during the Civil Wars (1642–51) also disorganised the system of market control, which had come to depend on national authority. That authority to regulate economic life never completely recovered even though the supervision of an expanding trade and commerce was maintained with decreasing effectiveness until well past the Restoration (in 1660).

As recounted in Chapter 4, these changes made it easier for the propertied elite to see civil society as based on a social contract, rather than socially defined moral obligations backed by divine law. Unlike the traditional natural law, natural-rights theories were based on conflict between the individual and the State. As the basis of legal obligation was redefined in terms of popular sovereignty and contract, the natural-law foundations of common-law rules began to disintegrate. By the eighteenth century, political theorists and men more generally thought of their relationships with each other, and the State, in contractual terms in which a key role was assigned to individual choice.

With this came a growing perception that judges did not merely discover law, they made it. Therefore, judges began to gradually feel free to disregard earlier precedent and to make law consistent with the prevailing contractual ideology. There developed, as a result, a close connection between liberal economic ideas and the rule of law as it came to be understood after 1688. In this regard, the idea that the law should be regular, certain and subject to interpretation by independent judges is not normatively neutral, but has a powerful value content—valuing individual freedom and free choice above some other values such as equity. Nor is the rule of law normatively neutral because by promoting procedural justice it enables the shrewd, the calculating and the wealthy to manipulate its forms to their advantage.

English common law gained its supremacy over the prerogatives of the Crown largely through the efforts of Sir Edward Coke (1552–1634). Coke was opposed
to what he saw as the usurping of power by the King, and appealed to the common law as a traditional barrier to the interference by government with the economic and other freedoms of the individual. In the process, Coke distorted and misinterpreted the past common-law tradition to make it seem more strongly favourable to economic liberalism than it was in fact. In particular, the doctrine of *caveat emptor* had no ancient ancestry. It was Coke who helped establish it by setting it down in his treatises on law. Lord Mansfield, Chief Justice of the King’s Bench from 1756 to 1788, was another economic liberal, who did much to consolidate and develop commercial law. During his tenure, the overthrow of the traditional role of the courts in regulating the equity of agreements began in earnest.

Mansfield’s conception of a general jurisdiction of commercial law—which emphasised its claimed universal character and its supposed correspondence with natural reason—had an overwhelming influence in the United States. This involved a new stress on the functionality and rationality of the legal rules free from every local peculiarity, and brought with it a growing distinction between morality and the law. Horwitz, in particular, notes the influence of a new utilitarianism in nineteenth-century US law in general and in the erosion of concern for the fairness of contracts in that country. What was involved was a change in the moral conception underlying contract in which the express contract became paramount. Horwitz also notes the influence of a new alliance between the mercantile classes and the legal profession—firstly in trying to subvert the influence of equity and of juries on commercial cases, and ultimately in moulding legal doctrine to accommodate commercial interests. This growth in commercial law also reflected the increasing complexity of economic transactions.

While there had never been an overt principle of fairness in the common law of contracts, lawyers of the seventeenth and eighteenth centuries were not indifferent to such concerns. There were signs of a broad principle of good faith emerging in the common law of contracts in the late eighteenth century—a development that ultimately came to naught. This could have been because jury control over damages rendered it unnecessary to strive for such a substantive doctrine. For Atiyah, it was the jury that bridged the gap between morality and the law. In any event, grossly unfair contracts were liable to be upset in chancery, and it was in chancery that the greater part of contract litigation took place.

Chancery was the second of two different traditions in English legal practice. Equity consisted originally of a body of rules and procedures that grew up separately from the common law and were administered in different courts. From the time of Edward II or earlier, the chancellor and his officials—later the Court of Chancery—as ‘keeper of the King’s conscience’, could give equitable relief where the common-law courts might provide no remedy. The chancellors until
the appointment of Sir Thomas Moore in 1529 were churchmen. With the rationalisation of legal practice, the common law and equity are now merged and administered by a single set of courts almost everywhere. While the merger of law and equity is usually portrayed as a rationalisation of civil procedure, for Horwitz, it represents the final and complete emasculation of equity as an independent source of legal standards.  

As the law moved increasingly to recognise the generality of the binding nature of contracts, they began to be seen as being about promises, wills and intentions and not about particular relationships and particular transactions. The rationalisation of the common law was influenced by a new legal literature looking for legal principles based on rational first principles. Further, there was a particularly close relationship between law, economics and the social sciences in the first 40 years of the nineteenth century. The economic ideas that influenced the development of the common law were those of the classical economists between 1776 and 1870. While they assumed that the law must provide for the enforcement of contract, they gave little thought to why the enforcement of contracts was not itself a form of government intervention.  

Laissez-faire principles might well have had more influence on judges—and judge-made law—than on the other organs of the State. Atiyah makes much of the emphasis on principle in Victorian life and on its tendency to become more absolute. The rise of formalism in the law, particularly in the United States, played a role in this attitude. This formalism—the attempt to place the law under the rubric of science—was a further development of the rationalism noted earlier. It involved a belief that all law was based on abstract legal doctrines and principles, which could be deduced from precedents, and that there was only one correct way of deciding a case. The formalists aspired to create formal general theories that would provide uniformity, certainty and predictability in legal arrangements and which would distinguish sharply between law and morals.  

This formalism served to reinforce the recently developed law of contract by giving the impression that the principles of the law of contract were inexorable deductions drawn from neutral principles. Within this framework, it was the market that supplied the so-called neutral principles, free from all political influence. This attempt to separate law from politics has been a central aspiration of the American legal profession in particular. It served the interests of the legal profession to represent the law as an objective, neutral, apolitical and scientific system. This encouraged a search for fixed principles that would govern a large number of cases without too close an inquiry into the facts. As a consequence, every law not fitting the pattern of the free market was defined simply as being outside the law of contract, as some other exceptional body of rules: company law, factory legislation, building laws, sanitary laws and so on. Such statutes were excluded from the emerging conceptual scheme of a general
law of contract based on free-market principles—the classical theory of contract. Nevertheless, Atiyah cautions that legal writers, in commenting on the influence of *caveat emptor* and *laissez-faire*, attribute a much greater significance to particular legal cases than is warranted by the practice of the courts more generally. Nevertheless, the effect of these changes in values was to reshape the legal system to the benefit of business and to the detriment of less powerful groups. The selection of ‘leading cases’ and the dismissal of the ‘anomalous’ were clearly influenced by the ideological commitments of the system builders.

Ironically, while the nineteenth century was the very heyday of sanctity of contract and of *laissez-faire*, it was also the period when Britain was creating its modern machinery of government. Despite the widespread support for free markets, the role of government and of government regulation expanded greatly. Atiyah comments that one of the main inhibitors of such government regulation had been ignorance of the social evils associated with rapid population growth, industrialisation and urbanisation, and of how to deal with them. The growth of a professional bureaucracy—and the activities of royal commissioners and parliamentary select committees—overcame this ignorance and led to much legislative and regulatory activity. Many of the participants—who started as disciples of Smith and Ricardo, and as firm believers in individualism and self-reliance—were converted by their inquiries into zealous public servants demanding more legislation, better enforcement and more administrative staff.

This enormous change in the character and quantity of legislation had a profound impact on the very idea of a contract-based society. With the growth in increasingly sophisticated legislative activity, the courts abandoned overt law-making activity. Atiyah argues, therefore, that by 1870, the influence of individualism had largely broken down, and had been replaced by a different order in which control, regulation, licensing and institutional arrangements had become the dominant mode of social organisation.

Atiyah also qualified his account of the dominance of the doctrine of freedom of contract by suggesting that English judges were stronger in doing justice in a pragmatic fashion than in providing theoretical justifications for their decisions. In addition, the weight of earlier tradition was influential in particular cases. As a result, *laissez-faire* and the doctrine of freedom of contract had a much greater influence on contract law in the United States than in England. Gilmore attributes this to the influence of ‘the great systems-builders’ seeking to develop self-contained and logically consistent systems of rules and doctrines. Gilmore also speculates that the Puritan ethic was somehow involved, noting the moral fervour with which judges insisted on the performance of contractual obligations. For Horwitz, nineteenth-century US judges professed a contractual ideology that was instrumental in promoting economic development and *laissez-faire*, in being hostile to legislative or administrative regulation. Moreover, the idea of
property as a pre-political Lockean natural right—not created by law—remained at the centre of American legal thought. Under this influence, the US Supreme Court in 1905 elevated the principle of freedom of contract to the level of a sacred constitutional principle. In the common law in England, however, the tide was about to turn. Even in the United States, the dominance of the doctrine of freedom of contract was short-lived. The US Supreme Court decision of 1905 provoked a progressive reaction and fundamental attacks on this form of legal thought. With these attacks came a breakdown in these absolute concepts of property and contract.

In England, the idea of caveat emptor did not long survive the growth in consumption of manufactured goods and the reality that people did rely on their suppliers when it came to the quality of the goods they supplied. For example, in *Piggott v. Stratton* in 1859, Lord Campbell and the Lords Justice of Appeal ruled that ‘the business of life could not be conducted if it were required that men should anticipate and expressly guard against the wily devices to which the deceitful may resort’. From the 1860s onwards, the English courts started to limit the application of the principle of caveat emptor. Consequently, some inquiry by the courts into the facts was needed from this date onwards. In 1884, in *Foakes v. Beer*, the House of Lords started to move back towards the idea of fairness in an exchange and away from the idea that a bare agreement was always binding. At the same time, the idea of freedom of contract was itself subject to increasing political challenge, particularly with the expansion in franchise. This involved a significant shift in political thinking—a shift that occurred in England and the United States. For example, in the 1880s, George Bernard Shaw opposed the appeal to free contract, free competition, free trade and laissez-faire against the regulatory activities of the State.

Similarly, philosopher T. H. Green set out to challenge the primacy of freedom of contract in his *Liberal Legislation and Freedom of Contract*: ‘To uphold the sanctity of contracts is doubtless a prime business of government, but it is no less its business to provide against contracts being made, which from the helplessness of one of the parties to them, instead of being a security for freedom becomes an instrument of disguised oppression.’

Joseph Chamberlain in 1885 also criticised the faith that had been placed in freedom of contract for the best part of the nineteenth century:

The great problem of our civilisation is still unresolved. We have to account for and to grapple with the mass of misery and destitution in our midst, co-existent as it is with the evidence of abundant wealth and teeming prosperity. It is a problem which some men would set aside by reference to the eternal laws of supply and demand, to the necessity of
freedom of contract, and to the sanctity of every private right of property. But gentlemen, these phrases are the convenient cant of selfish wealth.  

Increasingly, the common law and legislation interfered with that freedom of contract and with the principle of *caveat emptor*. The effect was to narrow significantly the field of activity over which freedom of contract and contract law held sway. This change is perhaps marked most clearly by the passage in England in 1893 of the *Sale of Goods Act*, dealing with such matters as title, quiet possession, freedom from encumbrances, correspondence with description, merchantable quality, fitness for purpose and sales by sample. This legislation was adopted virtually unchanged by every Australian state and territory.

It is clear, therefore, that the idea of freedom of contract as an absolute ideal gained credibility and influence in the nineteenth century but was eclipsed by the end of the century as the practical consequences of reliance on this principle began to be realised and began to offend the sense of justice of the bulk of the population.

Surely it is now clear that property and contract are not natural rights but social and legal artefacts, or even ‘techniques’. Atiyah argues that there is much about the modern world that suggests an affinity with some of the older traditions and suggests that, at least in England, the law is returning to these traditions. This is a theme that arose in Chapter 4 with Toulmin’s suggestion that there is a need to return to the humanism characterised by Erasmus and away from the dogmatism of the Enlightenment.

### Some Reflections on the Doctrine of Freedom of Contract

As indicated above, the doctrine of freedom of contract was the central doctrine of the classical contract law that came to full development in the last half of the nineteenth century. The very idea of a general law of contract is part and parcel of the same positivist era. This law was the creation of judges and thesis writers influenced by social-contract ideas dating back to Locke, by classical economic thought and the associated ideology of voluntariness. Among legal theorists of the late nineteenth century, the law of contract was the archetypical branch of what was conceived of as legal ‘science’. This involved an attempt to systematise the various doctrines and decisions of the courts to do with contract issues into a consistent and logical theory in which the legal rules were to be deduced from general concepts such as property.

The classical view of contract involved a process of abstraction, generalisation and systematisation in an attempt to create a unitary theory that was thought to be free of moral valuations and could therefore be described appropriately as a science. This development formed part of the more general attempt to substitute scientific discourse for moral discourse at a time when the traditional religious underpinnings of moral values were coming under increasing attack with the
decline in formal, traditional religious belief. There was, therefore, an attempt to distinguish between what was conceived of as public law and contract or private law—law that individuals legislated for themselves. This distinction between public and private law was part of the Enlightenment’s attempt to separate the public from the private realm in political and legal theory. Central to this conception of contract was the idea that contract obligations arose from the wills of the individuals concerned, and not as a result of a socially and historically constructed legal institution. It has much in common with the Lockean idea of property as a pre-social natural right. Indeed, the obligation to fulfil promises—central to classical contract law—was at its heart a Lockean natural law, but a natural law increasingly bereft of its metaphysical foundations.

In retrospect, this development could be seen as a process of reification—a manifestation of an excessively legalistic mentality in which legal rules and universal abstractions acquired sanctified status and became absolutes. What was also involved was an attempt to claim that the rule of law provided norms independently of politics. There is a close connection between this ideal of a rule of law and not of men and *laissez-faire* ideas. It was assumed that rules fixed and known beforehand would make it possible for economic actors to foresee how the courts would use their coercive powers and would allow those economic actors to plan their activities effectively. Hayek made much of these ideas in his defence of the market system.\(^32\) They involve an underlying assumption that predictability is associated with generality. It is also a view that conceives of courts as enforcers of rules rather than as settlers of disputes. This is a view that also conceives of judges as rulers on the truth—a view that encourages the adversarial approach of common-law courts. From this rule-based point of view, any movement away from the strict enforcement of rules towards multi-dimensional standards such as fairness is to be deplored. Herein lies the source of the conflict between equity as it had been developed in earlier times and classical contract law. The nineteenth-century desire for uniformity, certainty and predictability could not be reconciled with the discretionary element implicit in equity. Herein also lies the source of the reluctance to inquire too closely into the particularities of the subject matter of an agreement, the circumstances of its making, the expectations of the parties and especially of the outcomes realised. In practice, what came to be important in contracts was the written document as interpreted by the courts in a highly literalist manner, independent of any substantive inquiry of the parties (the parole evidence rule precluded such inquiry into the circumstances surrounding written contracts). All of this involved a commitment to a rigid and mechanical decision rule, to be implemented in a mechanical manner—a replica of the determinism of Newtonian physics.

This view of contract law has increasingly foundered on the evidence of experience. Too rigid an enforcement of contracts on the basis of freedom of
contract led to what were recognised clearly as unjust outcomes. Legislatures and, over time, the courts themselves did not tolerate these. As a matter of practical politics, legislatures everywhere moved to legislate and regulate to remove the grosser abuses of the contract system. These measures have not been confined to simply addressing issues associated with contract formation but have been concerned increasingly with the substantive outcomes of contractual arrangements. Therefore, contract law came to be robbed systematically by legislatures of much of its subject matter. As a consequence, pure contract law has ceased to occupy so central a position in the economic system.

Among legal theorists, it was recognised increasingly that the refusal to inquire into the circumstances surrounding a contract was obviously inconsistent with the will theory on which classical contract theory rested. This in turn led to the replacement of the will theory with the development of the objective theory of contract—a theory that acknowledged openly that contracts were enforced for reasons of public policy. It has come to be recognised—particularly in the work of the theorists of the American realist school—that classical contract theory is neither neutral nor natural; it is instead a historically contingent social and legal construct.

In consequence, the very idea of contract law as a neutral system has had to be abandoned. Rather, all valuations at law are moral choices. Contract law—and decisions in particular cases—involves a balancing of conflicting social values, not a deduction from consistent scientific principles. This realisation has posed an overwhelming challenge to deductive legal reasoning, as it is impossible to reason down from very general principles to particular decisions. Furthermore, this viewpoint leads directly to a good deal of scepticism about the practicality of general rules of the kind Hayek advocated.

It also became clear that classical contract law conferred a privileged position on the status quo, the intelligent and the powerful. Even the ideology of voluntariness has come under attack. The first point to be made in this regard is that methodological individualism in economic and moral theorising does not necessarily lead to any justification for a policy of self-reliance, however much the two are confused in practice. Secondly, it is obvious that individuals are frequently not the best judges of their own interests. In any event, individual interests are often subordinated to social and political goals, including in the law of contracts. It has been pointed out also that markets are to some extent coercive. Consequently, the problem is to decide what forms of coercion are to be regarded as legitimate.

The ideology of voluntariness has been seen to provide the more powerful party to a contract a freedom of manipulation and motivation, a freedom from any onus of articulation and a freedom from any other legal duties that cannot be fitted under the rubric of contract as promise. Consequently, there has been
a growing reluctance to concede to big business the right to dictate contract terms to less powerful parties—particularly consumers—through standard-form contracts. Equally, there is a problem of deciding to what extent deception and concealment of information in contractual negotiations are also to be regarded as legitimate.

More generally, having acknowledged that contracts are enforced for reasons of public policy, and that contracts involve a balancing of conflicting value choices, the idea that contracts should always be enforced is open to question. This is what has happened as a result of legislative action and as a consequence of judicial enlargement of the law of contract and various equitable doctrines. Adding to the confusion has been the realisation that the grounds for equitable intervention in the enforcement of contracts cannot be fitted under a unified doctrine or theory. The law is not in fact static. Judges are required frequently to rule on novel situations requiring departure from precedent. In such cases, even perfect knowledge of precedent and other case law applying to the situation will not protect the subject of litigation. In these cases, the judge retrospectively rules certain conduct to be contrary to law—that law being the decision just made. In practice, one can conduct oneself in accordance with the law only to find out some time later that when a judge considers that conduct it is ruled to be contrary to the law. Only at that point does the conduct become, retrospectively, contrary to law. No degree of knowledge or foresight can prepare someone for a judgement such as this.

As Joseph Schumpeter pointed out, it is inevitable that the creative destruction inherent in capitalism will create new situations. The destructive and creative impulses of capitalism create novel situations requiring novel judicial treatments. If judges were not free to create novel legal pronouncements, commercial activity would move progressively beyond the influence of law. While precedent binds judges, if they were not free to rule creatively in novel situations the law would ossify.

Equity is always available as a remedy in a court of law, even though equity is distinct from law. Being governed by vague maxims rather than strict rules—and gifted with great flexibility with regard to remedies—equity has been criticised by many legal scholars and practising jurists as too unpredictable to be relied on to produce the proper result. Nonetheless, all lawyers within the common-law tradition are examined in equity during their training, and equitable arguments are always available to litigants. It is the reputation of equity as soft, vague and unpredictable that prevents it from occupying a similar place of renown as the law proper. Only a brave barrister will resort to an equitable argument in place of a legal one, despite vast quantities of case law recording successful equitable arguments.
All of these influences have led to a period of confusion in contract theory. Here in Australia there has been a growing acceptance of the objective theory of contract at the very time that theorists in the United States detect a process of doctrinal disintegration. There, it has been perceived increasingly that contract law—as modified by the various equitable doctrines—involves a complex of diffused principles. Even the idea of—and a need for—a general law of contracts as a uniform body of rules has been questioned.

Some theorists such as Gilmore predict the death of contract and its collapse into the law of torts. While it might be going too far to suggest that a uniform law of civil obligations might emerge, there is certainly an increasing recognition of an obligation of good faith and a development in the direction of a duty of care in contractual arrangements. The former is not as radical as some of its opponents might like to suggest. For example, the German civil code has had such an obligation for more than a century and a doctrine of good faith is now firmly entrenched in the US Uniform Commercial Code and in the Restatement of Contract. More generally, contract theorists such as Atiyah and Ian Macneil have questioned whether contracts should be seen as a legal mechanism for establishing long-term business relationships, rather than the risk-allocation mechanisms that economists have conceived them to be. This point of view emphasises the relational element involved in any commercial arrangement that is not a simple one-off exchange transaction. Atiyah, for example, sees contractual obligations arising primarily from the reliance one party places on another, while Macneil stresses the fact that all longer-term contracts are incomplete. It is simply not possible, in practice, to anticipate all the possible eventualities and risks involved in a continuing commercial relationship. Macneil sees the solution to this incompleteness as involving the development of intermediate contract norms to govern the continuing relationship. This is consistent with empirical evidence of real commercial behaviour, particularly between large companies where the existence of a valued long-term relationship induces companies to resolve difficulties that occur in the relationship without reference to the written agreements between them, and without reference to the courts.

The Recent Fair-Trading Debate in Australia

These debates in eighteenth and nineteenth-century England and the United States have had their parallels in other jurisdictions that share the common-law tradition, including Australia—most recently, in the fair-trading debate that occurred at the federal level between 1974 and 1997. That debate arose out of continuing complaints from the small-business sector regarding the conduct of big business towards small business. It revolved around a series of proposals aimed at effectively broadening, by statute, the Equitable Doctrine of Unconscionability—the doctrine that carried the remnant of the medieval concern
for fairness in trade and contracts, and which permitted courts to decline to enforce contractual arrangements. As we saw above, while the remit of contract law diminished progressively in the past two centuries, the Equitable Doctrine of Unconscionability within contract law had been progressively emasculated—being restricted to tightly defined procedural issues. Consequently, the proposals at the heart of the fair-trading debate challenged directly the classical doctrine of freedom of contract.

Lack of space prevents me dealing with the movement away from the doctrine of freedom of contract in the Australian states through detailed legislation covering such matters as weights and measures, sale of goods, safety and hire-purchase legislation. In particular, attention will not be directed at the New South Wales Contract Review Act 1980, which authorised the NSW courts to rewrite unfair contracts or to refuse to enforce them. Rather, attention will be directed to Commonwealth legislation intended to apply broadly to all trade and commerce. Nor will a detailed account be given of the constitutional limitations that confine the application of that legislation.

The first Commonwealth trade practices legislation was the Australian Industries Preservation Act 1906, which was inspired by US antitrust laws. The act proved ineffective, being subjected to a successful High Court challenge in 1910 and a successful Privy Council challenge in 1912. Similar state legislation was also rendered ineffective. The second major attempt was the Trade Practices Act 1965–71, which took a limited approach, influenced by the UK’s Restrictive Trade Practices Act of 1956 rather than the broad prohibitions of the US law. It established a process of registration and adjudication of the lawfulness of a practice by an administrative tribunal. This act and related successors were criticised as being inefficient, slow and costly and because examinable agreements or practices remained operative until restrained by the tribunal.43

The Trade Practices Act 1974 was the third major attempt to introduce effective general trade practices legislation in Australia:

Restrictive trade practices have long been rife in Australia. Most of them are undesirable and have served the interests of the parties engaged in them, irrespective of whether those interests coincide with the interests of Australians generally. These practices cause prices to be maintained at artificially high levels. They enable particular enterprises or groups of enterprises to attain positions of economic dominance which are then susceptible to abuse; they interfere with the interplay of competitive forces which are the foundation of any market economy; they allow discriminatory action against small businesses, exploitation of consumers and feather bedding of industries…The consumer needs protection by law and this Bill will provide such protection.44
The Trade Practices Act 1974 involved a substantial statutory interference in freedom of contract. Not only was it intended to promote economic efficiency, it was intended to promote fairness in competition and in dealings between businesses and between businesses and consumers, and to promote honesty in the provision of information. The inference to be drawn was that in enacting this legislation, the government and parliament had accepted that market forces left to themselves would not produce either just or economically satisfactory outcomes.

Since the enactment of that legislation in 1974, there have been at least 18 major reports or proposals to amend the act to strengthen the regulation of unfair business practices. The most influential of these inquiries was the Fair Trading Inquiry by the House of Representatives Standing Committee on Industry, Science and Technology (the Reid Committee). The Reid Committee tabled a bipartisan report, *Finding a Balance Towards Fair Trading in Australia*, in the House of Representatives in May 1997. It concluded that concerns about unfair conduct towards small business were justified and should be addressed urgently. To this end, the report made wide-ranging recommendations to induce behavioural change on the part of big business towards small business and to provide adequate means of redress. In summary, the recommendations covered:

- major amendments of the Trade Practices Act 1974 prohibiting unfair conduct in trade or commerce
- Commonwealth facilitation of uniform state and territory retail tenancy legislation and a retail tenancy code backed by the Trade Practices Act 1974
- generic franchising legislation
- representative actions by the Trade Practices Commission in respect of Part IV of the Trade Practices Act
- a range of measures regarding the financial sector’s treatment of small business
- mandatory pre-trial mediation of unfair conduct disputes
- an educational campaign for small-business entrants.

The committee believed that an inequality of power in commercial transactions was the underlying cause of the unfair business conduct raised with it. The result was a bias in business dealings in favour of powerful companies with the financial resources to engage in lengthy litigation. This left small-business people open to arbitrary or opportunistic conduct with an associated economic and social cost. The committee pointed also to a lack of adequate research into small-business failures in Australia, and to an absence of any formal research in evidence tendered to the committee. Nevertheless, the anecdotal evidence provided by the numerous small-business people convinced the committee that unscrupulous conduct of big business towards small business was a serious problem causing significant economic and social damage. The committee was
conscious that in a competitive economic environment many businesses would fail, but that awareness did not exclude the need to examine the causes of failure—and action to alleviate its adverse consequences.

While acknowledging the inadequacies of the previous regulatory control regime, the committee was strongly critical of the efforts of the Australian Competition and Consumer Commission (ACCC) in relation to small-business disputes. It believed that there was a need to establish a body of precedent under proposed new provisions in the *Trade Practices Act 1974* as quickly as practicable.

The strength and breadth of the committee’s report came as a surprise to many observers, including small-business representatives. It ran directly counter to the rhetoric of deregulation that had surrounded much recent public policy debate, including the rhetoric contained in its own terms of reference. As could be expected, small-business representatives welcomed the committee’s report warmly, while big-business representatives were much more reserved. Typical of the critical reactions was an editorial in the *Australian Financial Review* on 26 June 1997, which attacked the report as naïve, claiming that economic competition was desirably deliberate and ruthless. The editorial also claimed that requiring fair conduct from banks or large shopping centre managers in dealing with their clients and tenants would be a restriction on their ability to compete and that small businesses would suffer as a result. For its part, the Property Council of Australia commissioned economic consultancy firm Access Economics to produce a so-called ‘independent’ response. Their document, *Tipping the Balance?*, which focused on retail tenancy issues, claimed the Reid report was not consistent with its terms of reference in that it would promote ‘sub-optimal economic outcomes’ as well as increasing the regulatory burden on retail businesses. Additionally, the Reid report was said to be internally inconsistent and to have paid scant regard to hard data on retail-industry performance. *Tipping the Balance?* criticised the Reid report’s reliance on anecdotal evidence from small-business operators and small-business groups and from competing expert witnesses. Of course, the claim to independence lacks credibility, given that the Property Council was paying. Rather, *Tipping the Balance?* provides an example of the partisan use made of economic analysis in public policy debate. It also provides an example of the demands made by economists generally that the forms of analysis used in public policy debate be confined to formal economic analysis relating to economic efficiency, as they define it, and that the direct experience of those involved in markets be disregarded.

Prominent economic fundamentalist P. P. McGuinness claimed that the Reid Committee’s report relied on emotion, prejudice and a desire to cater to the voters. This reflects an elitist contempt for the political process typical of many economic fundamentalists. McGuinness claimed that the report was a
classic case of an attempt to enrol political power and anti-competitive regulation in the cause of ripping off consumers. This one-sided application of capture theory also appears typical of economic fundamentalism: only economic fundamentalists can be trusted to present views untainted by self-interest—a view peculiarly inconsistent with their own theories. It also attempts to exploit the Enlightenment’s depreciation of the role of emotions in human judgement.

On the other side, Professor Andrew Terry argued in the Australian Financial Review on 27 June 1997 that the committee’s recommendations would not damage the economy, but would lead to a much needed extension and clarification of the law. The chief executive of the Council of Small Business Organisations in Australia, Rob Bastian, dismissed big-business concerns about uncertainty as ‘crap’, pointing to the uncertainty that had previously confronted hundreds of thousands of small businesses.48

Press reports claimed that the government had been subjected to heavy lobbying by several business groups strongly opposed to the committee’s proposals to adopt a new Section 51AA banning unfair conduct. The Treasury and the Department of Industry, Science and Technology were also reported to have been opposed. On the other hand, there was said to be support from coalition backbenchers.49 Interestingly, a significant proportion of the government’s backbench had experience with small business, including members of the Reid Committee.

On 11 July 1997, the Minister for Small Business, Geoff Prosser, who was hostile to the committee’s recommendations, was forced to resign his portfolio after weeks of political controversy because of a perceived conflict of interest on these issues. Prosser was replaced by one of the government’s most experienced and effective politicians, Peter Reith, whose portfolio, Workplace Relations, acquired responsibility for small-business matters. This represented a significant upgrading in the importance of the small-business portfolio.

The government responded to the committee’s report in a statement by Reith to the House of Representatives, ‘New Deal: Fair deal—giving small business a fair go’, on 30 September 1997. As far as the rhetoric of the statement was concerned, the minister said:

Make no mistake about it, this Federal Coalition Government, this Prime Minister, and this Minister, is [sic] pro-small business, and proud of it…This response on fair trading policy…is the strongest message ever sent from Canberra to Australia’s small business community that they now have a national Government that has listened, has understood and has acted.50

The minister announced that the government would act on the recommendations of each of the seven areas of reform identified by the committee: unfair conduct,
retail tenancy, franchising, misuse of market power, small-business finance, access to justice and education. Nevertheless, while claiming full credit, the government did not implement the committee’s recommendations in full. The minister said that, in a number of important respects, the government response had gone further than the committee’s recommendations, particularly in the area of effective enforcement of fair-trading issues by the ACCC. In summary, the government action involved:

- a new provision in the *Trade Practices Act* to give small business genuine access to protection against unconscionable conduct
- a new provision that would allow industry-designed codes of practice, in whole or part, to be underpinned legally and made mandatory under the *Trade Practices Act* and enforced as breaches of that act
- a new provision that would allow the ACCC to take representative action on behalf of small business for misuse of market power by big business
- a new provision that would give small-business interests equal importance to consumer interests when appointments were made to the ACCC
- a directive to the ACCC under the *Trade Practices Act 1974* requiring the ACCC to enforce small-business legal rights against unfair business conduct.

The government also provided funding to enable test cases to be undertaken.

In respect to the first of these, the new provision extended the existing common-law doctrine of unconscionability by mirroring the legal rights available to consumers under the existing Section 51AB and incorporating most of the matter included in the committee’s proposed Clause 51AA. Importantly, however, the government legislation persisted with the term ‘unconscionable conduct’ rather than ‘unfair conduct’ proposed by the committee. The committee had recommended that the term ‘unconscionable conduct’ be replaced with a term without its limiting legal entailments and proposed the term ‘unfair’ as covering all the circumstances that would be covered by the terms ‘unconscionable’, ‘harsh’ and ‘oppressive’. The government’s bill also dropped the terms ‘harshness of the result’ from the matters that the courts could take into account. Importantly, the new provision was also limited to transactions under $1 million and publicly listed companies were excluded from instigating action under the provision. This limit was subsequently raised to $3 million and is currently being increased to $10 million. In addition, a new provision is being added to include the use of a unilateral right to alter a contract as one of the matters the court can have regard to. Perhaps the most important recommendation that survived the government’s consideration of the Reid Committee’s proposals was the requirement that corporations covered by the section were effectively required to act in good faith.

While the committee recommended clearly that the law should be extended to cover procedural and substantive circumstances, it was unclear to what extent
the government’s legislation achieved that widening. The government’s response, therefore—which, in other respects, was very much in the spirit of the committee’s recommendations—fudged the central issue in the inquiry, and limited the application of the changes to unconscionability to relatively small transactions. Consequently, it will be necessary to await the reaction of the courts over time to the new clauses before it is clear how extensive the change has been. In this regard, Bob Baxt recently criticised the ACCC for its failure to bring more meaningful unconscionability cases to the courts in the past five years.51

Throughout this debate, the issues remained essentially the same: whether, and to what extent, the Commonwealth should legislate to regulate unfair conduct by big business towards small business. Similarly, the arguments used throughout changed in style only, not in content. The debate also exhibited the tendency for public policy to follow a path of incremental change, which the early Charles Lindblom advocated as the best form of policy development.52 It exhibits also the entrenched power of big-business groups that the less optimistic late Lindblom feared would forever provide a barrier to more radical change.53 It is also unusual among contemporary policy debates in that, for the most part, it finds big and small-business lobby groups on different sides of the debate. Governments had sought to chart a course through two powerful business lobbies—advancing two different conceptions of justice—neither of which governments wished to offend. Consequently, throughout the debate, governments of both persuasions conceded as little to the pressure of small-business groups as they could get away with at the time.

The debate also provides a good illustration of the entrenched power of economic methodologies and values as the dominant evaluative considerations used in contemporary policy debates. Big business used the rhetoric of classical contract law—along with the contemporary economic rationalist rhetoric of minimum effective regulation—as the means of deflecting the political pressure. Indeed, the debate has been conducted almost entirely under this rubric. For example, during the Blunt Committee Inquiry in 1979, in commenting on a proposal from the Law Council of Australia for a general prohibition of harsh, unconscionable or unfair conduct, the Blunt Committee expressed the view that the Trade Practices Act 1974 was directed primarily at enhancing competition and should not deal with the ‘moral’ issues involved in business conduct.54 The Business Council of Australia endorsed this view in its submission to the Reid Inquiry.55 The claim is, of course, unsustainable. It is a view that relies directly on the positivist separation of law and morals—a separation that is largely discredited. In the particular case, protecting competition—as the Trade Practices Act 1974 does in some of its sections—is not an end in itself. It is done because of the belief that competition enhances economic outcomes and that in turn enhances
human welfare. That is, it is done for moral reasons—economic efficiency being one of the intermediate moral values served by that Act. Competition is seen also as producing fairer economic outcomes, as enhancing equity. Consequently, the competition provisions of the Act are intended to enhance welfare and fairness. Conduct that directly reduces welfare or fairness can hardly be thought to be consistent with the aims of that Act. Even the Blunt Committee acknowledged that competition laws operated directly on business conduct and accepted that the Act’s thrust against anti-competitive conduct was tempered to some extent to protect small business and to promote fairness. This should come as no surprise as this is what the minister said when introducing the legislation in the first place. The Act was intended to enhance competition and protect against unscrupulous conduct.

There is some similarity between the position of the Business Council of Australia and Posner’s economic theory of the law, in which the law is seen as serving wealth maximisation. Of course, the law to which he refers is judge-made law, which he considers morally superior to statute law, which tends to depart from his efficiency norm. Posner’s theory is, in fact, an extreme manifestation of the economic fundamentalism of the Chicago school. It is such a transparently impoverished account of justice—running in the face of our contemporary moral vocabulary—that it warrants little serious consideration. For Posner, suffering is irrelevant to his conception of justice unless it is accompanied by a capacity to pay. It equates justice with economic efficiency, but an economic efficiency that is defined purely in terms of wealth maximisation. It is clearly intended to be a descriptive and a normative theory. It is a theory that attaches importance to freedom of choice, but only to the positive rights and values intrinsic to capitalism, the protection of private property rights, promise keeping and freedom of contract—those rights and obligations that are also central to Locke’s social-contract theory.

The Blunt Committee went on to define ‘desirable economic performance’ specifically in terms of ‘economic efficiency’—a concept that it took to be the equivalent of Pareto-optimality. The Blunt Committee acknowledged—in a footnote only—some limitations of this concept, but its analysis remained unaffected by that acknowledgement, a deficiency shared by subsequent references to ‘economic efficiency’ throughout this debate, and in recent public policy debate more generally. Similarly, the Business Council of Australia’s submission to the Reid Inquiry mounts a standard economic argument based on Pareto-optimality: that there should be ‘regulatory intervention’ only when ‘economic efficiency’ is lessened by distortions in a market—interventions that hinder the movement of resources to their most valuable and efficient use, and where the benefits of that intervention outweigh the costs. It went on to suggest that this calculus is one that should properly be performed by the Productivity
Commission, the successor body to the Industry Commission, an organisation believed popularly to be committed to economic fundamentalism.

Throughout the debate, the Trade Practices Commission and its successor—the ACCC—consistently argued that economic efficiency would be enhanced by action directed against unconscionable conduct in commercial transactions. Similarly, small-business groups responded with theoretical arguments to the effect that economic efficiency would be enhanced by legislation of the type they had proposed. There seems little recognition of the fact that mainstream economics has little to say about productive and dynamic efficiency.

Similarly, the Treasury responded with concerns about the impact of regulatory action on transaction costs throughout the economy. It went on to argue that there were two primary reasons for government intervention: market failure and equity/fairness. As we saw earlier, this use of the word ‘intervention’ is not neutral, as it implies interference in the normal, or even the ideal, state of affairs—an interference that has to be justified. The implication is that the normal or ideal is an unregulated market. It carries with it a commitment to the minimalist account of the role of the State derived from Locke. Treasury agreed, however, that inadequate information, high transaction costs and substantial market power might give rise to a ‘market failure’. This failure can result in efficient small businesses being discouraged from entering the market or being forced out of business, thereby producing a sub-optimal allocation of the community’s resources. Treasury also acknowledged that unfair business conduct could lead to other social costs, such as increased bankruptcies and social dislocation. It was concerned, however, that general legislative action to deal with these issues—and associated equity considerations—could have adverse consequences on business certainty and the competitive process. In relation to the economic arguments, neither the relevant departments nor the big-business lobby paid any serious attention to ‘distributional’ or equity issues. In the case of the Treasury, the existence of equity concerns is acknowledged briefly, but not discussed. There seems to be no recognition that, in practice, it is impossible to separate efficiency from distribution issues, however much economists like the conceptual distinction. More broadly, the word justice is never uttered.

In Chapter 3, attention was directed in particular to the role of trust in promoting social and economic interaction. In the language of neoclassical economics, however, trust and similar values—loyalty or truthfulness—are called ‘externalities’. The very language seems to marginalise their importance even though technically they are called externalities only because they are external to the price system—those areas in which the price system fails to operate. In a climate in which the importance of externalities is discounted, there is a danger that the importance of those moral values will be forgotten. This is relevant particularly to contracts in contemporary society that rely on informal constraints.
to ensure that parties will act honourably when unforeseen circumstances arise during the course of contracts, which, in practice, are necessarily incomplete.

The dangers associated with a transaction depend not only on the nature of that transaction, but with the trading environment of which it is a part. Consequently, opportunistic behaviour on the part of one party to a transaction or a contract can increase risks attached to all transactions and the costs of doing business generally. Consequently, the moral and legal sanctions that reduce opportunistic conduct also reduce transaction costs generally. In particular, they can have the effect of infusing trading confidence into transactions that are characterised by costly information and power asymmetries. Moral standards and a complementary legal framework provide infrastructure fundamental to the efficiency of the market system—our moral and legal institutions are an essential part of the capital of the economic system. As Arrow has noted, a lack of mutual trust is among the properties of many societies whose economic development is backward. This argument runs directly counter to Treasury’s claim that unfair trading laws could raise transaction costs generally.

Such social demands can be expressed through the internalised demands of conscience or they can be embodied in formal legal rules. Reliance on the more informal demands of conscience could well have efficiency benefits in some situations because of their adaptability to different circumstances. The calculation involved in the application of rigid rules could well be dysfunctional if cooperative attitudes—with their positive spill-over effects—are undermined. It follows that an exploitative business culture is likely to be less efficient than one in which there is a greater degree of give and take. A number of specific studies have looked at the role played by social convention in helping to sustain collaborative relationships—even where recourse to the courts might have been preferred. In particular, Stewart Macauley researched non-contractual relations in the manufacturing industry in Wisconsin in 1963. He found that business people often preferred to rely on a person’s word in a letter, a handshake or common honesty and decency—even when the transaction involved exposure to serious risks—rather than seek professional legal advice and protect themselves with a tightly worded contract. Macauley discovered that in some cases, business people considered that recourse to legalism in relationship-building indicated a lack of trust, turning a cooperative venture into an antagonistic horse-trade. Any weakening of the social and moral sanctions promoting such give and take could well increase the need for the codification of such standards through law.

The potential exists for significant conflict between the internalised social demands of conscience and the social demands expressed through formal legal rules, particularly in a litigious culture. Lacking extensive experience of the rigid application of the formal rules of contract law, inexperienced small-business operators are likely to expect that standards of conscience will govern—or at
least moderate—the business relationships they enter into. Further complicating this situation is the likelihood that unscrupulous businesses will exploit these expectations in contract negotiations so as to impose harsh contract terms. Of course, unscrupulous businesses have been known to lie about their intentions in order to obtain the agreement of the other party.

It is argued, therefore, that such competition as is permitted is the servant of our fundamental social values, not the determinant of our values. In particular, it is those fundamental values that define what is meant by social welfare. Consequently, such fundamental values as fairness or justice in social relationships are not to be conditioned by more instrumental values such as competition. Competition must therefore always remain bounded; the question that then has to be decided is to what extent? What is also evident is that the debate cannot be settled on the basis of theoretical arguments based on mainstream economic analysis or current moral theories based on individualistic premises. It involves the complex empirical issue of whether, in practice, unregulated markets can produce efficient or equitable outcomes. It appears to be an economic issue that can be answered only by experience—by experimentation. Economic categories do not, however, cover all the possible issues adequately. Some forms of behaviour are simply considered wrong, regardless of the consequences. Consequently, resolution of the question involves the application of practical moral wisdom and can be mediated only by the political process.

Curiously, it appears that we are unable to come to terms with the meanings of the words ‘unconscionable’ and ‘unfair’, while being obliged to pretend that all legal words should have an objective and identifiable meaning available to all. Of course, most people will not have heard of the word ‘unconscionable’, let alone how the courts have used it in recent times. This stands in marked contrast with the word ‘fair’, which is used daily by everyone in our society.

There is a particular irony about the closing phases of this debate as well. At a time when small-business groups were pressing strongly for justice in their dealings with large businesses—pointing in particular to oppressive terms and conditions of contractual arrangements, to the unilateral alterations of terms and conditions and to unfair terminations of long-term contractual arrangements—these same lobby groups were also opposing unfair dismissal laws intended to protect employees from similar unfair conduct by small-business employers.

The next chapter will turn to a more general reflection on the long journey we have shared together.
ENDNOTES

1 Mill 1994, p. 162.
2 Tawney 1926, pp. 252–3.
3 Horwitz 1974.
4 Horwitz 1977.
5 Tawney 1926, p. 157.
6 Hamilton 1931, p. 1133.
7 Horwitz 1977. Horwitz’s comment is applied to eighteenth-century America, but the context makes it clear that it applies with equal force to England in an earlier period.
8 Hamilton 1931.
9 Horwitz 1977.
10 Horwitz 1977b.
12 Viner 1960.
13 Hamilton 1931.
14 Horwitz 1977.
15 Atiyah 1979. In this account of the rise of the doctrine of freedom of contract, I have drawn heavily on Atiyah.
16 Horwitz 1977.
17 Atiyah 1979.
18 Ibid.
20 Horwitz 1977.
22 Gilmore 1974.
23 Horwitz 1977.
26 Atiyah 1979, p. 478.
27 Ibid.
28 Ibid., p. 585.
29 Ibid., p. 587.
30 Taperell et al. 1978.
31 Toulmin 1990.
33 Horwitz 1972.
34 Ibid.
38 Atiyah 1986.
39 Gilmore 1974.
40 Atiyah 1986.
41 Macneil 1980.
42 Atiyah 1986.
Government of Australia 1979. In the event, the committee considered that a law prohibiting ‘unfair’
business conduct was going further and was not compatible with the provisions of Part IV of the Act.
The committee felt, however, that there was great merit in exposing the proposal to debate and discussion
and considered it a worthwhile area for the government to keep under active examination.


Blunt Committee 1979.

Posner 1981.

Campbell 1988.

Arrow 1974.

Macaulay 1963.