

FROM FREEDOM OF CONTRACT TO CONSTRAINT OF CONTRACT: A MAJOR CHANGE IN CONTRACT THEORY AND FRAMEWORK

Donald B. KING *

Introduction

Some very major changes have taken place in terms of the framework of Contract Theory this relates to both to the general overall setting for Contract Theory and to individual portions of what might have previously been considered significant parts of Contract Law. These changes are very significant and relate to the realities of modern contracts, both in the commercial and consumer realms. The changes to a large extent reflect a shift away from a philosophy of freedom contract which had prevailed the law. It was not, however, a deliberate or even recognized change. Instead it has taken place gradually and in a variety of ways as discussed in this paper. Rather than there being a setting of freedom of contract, with its wide parameters, there is instead a constraint of contract setting which impose major limitations. It is within these theoretical lines of legal control that contracts must be drafted and performed. Otherwise they will be exposed to attack and judicial scouting. While some leeway of choice in contracting exists, it is only within the Constraint of Contract bonds.

It's somewhat ironic that many persons trained in the law still view Contract Theory in a manner which is out of accord with reality — that is in a context of "Freedom of Contract." Instead, it should be viewed in a setting of "Constraint of Contract." The legal profession has failed to recognize this new philosophy and to adequately adjust to it. later when sailing vessels daringly span the oceans in the trade of goods,

Background

Freedom of Contract has in many senses become very dated and out of the accord with reality. In earlier times, when trade crossed deserts and mountains in caravans relaying goods from point to point, or even

*Professor Law, Saint Louis University, President of the Academy of Commercial and Consumer Law.

later when sailing vessels daringly span the oceans in the trade of goods, freedom of contract may have been more useful and inevitable. Or in the time of the great expansion of manufacturing and trade caused by the industrial revolution, freedom of contract may have served to open new industry and the price paid by society seemed worthwhile. For the U.S. as a young nation, the great industrialists, the railroad magrates who building of railroads connected shore to shore of the continent, and other businessmen, freedom of contract permitted business expansion. In a still later era, when a new demand for consumer goods arose and an the average man gained the ability to purchase numerous consumer items, freedom of contract may have been considered important in opening up this vast new market. But with some greater stability in the establishment of business in regard to society, and with a greater social conscience and a gradual recognition of consumer rights, freedom of contract as it existed previously became more questionable. Even between business, the multitude of transactions and the use of printed forms made freedom of contract more theoretical than a pragmatic. In part the law has changed to meet some of the realistic considerations without noting that the atmosphere of freedom of contract has largely become illusory, and the constraint of contract is now a more common phenomenon.

Modern commentators from the beginning of this century have noted that some change has taken place in particular parts of the law in regard to freedom of contract. In 1919, Professor Patterson pointed out the fact that insurance contracts were often of an adhesion nature. There were terms imposed by the insurance company which were not bargained for or even the subject of negotiation. This phenomenon was also noted in the 1920's by Carl Llewelyn.

He also noted a distinction between dickered and undickered terms of a contract. He noted that many of the terms were a part of a frequently proposal that such "undickered" or "unegotiated" terms became part of the contract only if they could be viewed as reasonable.

The lack of any real freedom of contract was also noticed by various courts. The New Jersey Supreme Court, in *Hennington v. Bloomfield Motors*, pointed out some realistic aspects of the contract situation. This case, decided in the 1960s, is in a period of time when industry had become well established, modern advertising had created a great market, and millions of consumers existed in a society where the automobile had become a necessity and a standard item for almost every adult. One point the court made related to the fact that skilled draftsmen on the manufacturer's side were drowing up the contract clauses, whereas on the consumer's side there was no such expertise. The court also noted trat a monopolistic situation often pervaded some industries. The big three of the U.S. automobile industry had captured over ninety per cent of the market and standardized there printed contract terms. This meant that throughout the entire industry

there could be contracts containing certain standard clauses to which one was forced to agree if he wished to do business.

Constraints

"Constraint of Contract" as a new development is manifest in many forms of limits. Although some of these are discussed elsewhere, they do bear some mention here. One type of control relates to the "new business ethic" of the Uniform Commercial Code. It requires that the contract terms not be unconscionable in the making of the contract. The other relates to the requirement that all contracts must be performed and enforced in good faith. This new business ethic has placed certain limits on some of the contract clauses that would otherwise upheld under a "freedom of contract" atmosphere. A frequent thought which accompanied freedom of contract theory relates to ethics. It is that in the commercial world the law should impose no ethics; one must watch out for oneself—that one must expect the worst and be prepared for unethical business behavior. The caveat emptor — a buyer beware — philosophy of the sixteenth century prevailed for ensuing centuries. It may be partly due also to the rugged individualism of earlier eras. But the drafters of the Uniform Commercial Code, asserting that courts had in the past imposed constraints built this new ethic into a positive and statutory forms. While it's true that the imposition of unconscionability can be rationalized on the basis that no freedom of contract exists in those situations, it also serves as a controlling force. There is policing function which is undertaken by the courts in this regard.

Another limitation upon traditional freedom of contract relates to the reasonableness of the contract clauses. Even the Uniform Commercial Code, which purports in its initial section to support freedom of contract, recognizes limitations on disclaiming responsibility. It points out in §§ 1-102 that obligations of good faith, diligence, reasonableness, and care cannot be disclaimed by the parties. Even if they make an agreement as to standards which are to be utilized in regard to such matters, these are not permissible if they are manifestly unreasonable.

There are limited factors for obligations which may be imposed by custom or usage of the trade. One of these is that the doctrine of unconscionability which carries over from express clauses to implicit clauses resting on usage of trade. There is the policy that that customer usage must be reasonable and the drafters note that the ancient and established policy of policing trade usage by the courts is continued to the extent necessary to cope with unconscionability or dishonesty. While this may not be new, it has been placed in writing in the official comments to the Code. This facilitate use of this ethic by the courts and result in a more widespread application of it. The comments also note that the usages which become part

of the contract must be those observed by the majority of decent dealers and not those of dissidents who are ready to "cut corners."

Standards of reasonableness in contracting have been given emphasis in recent years and other countries as well. For example, under the Unfair Contract Terms Act, clauses which unreasonably limit the seller's or manufacturer's liability for negligence are excluded. The question of what is reasonable is a matter which is for the trier-of-fact to decide. Although there are few cases at this particular point of time, it is quite likely that a number will developed centered around striking contractual terms which are not reasonable.

In Germany, legislature on form contracts require that classes of such contracts must meet the test of reasonableness. Standards as to reasonableness are set forth in the act on Standard Contract terms.

In Sweden, the question of reasonableness of contract terms also arisen. It is provided that unfair contract terms are not permitted. The statute provides also for a governmental agency, the Consumer Ombudsman, to bring actions against companies using such unfair or unreasonable clauses. A special court for the consumer called the Market Court has been established to hear such cases. Some of the unreasonable contract clauses which have been held as unfair by the market court are:

terms which conflict with mandatory law but are still used in contracts

door to door sales clauses binding the cosumer despite his right to cancel

repossession without legal process

unlimited force majeure clauses in consumer contracts which limit the buyer's right to cancel

a clause cutting off consumer's right if the promissory note were transferred to a holder-in-due-course

a clause cutting of the consumer's right to complain about goods after eight days

an arbitration requirement in consumer contracts.

In addition to constraint of contract relating to ethical considerations or standards of reasonableness, there are controls which outlawed certain clases in the various contracts. In the U.S., most of such outlawing of certain types of clauses has been found in consumer protection legislature. The Uniform Consumer Credit Code contains sections which outlaw or make invalid a number of terms. This applies to contracts with the con-

sumer in regard to consumer credit. Some of the clauses which are prohibited are those relating to the buyer waivering defenses against a holder in due course or assignee of their contract, the use of clauses which are purport to give value or discount for referrals of names of prospective buyers, terms calling for balloon payments ,and cross-collateral security clauses. In addition, there are prohibitions on the types of secured interests which can be taken and the rights of the seller in regard to such interest upon defaults. In addition, other clauses relating to seller remedies are modified by allowing the buyer to cure his failure to make a required payment on time. There is a statutory definition of default and limits placed on the seller right to accelerate the total amount. The Act further states that while the UCC broadly permits variations by agreement, this Act starts from the premise that the consumer may not in general waive or agree to forgo rights or benefits under it.

In the English Unfair Contract Terms Act, there is also a prohibition of certain types of clauses: For example, the disclaimer of liability for personal injury from negligence or defective products is prohibited. In the German Act there is also a number of standard clauses which are specifically outlawed. For example, a party cannot use a clause which gives him an unreasonably long time to accept or regaret an offer of another party. A choice of law clause in an international contract for which no justifiable interest can be shown is void under German law. A clause exempting a business from liability for gross negligence likewise is not allowed. Other prohibited clauses deal with the altering of the normal burden of proof; restriction of liability on express warranties, a limitations on short term price raises.

In Sweden, there are certain terms which have been outlawed by virture of the consumer rights set forth in legislation. The Consumer Sales Act and Door-to-Door Sales Act contain a number of these rights.

Realities

Not only has there been movement from freedom of contract to constrained contracts through various concepts and prohibitions in the law, but also through the realities surrounding of modern contracting. Certainly in the consumer's everyday world of purchasing, he is confronted often with a printed form contract on which there are not negotiations. The consumer generally does not debate it. This is true of the purchase of both goods and services. He does not negotiate about the terms stamped on the back of a parking lot ticket as he is driving through the automatic parking lot gate. He does not enter into negotiations at the hotel desk about all the terms concerning his room and liability for his luggage. The consumer is not seen at the airline counter debating the terms printed on the back of his ticket. He does not entere into a heated argument with the salesman of manager

of a department store concerning terms on the back of a sales receipt or found in a warranty brochure. Even in buying an automobile or very expensive appliances, he does not enter into negotiations concerning the terms found in the contract warranty booklet or sales agreement or receipt. It is totally against all realities to say that there is any room for bargaining in this regard and hence any freedom of contract. Because the terms of these contracts are often similar within an entire trade of industry, he has not even the choice to change the terms by buying elsewhere.

In the commercial world, a very large number of transactions are conducted through exchange of printed forms which create the contract. There is a printed order form and a printed acknowledgement on with all of their boilerplate language. Although this is a topic in and of itself, it is a reality which conflicts with the idea of negotiating in an atmosphere of freedom of contract. It looks to in ascertaining whether or not the prevailing atmosphere is one of "freedom of contract" or "constraint of contract." Even these forms are most skillfully drawn by each party, they will have the effect of cancelling out each other in many situations. Thus, the contract is a much more limited one than either party had envisioned. The cancelling out effect leaves some points uncovered. In regard to missing terms or obligations, the law provides the standards for these terms. The contract thereby becomes constrained to the terms prescribed by law.

Even though in some commercial contracts there is negotiation and hard bargaining on many terms, for most part the reality even in the commercial world is one of constraint of contract. This is so because of the limits imposed by the "new business ethic" and other requirements of reasonableness mentioned earlier. Since this is so, it is unrealistic to speak so much in terms of freedom of contract, rather one should think in terms of constraint of contracts.

Effects

A constraint of contract theory will also have the interesting effect of upholding some contracts which would otherwise fall if a freedom of contract theory was utilized. This is primarily because of the recognition under constraint of contracts theory of what constitutes a sphere of reasonable terms and the recognition of court power to read such terms into the contract.

Under the traditional freedom of contract theory, the terms were the responsibility of the parties. The terms were those which the parties agreed upon. If the parties failed to agree upon the number of terms, or did not exercise their ability to contract in this regard, the contract was often declared by courts to be too indefinite to be enforced. This created a doctrine of definiteness of agreement in order for there to be a contract.

Under the Uniform Commercial Code, a contract may still be created even though a number of its terms are not agreed upon by the parties. The contract does not fail for indefiniteness if the parties intended to contract. In terms of contract formation, the Code declare that a contract in such situation exists.

The missing terms of the contract may be filled in with usage of trade, course of dealing, or course of performance. These are defined as part of the terms of the agreement under the Code. Even terms supplied by these means are subject to constraint of contract. As mentioned earlier, the constraint which is exercised on usage of trade is that of the reasonable practices of merchants generally. Likewise it is limited to those practices of decent dealers or merchants and not the practices of "corner-cutters" or unethical businessmen.

In cases where there is not trade usage or prior course of dealing or performance, then the Code provides for certain basic terms to be read into the contract by the court. These terms are consistent with the "constraint of contract" theory in that they represent a standard of reasonableness and common expectations. They do not carry with them the extremes which might have been obtained had the parties exercised their powers under a freedom of contract theory. For example, if the parties fail to provide for a price, or agree to agree upon a price under none is agreed upon, or simply leave the price term open, then the court will fill in a reasonable price under the Code. If the place of deliver is not specified, then the Code provides that that shall be at the seller's place of business. If it fails to provide whether delivery is to be in a single unit or several lots, then the goods must be tendered in a single delivery unless circumstances indicate otherwise. If the time or shipment for delivery is let out the contract, the court may read in a reasonable time. If the contract fails to provide for payment, then payment is deemed due by the law at the time and place where the buyer is to receive the goods. If there is no agreement as to the quality of the goods, then the quality is found in the standards of the warranty of merchantability and of the warranty for fitness for a particular purpose. Thus under constraint of contract theory, a contract is said to be formed and reasonable terms are implanted into it by the court.

Secured Interest Contracts

The constraint of contract theory manifests itself also in regard to the security agreement, which is a specialized type of contract related to the taking of secured interests in goods. Freedom of contract in regard to security agreements is controlled by the law in certain crucial ways.

The "new business ethic" which applies generally can be applied by an analogy to such agreements. The unconscionability principle is set forth

in Article Two in the Uniform Commercial Code dealing with the sale of goods. Nevertheless, may be applied by an analogy to secured interests in Article Nine. The same policies of preventing oppression and harsh terms are present. The procedural unconscionability which is found where fine print is involved and the attention of the secured party is not called to certain crucial provisions. In addition the requirement of good faith in the performance of contracts applies to secured directly. That principle is found in Article One and is applicable to all Articles of the Uniform Commercial Code including that on secured agreements.

Certain statutory constraints have been established in regard to contracts taking secured interests in goods of consumers. Under the Uniform Commercial Code, no secured interest may be taken in after-acquired goods unless the consumer acquired them within ten days later. The freedom to take a much larger secured interest in after-acquired goods which would be allowed under normal freedom of contract theory is not permitted.

Freedom of contract becomes even more restrained when one looks at the Uniform Consumer Credit Code. Under it a seller is limited to taking a secured interest in the goods sold, but is not allowed to take a secured interest in other goods or land. The only exception is if the goods sold have become closely connected with such land or other goods. In addition, where there are debts arising from two or more consumer credit sales and these are consolidated into a single debt, payments must be applied so as to satisfy payment of the debt first arising rather than being spread out over all. Under freedom of contract, the seller could put in a clause which allows the payments to be spread out over all debts and the result was that the buyer ended up never paying off a single debt; all of his purchases were constantly subjected to the secured interests. That practice which was declared unconscionable in the *Walker-Thomas* case is now prohibited by statute.

One of the major limitations of the Uniform Consumer Credit Code is that the creditor must choose between repossessing the goods or leaving them with the buyer and suing for a deficiency judgment. Under freedom of contract the seller could both repossess the goods and sue for deficiency judgment. Indeed, this is permitted under the Uniform Commercial Code which allows more freedom of contract in this regard. But under the consumer protection legislation there is constraint of contract.

The equity of redemption is a limitation on freedom of contract which developed at an early time in regard to real estate. The equity of redemption permits the buyer to pay the amount due and recover back the property. This prevents the property from being sold by the creditor; this type provision is found in the Uniform Commercial Code. Freedom of contract is limited in that the equity of redemption exists regardless of what clauses might be in that contract. While the buyer may give up his equity of redemption by agreement after the default, he cannot give it up in advance.

Thus there is a constraint of contract when the parties enter into the basic transaction.

In regard to the procedure which must be followed once there has been repossession of the property by the creditor, freedom of contract is further restricted. This is so under both the Uniform Commercial Code and the Uniform Consumer Credit Code. The statutory requirements for disposition of the property must be followed and cannot be eliminated by contract. Constraint of contract, not freedom of contract, is the doctrine that prevades.

Remedies

In the area of limiting the buyer's remedies, freedom of contract is controlled in major several ways. Thus this area of contracting may be said to be subject to the constraint of contract theory.

Limitation of remedy clauses are subject to the "new business ethic" just as other clauses of the contract. The good faith requirement of the Uniform Commercial Code requires that only good faith in the performance, but in the enforcement of the contract as well. This means that the limitations provided in the contract on the enforcement machinery can be exercised only in accordance with good faith.

Clauses in contracts limiting remedies are also subject to the concept of unconscionability. Indeed, some of the examples of unconscionable clauses given in the comments to the unconscionability section of the Uniform Commercial Code deal with clauses related to contract remedy. Some of these clauses concerned the buyer's remedy to return goods or to reject shipments. If freedom of contract had been followed, such limits on the buyer's remedies would have been allowed. Other examples relate to clauses which would effect the measurement of damages or the exclusion of warranty.

While consequential damage may be limited or excluded by contractual agreement, there also is some constraint of contract in this regard. Under a specific Code provision, the exclusion clause is not permitted if it is unconscionable. In the case of consumer goods, the limitation of consequential damages for injury to the person is made *prima facie* unconscionable. In the case of contracts commercial enterprises, there is not *prima facie* unconscionability, but there still may be unconscionability. The *com-manner*." There must be a fair quantum of remedy under the contract and any clause which take this away is subject to being stricken by the court as unconscionable. In such a situation the clause is eliminated and the remedies made available by the Code are applicable as if that clause had never existed. Thus freedom of contract is nullified and the constraint contract theory which requires at least some fair quantum of remedy is imposed.

A remedy clause setting forth an exclusive remedy would be allowed under freedom of contract. Under constraint of contract, such clauses can be limited. In under the Uniform Commercial Code, provision is made for situations where such remedies fail to give an effective remedy. It is said that the exclusive or limited remedy fails in its essential purpose; therefore such a clause will be ignored and relief may be sought under the Code's full remedy limited to repair of the goods. Yet frequent repairs do not seem to solve the problem or to bring the goods up to merchantable quality. In that situation, the contract terms providing for the inclusive or limited remedy can be stricken by the court.

Although freedom of contract which would allow the parties to set up any liquidated damages it is limited in several ways by the Code. While these reflect some of the caselaw limitations that developed over the past century, nevertheless they are reflective of a constraint of contract theory. The amount must be reasonable in light of anticipated or actual harm caused by the breach, the difficulties of proof of loss, and in the inconvenience or nonfeasibility of obtaining adequate remedy. There is further limitation that a term fixing unreasonably large liquid damages is considered true freedom of contract, it is deemed to be a penalty and rendered ineffective by the Code.

Conclusion

The major limitations to contracting which have been mentioned support the hypothesis that there has been a shift from "freedom of contract" of the past to a new "constraint of contract." While within legal boundaries, parties can still choose a number of terms, there are still general major constraints. These are found not only in the Uniform Commercial Code, but in the laws of some of the other countries as well. It is time to recognize this significant new development in the law.