

## LEGAL PROMISE AND PSYCHOLOGICAL CONTRACT

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### INTRODUCTION

This Essay argues that the “psychological contract”—the parties’ respective, subjective, idiosyncratic understandings of their contractual obligations to one another—is important and predictable. The common law of contract tells us how to discern the legal promise. By contrast, the “psychological contract” describes how the parties themselves understand their agreements, an inquiry that refers to the legal rules but also relies heavily on evidence from behavioral decision research: psychology, experimental economics, and empirical legal scholarship. The goal of this argument is to uncover the coherent structure of empirical contracts findings. This analysis pulls out the common mechanisms underlying a broad range of behavioral findings and offers a framework for predicting behavioral effects in real-world decisions.

Contracts scholars have always done a lot of talking about promising. Is a contractual agreement the same thing as a promise?<sup>1</sup> Is it wrong to break a contractual promise?<sup>2</sup> Is the contract a promise to perform or a promise to either perform or pay

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1. See, e.g., Jody S. Kraus, *The Correspondence of Contract and Promise*, 109 COLUM. L. REV. 1603, 1604 (2009) (“A natural account of the relationship between contract and promise holds that legal liability in contract enforces a corresponding moral responsibility for a promise.”); Seana Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 709 (2007) (“[A]lthough the legal doctrines of contract associate legal obligations with morally binding promises, the contents of the legal obligations and the legal significance of their breach do not correspond to the moral obligations and the moral significance of their breach.”).

2. See CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* 16 (1981) (“An individual is morally bound to keep his promises because he has intentionally invoked a convention whose function is to give grounds—moral grounds—for another to expect the promised performance. To renege is to abuse a confidence he was free to invite or not, and which he intentionally did invite.”).

damages?<sup>3</sup> Philosophers, judges, and economists have all turned their attention to these questions in the last century.<sup>4</sup> It should not be a surprise, then, to find that empirical legal scholars have begun to weigh in. Recent behavioral work on contract and promise has yielded a torrent of compelling results. A sampling: individuals prefer specific performance to money damages;<sup>5</sup> are more likely to comply with negotiated agreements than take-it-or-leave-it contracts;<sup>6</sup> are less likely to perform when a contract has been assigned;<sup>7</sup> and put more effort into performance when they are threatened with a deduction than when they are promised a bonus.<sup>8</sup> These kinds of findings pose a real challenge. On the one hand, they offer empirical evidence of how people navigate their legal and social worlds, and this is something that any model of contract behavior ought to capture. On the other hand, there are literally dozens of discrete results like these, and there is no obvious way to understand when they matter, how they interact with one another, and how to use them to build a better model of contracting in the real world.

Many scholars have recognized that the content of parties' understandings of their mutual obligations is not fully encapsulated by the contract terms and background law.<sup>9</sup> However, if you cannot figure out what parties think they are agreeing to by looking at the

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3. *E.g.*, Lewis A. Kornhauser, *An Introduction to the Economic Analysis of Contract Remedies*, 57 U. COLO. L. REV. 683, 687 (1986) ("Economic analyses reject the view of contract as promise, and replace it with the idea that contract law ought to promote 'efficiency.'").

4. *See, e.g.*, Randy E. Barnett, *Contract Scholarship and the Reemergence of Legal Philosophy*, 97 HARV. L. REV. 1223, 1223–24 (1984) (reviewing ALLAN FARNSWORTH, *CONTRACTS* (1982)); Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 832 (2003); Richard A. Posner, *Let Us Never Blame a Contract Breaker*, 107 MICH. L. REV. 1349, 1349 (2009).

5. Tess Wilkinson-Ryan, *Fault in Contracts: A Psychological Approach*, in *FAULT IN AMERICAN CONTRACT LAW* 298 (Omri Ben-Shahar & Ariel Porat eds., 2010).

6. Zev J. Eigen, *When and Why Individuals Obey Contracts: Experimental Evidence of Consent, Compliance, Promise, and Performance*, J. LEGAL STUD. (forthcoming 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1640245](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1640245).

7. Tess Wilkinson-Ryan, *Transferring Trust: Reciprocity Norms and Assignment of Contract*, J. EMP. LEGAL. STUD. (forthcoming 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1984656](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1984656).

8. Richard R. W. Brooks et al., *Framing Contracts: Why Loss Framing Increases Effort* (Yale L. & Econ. Research Paper No. 438, at 62, 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1990226](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1990226).

9. *See* Katherine V.W. Stone, *The New Psychological Contract: Implications of the Changing Workplace for Labor and Employment Law*, 48 UCLA L. REV. 519, 553–56 (2001) (explaining that the rise of the "boundaryless career" has resulted in employment contracts that only vaguely define employees' duties, leaving out many details to be filled in later).

contract or looking at the legal default rules, it begins to seem pointless to even try to apprehend the parties' subjective understandings and expectations—but that need not be the case. The baseline commonsense view is that contracts are promises to perform, and breaching a contract is morally wrong in the same way that breaking a promise is morally wrong.<sup>10</sup> Furthermore, empirical research on informal norms in legal decision making has yielded evidence that people draw on a set of consistent moral intuitions and social norms to understand the substance of the promissory obligation.<sup>11</sup> Behavioral economics has been criticized for offering lists of biases and heuristics but no way of predicting the magnitude of each effect or how they interact with other incentives and constraints in legal decision making.<sup>12</sup> The goal of this Essay is to discern some organizing principles for applying psychological research to the law and practice of contractual transactions.

The concept of the psychological contract is drawn mainly from organizational behavior research.<sup>13</sup> Contract law assumes that parties understand their contracts to include both the permissible terms included in the contract and the background rules of contract.<sup>14</sup> Psychological research on contractual exchange, interpreted broadly to include basic experimental research on trust and reciprocity, has offered three main contributions to the field. First, a series of findings suggests that most people do not know the background rules of contract and assume that the applicable rules are in line with their own moral intuitions.<sup>15</sup> Second, in many cases, parties understand their contractual obligations to encompass general moral and social norms of reciprocity and trustworthiness.<sup>16</sup> Third, parties incorporate relationship-specific informal norms and agreements into the psychological contract, even when those norms

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10. Tess Wilkinson-Ryan & Jonathan Baron, *Moral Judgment and Moral Heuristics in Breach of Contract*, 6 J. EMPIRICAL LEGAL STUD. 405, 405–07 (2009) (showing that participants in a series of experiments were sensitive to the moral context of breach of contract).

11. *Id.* at 420–21.

12. See, e.g., Jennifer Arlen, *Comment: The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1768–69 (1998) (arguing that without a theoretical explanation for behavioral results, we need a stronger theoretical link among results and a better-developed sense of the complexity of real decision-making environments).

13. Denise M. Rousseau, *Psychological and Implied Contracts in Organizations*, 2 EMP. RESP. & RTS. J. 121, 134 (1989).

14. See RESTATEMENT (SECOND) OF CONTRACTS § 5 cmts. a–c (1981) (noting that a contract consists of terms upon which both parties agree, contract terms supplied by the law, and contract terms codified by statute).

15. Shiffrin, *supra* note 1.

16. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 58 (1963).

and agreements are clearly outside, or even in conflict with, the explicit provisions of the written agreement.<sup>17</sup>

In other words, the research that bears on the psychological contract is about three different kinds of normative expectations: the normative expectations of the legal system, the normative expectations of our society, and the normative expectations of the counterparty.<sup>18</sup> This parsing of existing empirical literature has important benefits for contracts scholarship. The first is that it takes a series of ad hoc findings and pulls out the underlying mechanisms that connect them. The other advantage this kind of analysis offers is a way to think about how a given result matters for a particular context. For example, how should we think about cognitive bias in a context in which the parties are usually sophisticated repeat players? How will parties represented by counsel differ from those who negotiate directly? This analysis suggests as a starting point to ask what the parties in question believe that others expect of them and what their incentives are for taking those expectations seriously.

The argument proceeds in five steps. Part I introduces the concept of a psychological contract and identifies the overlaps and notable divergences between psychological and legal contracts. Part II presents common misconceptions about contract law that shape the way that ordinary citizens understand their legal obligations in contract. Part III argues that most people believe that their contractual promises include implicit commitments to honor moral and social norms like promise keeping and reciprocity. Part IV argues that even when parties ignore or disclaim background social norms in their contract relationships, they are nonetheless attentive to party-specific norms, taking into account the counterparty's legitimate expectations. Finally, Part V takes up some persistent questions and particular contract doctrines in light of this analysis.

## I. THE PSYCHOLOGICAL CONTRACT

A contract is a promise that the legal system recognizes; the psychological contract is the promise that the parties themselves recognize. Denise Rousseau, a professor and researcher of organizational behavior, first argued for the existence of psychological contracts distinct from written, enforceable contracts in the employment context:

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17. See Rousseau, *supra* note 13, at 123 ("Where interactions occur over time, and continued interaction over time is expected, beliefs regarding what parties owe to each other can arise both from overt promises as well as through numerous factors that the parties may take for granted.")

18. CRISTINA BICCHIERI, *THE GRAMMAR OF SOCIETY: THE NATURE AND DYNAMICS OF SOCIAL NORMS* 11 (2006).

The term psychological contract refers to an individual's beliefs regarding the terms and conditions of a reciprocal exchange agreement between that focal person and another party. Key issues here include the belief that a promise has been made and a consideration offered in exchange for it, binding the parties to some set of reciprocal obligations.<sup>19</sup>

In some ways, the psychological contract looks much like the actual contract. Both are meant to contain the terms of a bargained-for exchange. The psychological contract is not about bare promising; rather, it refers to the parties' expectations of one another in a mutually beneficial deal.<sup>20</sup> Psychologically, at least, the parties believe that their obligations are mutual and supported by consideration.<sup>21</sup> And, indeed, agreement about the terms of exchange is good for productivity. Guillermo Dabos and Denise Rousseau studied employer-employee dyads in university research centers and assessed the extent of consistency between their respective interpretations of the exchange agreement.<sup>22</sup> They found that more agreement about the nature of the contract terms (mutuality) and the implicit exchanges they represented (reciprocity) was associated with measurably higher joint productivity.<sup>23</sup> The psychological contract is not primarily characterized by an employee's unrealistic list of expectations. Rather, it is often an objectively reasonable, and even explicitly agreed-upon, schema for the terms of the exchange.<sup>24</sup>

Also like the real contract context, breach of the psychological contract has to do with the failure of one party to perform, not with the broader category of disappointed expectations. Employers may fail to live up to their employees' expectations in many ways. A company may be less successful than expected, or the coworkers less friendly or helpful, but an employee will not necessarily feel betrayed in these situations. The psychological contract literature argues that employees experience breach when they believe a

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19. Rousseau, *supra* note 13, at 123.

20. *Id.* at 130.

21. RESTATEMENT (SECOND) OF CONTRACTS § 71(2) (1981) ("A performance or return promise is bargained for if it is sought by the promisor in exchange for his promise and is given by the promisee in exchange for that promise.").

22. Guillermo E. Dabos & Denise M. Rousseau, *Mutuality and Reciprocity in the Psychological Contracts of Employees and Employers*, 89 J. APPLIED PSYCHOL. 52, 52 (2004).

23. *Id.* at 60–62.

24. *See id.* at 69 ("The bedrock of functional employment relationships are exchanges between workers and employees characterized by mutuality or shared understanding of all parties' obligations and reliance on their reciprocal commitments.").

benefit is either owed or promised.<sup>25</sup> In turn, the understanding of what is owed and promised depends on the contract schema. A schema is a mental model of a concept or category, sometimes described as “a theory of reality.”<sup>26</sup> It “refers to cognitive structures of organized prior knowledge, abstracted from experience with specific instances” and guides both the encoding of new information and the retrieval of existing knowledge and memory.<sup>27</sup> The schema of a particular contract includes prior beliefs about the nature of the domain as well as explicit rights and obligations iterated during the agreement stage.<sup>28</sup> What this means in practical terms is that people pay particular attention to schema-relevant information. The schema for “dog” includes things like four legs, fur, and barking. We can all agree that a dog with one missing leg is still a dog, but such a deviation from the schematic expectation is surprising and salient. In the employment contract world, the “cashier” schema presumably includes the handling of money and being polite to customers but probably does not include janitorial tasks. It should not be surprising that an employee hired to be a cashier would feel taken advantage of if it turned out that her responsibilities included cleaning toilets, whereas one hired to be a janitor would not.

In other ways, of course, psychological contracts differ substantially from legal contracts—that is why they are a subject worthy of separate consideration. First, the psychological contract is, by definition, subjective.<sup>29</sup> Its terms do not depend on actual or even constructive mutual agreement. To take a famous example as counterpoint, consider *Frigaliment Importing Co. v. B.N.S. International Sale Corp.*,<sup>30</sup> in which two parties to a contract have divergent interpretations of the meaning of “chicken.”<sup>31</sup> The court interpreting the contract goes to considerable effort to figure out what the parties could reasonably be understood to have meant in order to determine the nature of the true contract.<sup>32</sup> Assessing the

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25. Denise M. Rousseau, *Schema, Promise & Mutuality: The Building Blocks of the Psychological Contract*, 74 J. OCCUPATIONAL & ORG. PSYCHOL. 511, 511 (2001).

26. See, e.g., Seymour Epstein, *The Self-Concept Revisited, or a Theory of a Theory*, 28 AM. PSYCHOLOGIST 404, 409–10 (1973).

27. Susan Fiske & Patricia Linville, *What Does the Schema Concept Buy Us?*, 6 PERSONALITY & SOC. PSYCHOL. BULL. 543, 543 (1980).

28. See *id.* at 548 (explaining that a schema allows people to “integrate stimuli into a recognizable pattern” by indexing its characteristics).

29. See Sandra L. Robinson & Denise M. Rousseau, *Violating the Psychological Contract: Not the Exception but the Norm*, 15 J. ORG. BEHAV. 245, 246 (1994) (emphasizing that a psychological contract is formed based on the belief of only one party).

30. *Frigaliment Importing Co. v. B.N.S. Int’l Sales Corp.*, 190 F. Supp. 116, 117 (S.D.N.Y. 1960).

31. *Id.* at 117.

32. *Id.* at 121.

meaning of the psychological contract is much easier: the contract is what each of the parties thinks it is. The fact that there are two psychological contracts does not affect the validity of either one.<sup>33</sup> The psychological contract is defined by one party's understanding of her agreement with another, written or unwritten, legally enforceable or not.

Second, unlike a legal contract, the psychological contract is not necessarily enforceable. Existing scholarship on psychological contracts deals almost entirely with unenforceable terms.<sup>34</sup> This is partly a quirk of the history of psychological contracts, which have been studied mainly in the context of employment contracts.<sup>35</sup> Although formal employer-employee contracts certainly exist, they are necessarily incomplete and quickly out-of-date.<sup>36</sup> However, these unwritten and unenforceable terms are often of great import to the parties.<sup>37</sup> For example, an employee may take a lower-paying job because she understands that the employer is offering long-term stability (for example, government work). In the same vein, an employer may offer a raise to an employee expected to be more productive in a new role. These are contracts that are rarely enforceable in court and, indeed, are not understood by the parties themselves to have legal ramifications.<sup>38</sup>

The idea of the psychological contract has purchase outside of the employment context and ought to be taken seriously even for contracts that the parties believe to be legally meaningful. In the framework I am proposing, I am assuming that every legal agreement involves a psychological contract. On one end of the spectrum, we might have a straightforward one-shot deal negotiated

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33. See Robinson & Rousseau, *supra* note 29, at 246 (explaining how two psychological contracts can be created simultaneously).

34. See, e.g., Jackie Coyle-Shapiro & Ian Kessler, *Consequences of the Psychological Contract for the Employment Relationship: A Large Scale Survey*, 37 J. MGMT. STUD. 903, 907–09 (2000).

35. See, e.g., *id.* at 903 (reporting the results of a large-scale survey that found that most employees and managers believe that most employees have experienced contract breach); Denise Rousseau & R.J. Anton, *Fairness and Implied Contract Obligations in Job Terminations: The Role of Contributions, Promises and Performance*, 12 J. ORG. BEHAV. 287, 287 (1991) (using empirical research to demonstrate that judgments about terminating employees are affected by seniority and past commitments of long-term employment).

36. See Richard C. Reuben, *Democracy and Dispute Resolution: Systems Design and the New Workplace*, 10 HARV. NEGOT. L. REV. 11, 17 (2005) (characterizing the “new workplace” as “dynamic” and requiring flexibility and mobility).

37. See *id.* at 19–24 (delineating some values that characterize the informal relationship between employees and employers).

38. But see *id.* at 24 (suggesting that dispute resolution should be used to resolve conflicts arising out of uncodified employee expectations as a means of preserving the “new workplace”).

by attorneys for which the psychological contract is entirely captured by the written terms. At the other extreme, buyers and sellers may have long-term relationships in which they exchange written forms but explicitly agree that their deal is governed by the informal arrangements that they have worked out over time. In other words, in some cases, the overlap of the enforceable legal contract and the psychological contract may be complete, and in other cases, nearly nonexistent. My contention is only that every contract involves parties who have some mental picture of their rights and obligations, whether this picture is in conflict with the legal contract, complementary to the legal contract, or exactly the same as the legal contract.

The implications of the psychological contract for parties' behavior have been taken up mainly as questions of when employees perceive breach of that contract and how they respond.<sup>39</sup> The remedies for breach of contract are typically negotiated between the parties with the knowledge that a remedy at law is available. The remedy for breach of the psychological contract is essentially self-help—retaliation or exit. One study of graduate management alumni from a top business school found that over half of the respondents reported that their employers had breached the psychological contract, and the psychological contract breach had real consequences.<sup>40</sup> Violations were correlated with employee dissatisfaction and high turnover.<sup>41</sup> Researchers have also observed that when employees perceive a breach, they become more likely to shirk.<sup>42</sup> This kind of effect is largely mediated by the effect of breach on trust. When one party perceives the other party's breach as a betrayal, the loss of trust in turn erodes the non-breaching party's commitment to the contract, which leads to employees putting in less effort or even quitting.<sup>43</sup>

As I have noted, most work on the psychological contract is interested in what happens when the contract is breached. But the concept of a psychological contract has implications for other questions I will take up here. How do parties decide whether to breach their contract? How does the background law affect the psychological contract? How does the actual contract affect the

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39. Elizabeth Wolfe Morrison & Sandra L. Robinson, *When Employees Feel Betrayed: A Model of How Psychological Contract Violation Develops*, 22 ACAD. MGMT. REV. 226, 227, 230–33 (1997) (outlining a model for an employee's cognitive processes preceding perception of breach of the psychological contract).

40. Robinson & Rousseau, *supra* note 29, at 245.

41. *Id.*

42. Sandra L. Robinson, *Trust and Breach of the Psychological Contract*, 41 ADMIN. SCI. Q. 574, 574 (1996).

43. *Id.* at 577.



psychological contract? In other words, what is the content of the psychological contract?

When parties are trying to figure out their contractual obligations, they ask themselves what is expected of them. Philosopher Cristina Bicchieri has argued that the idea of “normative expectations” is crucial for understanding when a norm exists.<sup>44</sup> We know that a particular behavior is a norm not just because a lot of people are doing it but because we understand that other people believe that we *ought* to follow the rule.<sup>45</sup> Here, I am arguing that the psychological contract is informed by a party’s understanding of three sets of normative expectations, those of the legal system, of culture or society, and of the other party.

Norms can affect behavior via multiple pathways. People may choose to follow a norm because they believe that the norm will be enforced, either formally or informally, or because they believe that they are morally obligated to follow the norm irrespective of the prospect of sanctions.<sup>46</sup> In the Part of this Essay on legal norms, I am primarily referring to the rules that parties think will be enforced, though I do not discount the possibility that most people think following the law is the right thing to do even when the possibility of punishment is infinitesimal. In the subsequent Parts on social and party-specific norms, the core of the argument is about “moral norms”—norms that people believe they should follow even without threat of sanctions.<sup>47</sup>

## II. LEGAL NORMS

What help could psychology possibly be in understanding positive law? The most facially plausible answer is probably “none.” If you want to know what the legal system expects of you, surely you should start looking up statutes or checking the case law—the cognitive processes of the citizens bound by a set of legal norms are not especially useful for understanding the actual legal rules. Be that as it may, we may still want to worry about the cases in which parties do not know the legal rule or norm, *but they think they do*. As long as we are in the realm of private decision making, parties’ predictions about a particular legal response matter, irrespective of their basis in actual legal rules.

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44. See Cristina Bicchieri & Erte Xiao, *Do the Right Thing: But Only if Others Do So*, J. BEHAV. DECISIONMAKING (forthcoming), available at <http://www.sas.upenn.edu/ppe/documents/DotheRightThing.10.2.08.pdf> (defining “normative expectations” as “what we believe others think we ought to do”).

45. BICCHIERI, *supra* note 18, at 11.

46. *Id.* at 2.

47. *Id.* at 20.

This is essentially a new twist on an old argument. Robert Mnookin and Lewis Kornhauser introduced the idea of the law as a framework within which individuals act when they described “bargaining in the shadow of the law.”<sup>48</sup> The basic thrust of their proposition is that legal rules can serve as bounds or frames on private ordering.<sup>49</sup> In many cases, the law does not and need not define parties’ entitlements or obligations specifically, but it does place limits on how individuals can choose to define and execute their private agreements. Parties may be limited because they understand that a particular arrangement is prohibited (for example, a penalty clause in contract) or required (for example, certain forms of insurance for employees).<sup>50</sup> But they may also be practically limited because the parties have an understanding of the likely outcome in court—for instance, what a jury would award in a tort case, or how a judge would allocate property in a divorce proceeding.<sup>51</sup> A rational party to a contract who wishes to breach is unlikely to pay the disappointed promisee more than the sum of a court’s likely award plus transactions costs because he knows it is cheaper to go to court. The idea of law as a framework to the parties’ negotiations is a really powerful one, and in this argument I want to leverage it with the following modification: as long as we are talking about private parties making decisions without the aid of counsel, behavior is bounded by the *supposed* legal rule, whether or not it is correct. But what is that supposed legal rule? In the contracts context, what parties think the law requires of them is neither entirely random nor entirely based in fact—studies suggest that people tend to believe that they are bound by the terms of the contract as written.<sup>52</sup>

Evidence from a variety of substantive domains suggests that when people do not know the legal rule, they assume that it is in line with their intuitions. When people do not know the criminal statutes that apply in a jurisdiction, they predict that the applicable law is the intuitive one.<sup>53</sup> In family law, for example, people believe

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48. Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 952 (1979).

49. *Id.* at 950.

50. *Id.* at 953–55.

51. *See id.* at 968–69 (explaining that in divorce proceedings, negotiations are affected by what solution the parties believe the court will impose in the absence of an agreement).

52. Dennis P. Stolle & Andrew J. Slain, *Standard Form Contracts and Contract Schemas: A Preliminary Investigation of the Effects of Exculpatory Clauses on Consumers’ Propensity to Sue*, 15 BEHAV. SCI. & L. 83, 91 (1997).

53. *See* Paul H. Robinson & John M. Darley, *Does Criminal Law Deter? A Behavioral Science Investigation*, 24 OXFORD J. LEGAL STUD. 173, 176 (2004) (presenting evidence that predictions of a legal rule reflect citizens’ respective moral intuitions).

not only that fault *ought* to matter for the division of property at divorce but that it *does*.<sup>54</sup> Even when subjects are informed that fault is irrelevant for the division of property, they predict that the judge will nonetheless take it into account.<sup>55</sup> In this Part, I make two main claims about intuitive approaches to the law of contract. First, many people think that signing a contract is essentially a waiver of most rights, such that any promise formally consented to is binding. Second, they think that the available (and perhaps default) legal remedies include specific performance and punitive damages—remedies that reflect the underlying violation of promise breaking.<sup>56</sup>

A. *Formality and Enforceability*

My first claim is that people think that the legal system holds parties to the explicit terms of their contracts. This has implications for various contract doctrines on unenforceable terms. At the anecdotal level, many law professors have the sense that first-year law students are surprised to learn about the rule against penalty clauses. They believe that if the parties contracted for the penalty, then the court will enforce it. Studies have also observed this effect. For example, one study found that subjects who read a contract with an exculpatory clause reported that they would be less likely to sue than subjects who read the same contract without the exculpatory clause—even though the clause would almost certainly be unenforceable.<sup>57</sup> As Lawrence Cunningham has pointed out, it also means that the notion of consideration is often ignored; most people think that promises to make gifts are legally enforceable.<sup>58</sup> To the extent that ordinary citizens make an intuitive connection between promise and contract, they expect that any freely assumed contractual obligation may be enforced, in the same way that we would hold someone accountable for breaking an ill-considered but nonetheless freely made promise.<sup>59</sup>

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54. See Mnookin & Kornhauser, *supra* note 48, at 991–92 (explaining that even in the wake of no-fault regime, divorce proceedings have retained their adversarial nature).

55. Tess Wilkinson-Ryan & Jonathan Baron, *The Effect of Conflicting Moral and Legal Rules on Bargaining Behavior: The Case of No-Fault Divorce*, 37 J. LEGAL STUD. 315, 317 (2008).

56. There are almost certainly other contract doctrines that people find counterintuitive or misguided, but they are not yet part of the behavioral canon. I suspect many people believe that contracts must be written and signed, for example.

57. See Stolle & Slain, *supra* note 52, at 91.

58. Lawrence Cunningham, *Popular Misconceptions About Contracts*, CONCURRING OPINIONS, <http://www.concurringopinions.com/archives/2011/07/popular-misconceptions-about-contracts.html> (last visited Sept. 14, 2012).

59. *Id.*

*B. Specific Performance and Punitive Damages*

An intuitive account of contract law also diverges from the actual common law in the area of remedies. Many people have the intuition that as long as both parties legitimately agreed to the bargain, the court will “throw its weight on the side of performance” in the famous words of Holmes’s dissenting opinion in *Bailey v. Alabama*.<sup>60</sup> This means that they think that specific performance is common and appropriate even in cases in which damages are easy to estimate. In one study, subjects were presented with six fairly run-of-the-mill breach of contract scenarios.<sup>61</sup> The harms were minor and easily calculable.<sup>62</sup> Nonetheless, more than half of the subjects not only believed that specific performance was appropriate in many of the cases but predicted that at least one of the cases would result in an award of specific performance.<sup>63</sup> Along these lines, subjects also believed that a judge could and would award punitive damages in these contracts cases, punishing willful breachers.<sup>64</sup> Similarly, in a number of studies, subjects have indicated an overall preference for damages above the expectation level—in other words, they seem to want to impose punitive damages.<sup>65</sup>

In all, when ordinary citizens guess (and guess *wrongly*) about the legal rules governing contract, they assume that the terms of the agreement are first and foremost guided by the text of the contract and, in turn, that the court’s enforcement is motivated by that principle, holding people as closely as possible to their actual promises and punishing them for the wrong of promise breaking.

## III. SOCIAL AND MORAL NORMS

Parties to a contract consider themselves to be constrained by the legal rules of contract, the social and moral norms of the culture in which they are contracting, and the party- or transaction-specific norms relevant to the particular contract in question. This Part addresses the role of cultural norms in the psychological contract. At least in the context of American contract law, behavioral research has identified two important norms. First, most people believe that they have a moral obligation to keep their promises.<sup>66</sup> Second, the

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60. *Bailey v. Alabama*, 219 U.S. 219, 247 (1911) (Holmes, J., dissenting); Cunningham, *supra* note 58.

61. Wilkinson-Ryan, *supra* note 5, at 291–92.

62. *Id.* at 292–93. For example, subjects read scenarios about contracts for minor home improvements like painting or floor refinishing.

63. *Id.* at 298.

64. *See id.* at 296, 298.

65. *See, e.g.*, Wilkinson-Ryan & Baron, *supra* note 10, at 414–19 (showing a mean and median preferred damages level above the expectation level in three experimental questionnaire studies).

66. *Id.* at 405.

contractual obligation is affected by the norm of fairness, encouraging parties to reward trust with trustworthiness and to punish selfishness with breach.<sup>67</sup>

#### A. *Promise Keeping*

It is hard to overstate the importance of promise keeping for human cultures. Every known society has espoused a moral rule requiring individuals to honor their promises to one another.<sup>68</sup> Contract scholars were analyzing contract doctrine in terms of the moral requirements of promising well before Charles Fried's book,<sup>69</sup> and modern philosophers of contract continue to argue that contract law is all about promising.<sup>70</sup> This has also played out in the descriptive literature. Relational contract studies speak specifically to the notion of promise, detailing the importance of extracontractual promising for the psychological contract.<sup>71</sup> Even in one-shot games, players in experimental settings are much more likely to cooperate if they have promised to do so.<sup>72</sup> Promise keeping is a strong norm.

Behavioral researchers have struggled with the question of why people keep their promises, an issue with real implications for contract law. One theory is that people have general other-regarding preferences and do not want others to be disappointed; promising generally creates a set of expectations, and that is why breaking a promise is bad. Alternatively, we may think that people have a strong preference for honoring their freely undertaken commitments, in which case it is the promise itself, not the resultant expectations, that contains the core of the moral obligation.

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67. *Id.* at 421–22.

68. *See, e.g.*, Paul H. Robinson et al., *The Origins of Shared Intuitions of Justice*, 60 VAND. L. REV. 1633, 1653–54 (2007).

69. FRIED, *supra* note 2; *see, e.g.*, Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553, 578 (1933); E. Allan Farnsworth, *The Past of Promise: An Historical Introduction to Contract*, 69 COLUM. L. REV. 576, 576, 588–90 (1969); George K. Gardner, *An Inquiry into the Principles of the Law of Contracts*, 46 HARV. L. REV. 1, 7–8 (1932).

70. *See, e.g.*, Aditi Bagchi, *Separating Contract and Promise*, 38 FLA. ST. U. L. REV. 709 (2011); Shiffrin, *supra* note 1.

71. *See* Bagchi, *supra* note 70, at 752 (explaining that commercial promisors often make extralegal representations that are not included in the written expression of their agreements).

72. *See, e.g.*, Gary Charness & Martin Dufwenberg, *Promises and Partnership*, 74 ECONOMETRICA 1579, 1579 (2006) (showing experimental evidence in support of the hypothesis that people strive to live up to others' expectations in order to avoid feeling guilty); Robyn M. Dawes et al., *Behavior, Communication, and Assumptions About Other People's Behavior in a Commons Dilemma Situation*, 35 J. PERSONALITY & SOC. PSYCHOL. 1, 3 (1977) (finding that when players announce their intentions to behave generously they are more likely to do so than if they simply get to know one another).

Experimental evidence suggests that there is real support for the latter explanation—that the preference is at least partially dependent on the promise itself.<sup>73</sup>

Decision researcher Christoph Vanberg used a “Dictator Game” to test the explanations.<sup>74</sup> In a Dictator Game, the Dictator is given some amount of money and then instructed to offer any or none of it to the Recipient.<sup>75</sup> The Recipient receives whatever was offered, and the game is over.<sup>76</sup> Players typically do not meet face-to-face and communicate only by computer.<sup>77</sup> In this version, players were paired up before being assigned their roles and told that the Dictators would be able to make one of two choices: either to keep fourteen Euros and give nothing to the Recipient, or to keep ten Euros and give the Recipient a five-sixths chance of receiving twelve Euros (with a one-sixth chance of receiving nothing).<sup>78</sup> Most pairs exchanged promises that the Dictator would choose the sharing option.<sup>79</sup> After the players were told their roles, half of them were switched to new partners.<sup>80</sup> Then the Dictators made their choices.<sup>81</sup> Vanberg found that Dictators were less likely to share when they were matched with a new partner, even if they knew that the new partner had been promised sharing by her previous partner.<sup>82</sup> Thus, in two situations with equally deserving, expectant promisees, the players most likely to be generous were those who had made the particular promise, to the particular counterparty, to be generous.

Evidence from this controlled, incentive-compatible experiment comports with reports from formal and informal surveys of contracting parties. For example, self-reported data from a study of moral intuitions in contract indicate that people think that breaking a contract is more morally culpable and ought to be more severely punished than an identical harm in tort.<sup>83</sup> That means that the broken promise is treated as an additional blameworthy act. In theory, people could believe that a promise in contract is the kind of

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73. Christoph Vanberg, *Why Do People Keep Their Promises? An Experimental Test of Two Explanations*, 76 *ECONOMETRICA* 1467, 1467 (2008).

74. *Id.* at 1469.

75. *Id.*

76. *Id.* at 1469–71.

77. *Id.* at 1471.

78. *Id.* at 1469.

79. *Id.*

80. *Id.* at 1471–72.

81. *Id.* at 1472.

82. *Id.* at 1473.

83. Wilkinson-Ryan & Baron, *supra* note 10, at 405 (reporting questionnaire results showing that subjects believed that higher fines should be levied against a breacher than a tortfeasor and that the breacher’s conduct was more immoral).

promise that Holmes envisioned—a promise to either perform or pay damages.<sup>84</sup> Substantial evidence suggests that this is not the case.<sup>85</sup> For most ordinary citizens, keeping one's word means actually undertaking the promised performance. As one participant in an earlier study of my own commented, “[p]eople should be held to their word, and a contract is the legally binding word.”<sup>86</sup>

### B. Fairness

The intuitive connection between promise and contract is so strong that it can obscure the equally important relationship between contract and notions of fairness. Contracts in the American common law tradition require promising (mutual assent), but that is not, of course, sufficient. There must also be consideration—a mutuality of obligation, or an exchange.<sup>87</sup> It is this element of exchange that implicates fairness norms. You can break a promise without being unfair to the promisee, but any exchange is subject to judgments about the fairness of each party's formal obligations and actual performance. In contract law, courts formally take up fairness questions in a variety of contexts that deal with the nature of the parties' obligations to one another: when they consider whether the promise is illusory,<sup>88</sup> when they decide whether a party has breached,<sup>89</sup> and when they decide whether the contract is unconscionable.<sup>90</sup> Individuals also understand their obligations with reference to fairness norms. Within contracts, parties have to make a number of decisions about how to perform—decisions that are essentially guided by the terms of the psychological contract. In this Subpart, I argue that parties understand their obligations in terms of reciprocity and bounded self-interest.

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84. *Bailey v. Alabama*, 219 U.S. 219, 247–49 (1911) (Holmes, J., dissenting).

85. *Wilkinson-Ryan & Baron*, *supra* note 10, at 407–08.

86. Participants' Comments to Online Study (July 28, 2006) (unpublished comments on file with author) (study available at <http://finzi.psych.upenn.edu/~baron/ex/tess/con3.htm>).

87. RESTATEMENT (SECOND) OF CONTRACTS § 71 (1981) (“To constitute consideration, a performance or a return promise must be bargained for.”).

88. *See, e.g.*, *Wood v. Lucy, Lady Duff Gordon*, 118 N.E. 214, 214–15 (N.Y. 1917) (inferring a duty to promote sales where there would otherwise be no consideration).

89. *See, e.g.*, *Mutual Life Ins. Co. of New York v. Tailored Woman*, 128 N.E.2d 401, 403 (N.Y. 1955) (holding there was no breach where the defendant acted in such a way that did not maximize the plaintiff's profits, but did so in good faith).

90. *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445, 448–50 (D.C. Cir. 1965) (holding a contract invalid where terms were unreasonably favorable for the defendant).

### 1. *Reciprocity*

Reciprocity norms cut in two directions. First, people often reward trust or generosity with trustworthiness and reciprocal generosity. Second, they respond punitively to selfishness and greed.

The implications of positive reciprocity norms for contract are straightforward. There are lots of ways in which parties have leeway in how they treat one another. Reciprocal generosity may take the form of allowing minor delays or modifications without complaint, performing fully rather than shirking on the margins, or, when breach is more profitable than performance, performing and forgoing an additional profit. In a typical contractual exchange, the promisor has at least two reasons to be generous toward the promisee. First, the promisee has chosen the promisor from the group of possible counterparties. This confers a material benefit on the promisor (for example, landing a job) and signals that the promisee believes that the promisor is trustworthy. Second, the promisee has often already begun or even completed performance.

The paradigmatic experimental design used to demonstrate this type of reciprocity is the “Trust Game,” and it has been used by a number of scholars to test explicitly contractual hypotheses.<sup>91</sup> The Trust Game has two players: an Investor and a Trustee.<sup>92</sup> The Investor is endowed with some amount of money, often ten dollars, and advised that she may pass any amount of it to the Trustee.<sup>93</sup> Any money passed to the Trustee triples so that the Trustee receives three times the amount that the Investor gives up.<sup>94</sup> In the last move of the game, the Trustee may pass back some of her endowment to the Investor.<sup>95</sup> In various iterations on this game, experimenters have demonstrated that Investors usually make a positive amount of money on their investments in Trustees, even though Trustees have no extrinsic incentive to give away any of their money.<sup>96</sup>

The moral and social norm of positive reciprocity is clearly relevant in contract law, but the parallel norm of retaliation is also

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91. See, e.g., Iris Bohnet et al., *More Order with Less Law: On Contract Enforcement, Trust, and Crowding*, 95 AM. POLI. SCI. REV. 131, 133 (2001) (using a Trust Game to test the effect of enforcement on contract performance); see also Ernst Fehr et al., *Reciprocity as a Contract Enforcement Device: Experimental Evidence*, 65 ECONOMETRICA 833, 836 (1997) (using a repeated Trust Game to demonstrate the effect of opportunities for reciprocity on worker effort in the employment contract context).

92. Joyce Berg et al., *Trust, Reciprocity, and Social History*, 10 GAMES & ECON. BEHAV. 122, 123 (1995).

93. *Id.*

94. *Id.*

95. *Id.*

96. *Id.*



important, if less obvious. Negative reciprocity comes into play with respect to both breach and performance: aggrieved parties will want to punish selfish breaches of contract, and selfish or distrusting behavior by one party will decrease the other party's incentives to perform.<sup>97</sup> People experience breach of contract as a betrayal, and when they believe that the other party has been selfish, greedy, or dishonest, the desire to punish is exacerbated.<sup>98</sup> Subjects in questionnaire experiments report that they think that greedy breachers should be punished more severely than unfortunate breachers.<sup>99</sup> They are more sympathetic toward accidental breaches than otherwise identical breaches caused by minor shirking and are apt to punish dishonesty more harshly than ineptitude, holding the magnitude of harm constant.<sup>100</sup>

Even when the parties remain in the contract, negative reciprocity norms may affect performance. The classic case is the self-fulfilling prophecy of distrust—a promisor who believes she is not trusted and is untrustworthy in response. Entering a contract is often an indication in itself of a party's trust for her counterparty. However, by the terms of their agreements, parties can choose and express their respective levels of trust. One indicator of distrust is monitoring.<sup>101</sup> The paradigmatic example of this might be in the childcare context. Parents can choose to trust that their babysitters are going to be hard working, kind, and responsive—or they can buy a NannyCam and watch for themselves. Swiss economist Bruno Frey has modeled the worker's utility function with the inclusion of a "conscience" element and has argued that if there is no mutual trust relationship with the employers, the employee's marginal benefit from work effort may be overcome by "profitable shirking."<sup>102</sup> When a psychological contract exists between parties, increased monitoring is perceived to be an indication of distrust, in turn inducing the monitored parties to put less effort into their work.<sup>103</sup>

This model has been borne out experimentally. In one laboratory game, players were partnered in a principal-agent relationship.<sup>104</sup> The agent began the game with an endowment, and

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97. *Id.* at 138.

98. Wilkinson-Ryan & Baron, *supra* note 10, at 421.

99. *Id.* at 405.

100. Tess Wilkinson-Ryan & David A. Hoffman, *Breach is for Suckers*, 63 VAND. L. REV. 1003, 1032–33 (2010).

101. See Seth J. Chandler, *Visualizing Moral Hazard*, 1 CONN. INS. L.J. 97, 98 (1995) (explaining how monitoring is one way in which contracting parties may ensure compliance under a contract, but arguing that doing so is costly).

102. Bruno S. Frey, *Does Monitoring Increase Work Effort? The Rivalry with Trust and Loyalty*, 31 ECON. INQUIRY 663, 665 (1993).

103. *Id.*

104. Armin Falk & Michael Kosfeld, *The Hidden Costs of Control*, 96 AM. ECON. REV. 1611, 1614 (2006).

the principal with nothing.<sup>105</sup> The primary task for the game was for the agent to decide on a productivity level (essentially a decision about how to share the endowment), choosing from a predetermined set of productivity levels.<sup>106</sup> The principal was permitted to further restrict the decision set to raise the minimum productivity.<sup>107</sup> Experimenters compared the agent's productivity in three conditions: no productivity requirement, exogenous productivity requirement (for example, experimenter raised the minimum), or principal-chosen productivity requirement.<sup>108</sup> When there was no requirement for productivity, agents were productive—more productive or generous than would be expected if they were strict wealth maximizers.<sup>109</sup> When the productivity requirement was exogenously determined, they remained overall fairly generous.<sup>110</sup> However, when the principal set the productivity requirement, productivity fell to the bare minimum.<sup>111</sup> There was a “hidden cost” to control, in the sense that when the principals used formal controls over the agents, the agents reported that the productivity requirement from the principal was a signal of distrust.<sup>112</sup>

There is evidence that this negative reciprocity has effects in contextualized contracts studies as well as in the real world. Studies of liquidated damages clauses<sup>113</sup> and contract assignment,<sup>114</sup> respectively, have offered evidence that people are more willing to breach contracts in which their counterparties have made these self-protective moves. One salient example of negative reciprocity in high-stakes, real-world contracting involves strategic default on subprime mortgages. In a number of debates over the economic and moral implications of defaulting on a home loan, commenters have suggested that walking away from an underwater loan seems much less problematic when the counterparty is a bank that has itself acted in bad faith by peddling subprime loans in already vulnerable communities.<sup>115</sup> Parties to contracts have real power to adjust their behavior to respond to the moral and social incentives and reciprocity.

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105. *Id.*

106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.* at 1617.

110. *Id.* at 1619.

111. *Id.* at 1621.

112. *See id.*

113. Tess Wilkinson-Ryan, *Breaching the Mortgage Contract: The Behavioral Economics of Strategic Default*, 64 VAND. L. REV. 1547, 1549–50 (2011).

114. *Id.* at 1574.

115. *Id.* at 1564.

## 2. *Bounded Self-Interest*

When parties enter into a contractual relationship, they change their interpersonal stance. They may not become friends or partners, but they are no longer permitted to exploit every weakness or grab every advantage. In contract law, this principle is espoused in the duty of good faith and fair dealing.<sup>116</sup> In the psychological contract, the colloquial understanding of this duty has some particular parameters: parties often believe that it is fine to *protect* a profit at the expense of others but unfair to seek to *increase* a profit at their expense.<sup>117</sup> Daniel Kahneman, Jack Knetsch, and Richard Thaler refer to this as the “reference transaction,” a term that explicitly refers to the underlying Prospect Theory mechanism behind the effect.<sup>118</sup> Of course, economists would say that the distinction between seeking and keeping a profit is essentially meaningless, insofar as it depends entirely on framing.<sup>119</sup> The idea is that parties evaluate the fairness of a party’s actions by looking to the reference transaction.<sup>120</sup> In the contract context, the reference transaction is the original contract. An example from the original paper is as follows:

A small company employs several workers and has been paying them average wages. There is severe unemployment in the area and the company could easily replace its current employees with good workers at a lower wage. The company has been making money. The owners reduce the current workers’ wages by 5 percent.<sup>121</sup>

Seventy-seven percent of respondents thought this was unfair.<sup>122</sup> But if the company’s position is different, the norm changes. When subjects read that “[t]he company has been losing money. The owners reduce the current workers’ wages by 5 percent,” only thirty-two percent thought that the wage-cut was unfair.<sup>123</sup> In this example, the contract is the employment contract between the company and its workers. The contract is for a certain kind of labor in return for a specified wage. The original terms are the “reference transaction.” The firm is permitted to “breach”—to

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116. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.”).

117. Daniel Kahneman et al., *Fairness as a Constraint on Profit Seeking: Entitlements in the Market*, 76 AM. ECON. REV. 728, 728 (1986).

118. *Id.* at 729.

119. *Id.* at 731.

120. *Id.* at 729.

121. *Id.* at 733.

122. *Id.*

123. *Id.*

deliver less than it promised in the original contract—in order to protect its original profits. It is not permitted to burden the other party in order to add to its own benefit.

Oliver Hart and John Moore have used the idea of the reference transaction in their development of a model of behavior called “contracts as reference points.”<sup>124</sup> Hart and Moore posit that contracts shape parties’ expectations, and thus their evaluations of outcomes.<sup>125</sup> As such, parties who enter into low-profit deals and earn low profits are content; parties who enter into more flexible deals and earn the same low profits are aggrieved.<sup>126</sup> This prediction was tested by Ernst Fehr, Oliver Hart, and Christian Zehnder using a laboratory game.<sup>127</sup> I describe the game in detail here because its results have very interesting implications for contract. Participants in the game were assigned to be either buyers or sellers who participate in an auction.<sup>128</sup> Buyers could choose to offer a rigid contract with a fixed price determined by the auction or a flexible contract in which the auction determined only the lower bound of the price.<sup>129</sup> Once buyers and sellers were paired, they were informed about the “state of nature” or the market value of the trade.<sup>130</sup> If the contract is rigid, the state of nature has no effect on the trade because the price is set.<sup>131</sup> If the contract is flexible, the buyer chooses how to set the price within the established bounds.<sup>132</sup> The final decision is the seller’s: the seller can choose what level of “quality” to provide—in this game, choosing low quality means choosing unilaterally to decrease the buyer’s profit.<sup>133</sup> The main variable of interest is how sellers respond to low profits across contract types (rigid vs. flexible) when the value of the trade is high.<sup>134</sup> When the contract is rigid, they offer normal quality—that is, they do not do anything to decrease the buyer’s profit.<sup>135</sup> When the contract is flexible, however, sellers are more likely to offer low quality.<sup>136</sup> This means that players did not retaliate when the buyer was selfish at the auction stage; they only retaliated when a buyer

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124. Oliver Hart & John Moore, *Contracts as Reference Points*, 123 Q.J. ECON. 1, 1 (2008).

125. *Id.* at 2.

126. *Id.*

127. Ernst Fehr et al., *Contracts as Reference Points: Experimental Evidence*, 101 AM. ECON. REV. 493, 493 (2011).

128. *Id.* at 497.

129. *Id.* at 498.

130. *Id.* at 499.

131. *Id.*

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.* at 507.

136. *Id.*

with flexibility was selfish at the performance stage. Once the buyer is in the contract, he is no longer permitted to raise his own profits at the expense of the seller's expected profit.

The idea of the contract as a reference point for understanding expectations helps to explain, and predict, a variety of contract behaviors. For example, experimental evidence suggests people are more sympathetic toward a breacher who breaks a deal in order to avoid an unexpected loss than they are toward a breacher who breaks a deal to take advantage of an unexpected opportunity for gain.<sup>137</sup> A party who asks for an increase in the contract price to respond to an increase in costs of materials is regarded as sensible, but one who asks for a higher price in response to increased demand or need is regarded as exploitative.<sup>138</sup> Most people are highly loss averse, and this aversion helps define the boundaries of fair dealing within the contract.<sup>139</sup>

#### IV. PARTY-SPECIFIC NORMS

The previous Parts argued that the psychological contract encompasses background norms of fairness and promise keeping. These are general norms, norms that most people take into account by default. In this Part, I turn to the more idiosyncratic norms that form between two parties to a contract. These unwritten elements of the agreement may be the result of explicit communication between the parties, or they may come about in the context of a long-term exchange relationship in which the parties' behaviors have become predictable.

##### A. *Customs, Relationships, and Contracts*

In many ways, the existence of party-specific norms is one of the easiest propositions to defend to a contracts audience. This is a concept that has been around for a long time, and one that began with traditional legal scholars rather than social scientists. In 1963, Stewart Macaulay interviewed both businessmen and attorneys practicing in Wisconsin.<sup>140</sup> He found that when parties to a contractual exchange were engaged in repeated similar transactions, they often relied on "normal business patterns" to define their obligations.<sup>141</sup> When disputes arose, most interviewees reported that they preferred to settle the matter without reference

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137. Wilkinon-Ryan & Hoffman, *supra* note 100, at 1041–43.

138. Kahneman et al., *supra* note 117, at 729.

139. *Id.* at 731.

140. Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55, 55 (1963).

141. *Id.* at 58.

to the written contract, and certainly without resort to formal dispute resolution.<sup>142</sup>

The importance of repeated transactions is clear not only for contract dyads but for small communities with known standards of transacting. In such cases, parties know how others have behaved in the past even if they have not been directly involved with one another. One of the most interesting case studies in Macaulay's study involved the colloquial view of "cancelling an order" as distinct from breaching a contract. One business lawyer reported:

Often businessmen do not feel that they have "a contract"—rather they have "an order." They speak of "cancelling the order" rather than "breaching our contract." When I began practice I referred to order cancellations as breaches of contract, but my clients objected since they do not think of cancellation as wrong.<sup>143</sup>

The rule of expectation damages was alive and well in Wisconsin in 1963, but it was understood among parties that it was not a part of the deal. "You don't read legalistic contract clauses at each other if you ever want to do business again," said one purchasing agent.<sup>144</sup> These parties had expectations of one another based on previous customs in that business. This is not "custom" in the sense it is used in contract doctrine—it seems fairly clear that a suit for breach would be at least *prima facie* valid in the case of an order cancellation. This is a custom that the parties treat as part of the contract, even though it conflicts with the explicit provisions of the written agreement.

A parallel finding exists from Lisa Bernstein's study of the diamond industry.<sup>145</sup> For the purposes of this discussion, her findings can be broken down into two main observations. First, diamond traders have a set of rules and norms in what is an unusually closed community.<sup>146</sup> They have expectations of one another based on how members of this community have behaved in the past.<sup>147</sup> Second, the diamond traders draft and exchange legally unenforceable agreements.<sup>148</sup> Thus, the parties' expectations of one another in a given transaction are entirely clear, and yet they do not depend on the background law of contracts. In both the Macaulay example and the Bernstein research, we see contracts that can only

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142. *Id.* at 61.

143. *Id.*

144. *Id.*

145. Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relationships in the Diamond Industry*, 21 J. LEGAL. STUD. 115, 115 (1992).

146. *Id.* at 119–21.

147. *Id.* at 121–22.

148. *Id.* at 121–23.

be understood with reference to the particular actors and cultural context.

Even if parties do not follow particular community or industry norms, they may have a history with each other that provides a structure for understanding the meaning of the contract. This concept is not foreign to contract law; the familiar decision from *Hobbs v. Massasoit Whip Co.*<sup>149</sup> is that the plaintiff may recover when the defendant should have known based on previous dealings that the plaintiff took silence to be a manifestation of assent to the contract.<sup>150</sup> Even in less extreme cases, proponents of a relational contracting model have cited numerous examples of contracts whose expectations and methods are only discernible in the context of the long-term relationship of the parties involved.<sup>151</sup>

Finally, aside from the particular customs of a community and a contracting dyad, the contract itself can impart information about what the parties expect from one another. A review of informal norms in contractual relationships can make it sound as though contracts themselves are irrelevant—just pieces of paper passed back and forth as a formality, never read and rarely litigated. This is of course not the case. The basic terms of a contractual exchange are usually dictated by the contract itself. In most cases, parties exchanging widgets for money need not rely on background or informal norms to understand the price or the goods required for performance. Leaving that aside as a relatively uncontroversial proposition, I focus on other cases in which the written contract shapes the psychological contract. These are cases in which the terms are (a) known and (b) contrary to the background norm. By “known,” I mean primarily that the parties have read and understood the terms. A term that the parties do not suspect exists has no effect on the psychological contract. Whether a term is “contrary to a background norm” is a slightly fuzzier question, but the gist is that if the parties would otherwise assume a default rule that is different from the actual term, it will be psychologically salient. In the next Subpart, I look at an example of a common contract term, a liquidated damages clause, to see how the written contract interacts with the background legal and moral norms.

### B. *Liquidated Damages Case Study*

I have argued here and elsewhere that most people believe that they are bound to perform as promised. Many people believe that

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149. *Hobbs v. Massasoit Whip Co.*, 33 N.E. 495 (Mass. 1893).

150. *Id.* at 495.

151. See, e.g., Franklin G. Snyder, *More Pieces of the CEO Compensation Puzzle*, 28 DEL. J. CORP. L. 129, 149 (2003) (explaining that relational contract theory has produced the “truism” that parties who contract with one another long term interact with one another differently than parties who do not).

specific performance is the legal remedy for breach of contract, and even when they know the legal rule, they still believe that the moral and social norm is performance. Legally, of course, the contractual promise is a promise to perform or pay. But this rule does not seem to affect parties' behavior—unless it is written into the contract, in the form of a liquidated damages clause. In an earlier work, I showed study participants a description of a contract and asked them to put themselves in the position of a would-be breacher, someone who faces the choice of whether and when to breach a contract when breach would be more profitable than performance.<sup>152</sup> Subjects who were told that the background rule was for damages were less likely to breach (for example, they required a greater financial incentive to breach) than subjects who were told that an identical damages provision was written into the contract in the form of a liquidated damages clause.<sup>153</sup>

This result suggests two things about the psychological contract. First, if the parties know the background law but do not think that it is in line with the informal norms at play, it is not incorporated into the contract. If knowing the background rule were enough, it would not matter whether it was presented as a background rule or as a stipulation in the contract. Second, the content of the contract *does* matter for how parties understand their obligations. Subjects in that study commented that breach would be less morally problematic in the liquidated damages contract because the other party would not be blindsided.<sup>154</sup> The possibility of breach was explicitly part of the deal.

This case raises an interesting question of interpretation for contracts scholars looking to behavioral decision research. Experimental research has been documenting the effect of small sanctions on cooperation for over ten years.<sup>155</sup> Researchers have shown that the introduction of a penalty for selfishness to a situation in which most people behave generously makes people more likely to behave selfishly.<sup>156</sup> For example, if Investors institute a small penalty of, for example, \$1.50 in a Trust Game for Trustees

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152. Tess Wilkinson-Ryan, *Do Liquidated Damages Encourage Breach? A Psychological Experiment*, 108 MICH. L. REV. 633, 657 (2010).

153. *Id.* at 659.

154. *Id.* at 669.

155. See, e.g., Uri Gneezy & Aldo Rustichini, *A Fine Is a Price*, J. LEGAL STUD. 1, 3 (2000) (presenting the now-famous Israeli daycare study, including evidence that parents asked to pay a fine when they were late to pick up children from daycare were actually more likely to be late than parents not formally penalized).

156. See Ernst Fehr & Bettina Rockenbach, *Detrimental Effects of Sanctions on Human Altruism*, 422 NATURE 137, 137 (2003) (showing evidence of lower levels of altruistic behavior when sanctions were available to punish selfishness).



who do not return generously, more Trustees choose to pay the penalty and keep the rest.<sup>157</sup> Contracts scholars have naturally pondered the analogy between the Trustee in the Trust Game and a promisor tempted to breach a contract in a case when breach is more profitable than performance.<sup>158</sup>

One possible interpretation of the weak sanction literature for contract is that contract law is just like the Trust Game with a sanction. For parties who want to be selfish, contract law lays out the rules and essentially makes every contract into an option contract. On this view, contract law itself nudges individuals to be rational wealth maximizers, and the liquidated damages clause is superfluous. In fact, real-world contracting is unlike the Trust Game in that its contracts exist in a social and moral context. Some people may not know the rule of expectation damages, and others may know it but believe that the moral and social rule favors performance. In either case, the liquidated damages clause updates a party's information about her obligations under the contract. In this sense, the liquidated damages clause is a signal within the contract that the default norm (promise keeping, in this case) does not apply. The parties can use the contract to define not only their particular obligations but also the general expectations and standards that they want to govern their particular relationship.

## V. APPLICATIONS AND HYPOTHESES

I have claimed that the framework set out above can help provide a general approach for understanding the content of the psychological contract. In this Part, I use that framework to think systematically about some of the challenges and open questions in the behavioral contracts research.

### A. *Sophisticated Actors*

One of the most important questions for scholars who discuss informal norms in contracts is whether such norms really apply to the kinds of people who regularly engage in commercial transactions. Or, more pointedly, what is the psychological contract when neither party is an individual and both parties are represented by counsel? When scholars talk about sophisticated actors or sophisticated players, they are referring to people with some combination of superior cognitive skills and relevant experience in the arena.<sup>159</sup> The idea of sophisticated actors is often stretched beyond this to include anyone who appears to have strong wealth-maximizing preferences—commercial actors rather than

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157. *Id.* at 137–38.

158. *Id.* at 140.

159. *See, e.g.*, Bernstein, *supra* note 145.

consumers, and agents rather than principles, for example.<sup>160</sup> One of the reasons one might dismiss psychological findings in the real-world contracts context is that many contracts are between people who (a) are trying to make money and (b) have done this kind of thing before. Alan Schwartz and Robert Scott put it this way: “[W]e speculate that individuals in laboratories may perform worse than officers of firms because experimental subjects have not been trained to make good decisions and are not subject to the pressures to maximize . . . .”<sup>161</sup> For the purposes of my argument, I grant some of the premises of this objection to behavioral research. It is probably true that the average director of a Fortune 500 company knows more about American contract law than people without comparable experience with contracts (or, at least, is less likely to sign an agreement without advice of counsel), and that he or she is more highly motivated to secure a profit, and maybe even less constrained by squishier moral or emotional approaches to contracting.

That said this does not mean that there is no psychological contract, or that parties can afford to ignore it. Let us take an example of a hypothetical contract for a big sale of goods from one large company to another. Under what circumstances might we imagine that their interactions are defined by any informal norms not encapsulated in the contract or the background law? First, we might think that it is precisely the goal of profit maximization that motivates parties to incorporate social norms into their contracts. There are reasons to think that parties stand to gain by being generous and relying on reciprocal generosity rather than formal rewards and sanctions.<sup>162</sup> Among other concerns, contract negotiation is expensive. Second, moral and social norms may have more bite, even in the business context, than many commentators have been willing to admit. In mergers and acquisitions,<sup>163</sup> in insurance,<sup>164</sup> in corporate transactions,<sup>165</sup> and even in securities,<sup>166</sup>

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160. See, e.g., Andrew A. Schwartz, *Consumer Contract Exchanges and the Problem of Adhesion*, 28 YALE J. ON REG. 313, 331 (2011) (distinguishing between consumers and the special position of sophisticated parties whose wealth allows them to dominate contractual relationships).

161. Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 551–52 n.18 (2003).

162. See, e.g., Bohnet et al., *supra* note 91 (using a Trust Game to test the effect of enforcement on contract performance).

163. See, e.g., Benjamin Grossman, *Another View: Rethinking Reverse Break-Up Fees*, N.Y. TIMES (Aug. 11, 2009, 10:30 AM), <http://dealbook.nytimes.com/2009/08/11/another-view-rethinking-reverse-break-up-fees/> (arguing that reverse break-up fees reduce the stigma that acquirers face if they back out of a deal).

164. See, e.g., Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1426 (1993) (“The real promise of the insurance relationship is not ‘if X

there is evidence that some owners, directors, merchants, and salespeople value promise keeping. This means both that sophisticated actors may prefer themselves to keep a promise and that they may punish others perceived to be promise breakers.

Sophisticated actors may also rely on party-specific norms. Diamond wholesalers and retailers, for example, rely on industry norms.<sup>167</sup> Macaulay's Wisconsin businessmen had patterns of interaction with one another, such that each party understood his mutual obligations, but the understanding was quite separate from the written agreement.<sup>168</sup> This is not so unusual. The modern case used to illustrate the "battle of the forms" under the Uniform Commercial Code is *Step-Saver Data Systems, Inc. v. Wyse Technology*,<sup>169</sup> a dispute that is all about parties trading forms back and forth with various conflicting terms, but agreeing among themselves that only some of the terms would be enforceable.<sup>170</sup> Even when the contract in question is between two corporations, it is worth asking whether industry practices or extracontractual promises are incorporated into the psychological contract.

Of course, commercial actors are not always paired with other commercial actors. In fact, the vast majority of contracts are contracts between individual consumers and their corporate counterparties.<sup>171</sup> In these cases, rational-maximizing companies may prefer to exploit every permissible advantage—but they do not, because they fear reputation effects. If, for example, consumers expect companies to waive certain late fees or penalties when there is a good (but not legally cognizable) excuse, the companies may choose to do so, even though they are not so obligated under the formal contract. Similarly, a service provider dealing with a homeowner may decide not to breach, even if breach would be efficient and the homeowner could be fully compensated, because the service provider believes that the homeowner would be angry in the event of breach. In experimental research on moral harm in

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happens, we'll pay Y dollars', but rather 'we'll be there for you,' keeping your life or business together when disaster strikes.”).

165. See, e.g., Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1271 (1999) (arguing that corporate law is sensitive to moral and social norms including trustworthiness and loyalty).

166. See Eric Talley, *Disclosure Norms*, 149 U. PA. L. REV. 1955, 1959 (2001) (observing that informal norms of honesty can augment federal securities law).

167. See discussion *supra* Part IV.A.

168. See discussion *supra* Part IV.A.

169. *Step-Saver Data Sys., Inc. v. Wyse Tech.*, 939 F.2d 91 (3d Cir. 1991).

170. *Id.* at 96–98.

171. W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 529–30 (1971) (observing that standard form contracts account for more than ninety-nine percent of all contracts entered into).

contract, a number of participants have volunteered that they would be unwilling to breach a contract because of the reputation effects.<sup>172</sup> For example, one study surveyed law students on their attitudes toward efficient breach, showing them a situation in which the breacher would fully compensate the promisee.<sup>173</sup> The respondents said that they would need to earn a significant premium over the efficient amount to be willing to breach, and many cited reputation effects.<sup>174</sup> For example: “I think in all the situations it is economically efficient to breach the contract and give compensation to the party suffering the breach, but I think it is unwise in terms of potentially harming the breacher’s reputation to do so,” or “To the extent that breaking a promise hurts his reputation, it is a bad business decision.”<sup>175</sup>

Sometimes, the question about sophisticated parties is framed in terms of repeat players.<sup>176</sup> This is a similar idea—both are assumed to have acquired superior skills in one way or another, and thus to be less vulnerable to cognitive biases. The repeat player concern mainly highlights the importance of reputation. Thus, on the one hand, we may believe that repeat players learn how to minimize their mistakes, but they may also learn the norms of the interaction such that they are less likely to offend the counterparty and suffer the consequences.

Legal scholars are sometimes skeptical that behavioral-decision research could bear on the kinds of contracts that drive most contract law and policy—sale of goods, construction contracts, and contracts of adhesion.<sup>177</sup> But this research is about more than heuristic reasoning and cognitive bias. It also aims to describe how people across a variety of contexts rely on informal norms rather than formal rules to shape their behavior.<sup>178</sup> Sophisticated actors may not mistake norms for rules, but that does not mean that they do not take informal norms seriously, whether because of their own personal moral commitments, because they believe that informal contracts are efficient contracts, or because they believe that others expect them to conform and will punish them if they do not.

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172. Wilkinson-Ryan & Baron, *supra* note 10, at 423.

173. Online Survey (Sept. 5, 2008) (unpublished comments on file with author) (full survey available at <http://finzi.psych.upenn.edu/~baron/ex/tess/con121.htm>).

174. *Id.*

175. *Id.*

176. *See, e.g.*, Sarah R. Cole & Kristen M. Blankley, *Empirical Research on Consumer Arbitration: What the Data Reveals*, 113 PENN ST. L. REV. 1051, 1057 (2009) (describing the “repeat player effect,” in which sophisticated companies obtain favorable outcomes in a significant proportion of arbitration disputes against consumers).

177. *See* Wilkinson-Ryan, *supra* note 152, at 634–35.

178. *Id.* at 635.

*B. Individuals and Institutional Counterparties*

Many people share the intuition that the commonsense moral requirements for contracts obligations shift (down, usually) when we are in a contract with a corporate counterparty. It is one thing to think that people adhere to shared moral norms when they are dealing with other individuals—counterparties with a name and a face, as it were.<sup>179</sup> The demands of moral norms may be different, though, with respect to a contract with a company. Imagine a person who has agreed to rent a cottage for a summer vacation and then finds out that something better and cheaper is available (imagining, for the moment, that for one reason or another damages are unlikely). We would not be surprised to find that many more people would stick to the original contract if the cottage was owned by, say, the Smith family than if the cottage belonged to the Marriott Hotels corporation.

But what is the difference? Why do we have this intuition, and when does the identity of the counterparty matter for the psychological contract? As a preliminary matter, I do not think the difference lies in the legal norms. There is no obvious reason to believe that individuals are more likely to think that the law expects performance when they are dealing with other individuals than when they are dealing with corporations—and, indeed, if anything, we might think that they believe corporations are more likely to enforce contracts through litigation.

This leaves two other sets of normative expectations that might differ based on the nature of one's counterparty: the social and moral norms and the particulars of the contract relationship. I have posited two overarching moral norms associated with contract: promise keeping and fairness. My suggestion here is that the moral norm of promise keeping has the same basic purchase in most contexts. For many people, keeping a promise is essentially a personal moral commitment. Going back on your word is a moral wrong whether the promise was to your grandmother or to your mortgage broker. However, contracts require not only promises but bargains, and this is where we may see systematic differences between contracts with individuals and contracts with corporations. Reciprocity matters for contracts generally, of course, and in any contract where one party starts to shirk or act in bad faith, we can expect retaliation. Even absent actual stinginess, corporations may be perceived as being categorically undeserving of generosity, irrespective of their performance in a particular contract. First,

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179. See generally, e.g., Joshua Knobe & Jesse Prinz, *Intuitions About Consciousness: Experimental Studies*, 7 PHENOMENOLOGY & COGNITIVE SCI. 67 (2008) (comparing human counterparties to corporate counterparties).

people think that corporations are generally greedy.<sup>180</sup> In the current social and economic climate, for example, people explicitly blame corporate free riding for the economic woes of the lower and middle class.<sup>181</sup> Second, people may think that breaching a contract with a firm does not result in the same level of economic harm as breaching a contract with an individual, insofar as firms are both wealthier and better able to spread the loss across many individuals. Thus, the social and moral norm of fairness may have systematically different implications for individuals in contracts with large corporations.

In general, contracts with individuals will also have a very different relational feel to them than contracts with big corporations. Individuals with credit cards, for example, are highly unlikely to have any specialized or informal understandings with their credit card companies in the manner of the Wisconsin businessmen from Macaulay's studies. However, corporate contracts may nonetheless convey information about the kind of promissory obligation the firm has in mind. For instance, when a cell phone contract includes a penalty for early termination, individuals may understand the company to be communicating that this is not a contract based on informal trust norms.<sup>182</sup> When a mortgage lender sells a homeowner's loan to a third party, it serves as a signal to the borrower that the loan is an impersonal transaction and not a personal promise.<sup>183</sup> In sum, there are reasons to predict, based on behavioral findings, that the psychological contract between an individual and a company invokes fewer moral obligations.

#### CONCLUSION

The economic and legal foundation of contracts is grounded in expectations. Parties enter contracts because they expect to be better off. When contracts fail, damages are measured in terms of the parties' expectations (limited, of course, by doctrines like avoidability and certainty). Contracts scholars need a way to approach the question of what the parties expect without devolving into an exercise in individual mindreading. This Essay presents a

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180. JOHN MACKEY, *WHOLE FOODS, CONSCIOUS CAPITALISM* para.1 (2007) available at [http://www.wholeplanetfoundation.org/files/uploaded/John\\_Mackey-Conscious\\_Capitalism.pdf](http://www.wholeplanetfoundation.org/files/uploaded/John_Mackey-Conscious_Capitalism.pdf) ("Instead corporations are widely perceived as greedy, selfish, exploitative, and uncaring – and interested only in maximizing profits.").

181. See, e.g., Editorial, *The Corporate Free Ride*, N.Y. TIMES, Aug. 18, 2008, at A18 (referring to the "fundamental unfairness" of the American corporate tax system).

182. See Wilkinson-Ryan, *supra* note 152, at 650.

183. Wilkinson-Ryan, *supra* note 113, at 1573–74.

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framework to describe the makeup of the psychological contract. This approach pulls together the different strands of scholarship that have taken an empirical approach to contract: the intuitive moral connection between contract and promise, the evidence from experimental economics of strong preferences for equity and reciprocity, and the focus on reputation and personal relationships from relational contracting. The world of contracts is big and diverse. The psychological contract construct is a systematic way to assess the social, moral, and practical meaning of promissory obligations.