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# Contract Law and the Hand Formula

Daniel P. O’Gorman\*

## ABSTRACT

*Contract law is largely about negligence. Through the use of a “reason to know” or “reason to believe” standard in many of the black letter rules in the Restatement (Second) of Contracts, contract liability can often be traced to a party’s failure to exercise reasonable care. The Restatement, however, fails to adequately explain when a person has reason to know or reason to believe something. In other words, despite being largely about careless behavior, contract law fails to adequately explain the standard of care expected of parties. Importantly, though, the Restatement at least makes clear that a person might have reason to know or reason to believe something even when a reasonable person would believe the probability of the fact’s existence (or future existence) is less than 50%, as long as the probability is sufficiently substantial. The Restatement does not, however, provide much guidance on when the probability should be considered sufficiently substantial. This Article proposes that negligence law’s Hand formula be applied to make this determination.*

## INTRODUCTION

Contract law is largely about negligence.<sup>1</sup> Through the direct and indirect use of a “reason to know” or “reason to believe” standard in many of the black letter rules in the *Restatement (Second) of Contracts*, contract liability can often be traced to a party’s failure to exercise reasonable care under the

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1. This Article uses the word *negligence* in the sense of behavior that falls below an acceptable level of care, as opposed to referring to a tort claim of negligence. See JOHN L. DIAMOND, UNDERSTANDING TORTS 46 (5th ed. 2013) (explaining the two different senses in which *negligence* is used); see also BLACK’S LAW DICTIONARY 1133 (9th ed. 2009) (defining *negligence* as “[t]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregarding of others’ rights,” but also as “[a] tort grounded in this failure”).

circumstances.<sup>2</sup> The *Restatement*, however, fails to adequately explain when a person has reason to know or reason to believe something. In other words, despite being largely about careless behavior, contract law fails to adequately explain the standard of care expected of parties.

This Article proposes that negligence law's Hand formula<sup>3</sup> be applied in contract law to determine whether a person has "reason to know" or "reason to believe" something. As will be shown, using the Hand formula explains the relevance of facts traditionally considered irrelevant under a contract-law analysis, but which intuitively seem relevant.

Part I of this Article explains how contract law is largely about negligence. Part II discusses the *Restatement's* "reason to know" and "reason to believe" standard and shows that the *Restatement* fails to adequately explain it. Part III discusses negligence law's famous Hand formula. Part IV maintains that the Hand formula should be used to determine when a party is negligent under contract law's "reason to know" and "reason to believe" standard. Part V provides examples, through the use of well-known cases, of how the Hand formula would apply in cases involving the standard.

## I. CONTRACT LAW AS A LAW OF NEGLIGENCE

Although a bargain might usually involve each party intentionally assuming obligations,<sup>4</sup> contract law, like tort law,<sup>5</sup> is

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2. See RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 (2010) (providing that "[a] person acts negligently if the person does not exercise reasonable care under all the circumstances"). "Reason to know" would presumably apply when asking if a person had reason to know the existence of a current or past fact. "Reason to believe" would presumably apply when asking if a person had reason to believe that some fact would arise in the future. The *Restatement*, however, creates confusion by referring to "reason to know" of a fact, "present or future." See RESTATEMENT (SECOND) OF CONTRACTS § 19 cmt. b (1981). The *Restatement* uses the phrase "reason to understand" in Section 69 (acceptance by silence or exercise of dominion), but it is unclear whether such a standard differs in a meaningful way from "reason to know" or "reason to believe." *Id.* § 69(1)(b).

3. See *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947) (setting forth a formula for determining whether a person's conduct fell below the appropriate standard of care for purposes of determining negligence liability in tort).

4. See MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 98 (11th ed. 2003) (defining *bargain* as "an agreement between parties settling what each gives or receives in a transaction between them or what course of action or policy each pursues in respect to the other").

primarily about negligence. Such an assertion might be contrary to what is commonly assumed,<sup>6</sup> but a survey of contract law's black letter rules reveals its truth.

For example, one need look no further than Section 2 of the *Restatement* for confirmation that contract law is primarily about negligence. Section 2 defines *promise* (the most important term in contract law)<sup>7</sup> as "a *manifestation of intention* to act or refrain from acting in a specified way, so made as to *justify* a promisee in understanding that a commitment has been made."<sup>8</sup> A comment to Section 2 explains that the phrase "manifestation of intention" is used to make clear that a person need not intend to make a promise, provided she had "reason to believe" her words or actions would be interpreted as an intention to act or refrain from acting in a specified way.<sup>9</sup> Also, the promisee must be justified in understanding that a commitment has been made.<sup>10</sup> A promisee whose understanding is unjustified is at fault for having such an understanding and, in such a situation, the communication will not be considered a promise. Thus, the definition of *promise* incorporates a fault standard that applies to both the promisor and the promisee.<sup>11</sup>

The word *manifestation*, with its "reason to believe" fault standard, is repeated in the *Restatement's* definition of *agreement*—"a manifestation of mutual assent on the part of two

5. See DIAMOND, *supra* note 1, at 46 ("[N]egligence, as a form of fault-based liability . . . continues to be the central basis for liability in most tort cases.").

6. See Robert A. Hillman, *Contract Lore*, 27 J. CORP. L. 505, 510 (2002) ("The understood purpose of contract law is to facilitate people's freely made private exchange transactions."); CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* 2 (1981) ("Contract law ratifies and enforces our joint ventures . . . [T]he law of contracts facilitates our disposing of [our] rights on terms that seem best to us."); Patrick Atiyah, *Contracts, Promises and the Law of Obligations*, 94 L.Q. REV. 193 (1978), reprinted in A *CONTRACTS ANTHOLOGY* 78, 78 (Peter Linzer ed., 2d ed. 1995) (noting that contract law is usually considered to be based on voluntarily-assumed obligations).

7. See RESTATEMENT (SECOND) OF CONTRACTS § 1 (1981) (defining *contract* as "a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty"); see also FRIED, *supra* note 6, at 7-27 (arguing that contract law is primarily about the morality of promising).

8. RESTATEMENT (SECOND) OF CONTRACTS § 2 (1981) (emphasis added).

9. *Id.* § 2 cmt. b.

10. *Id.* § 2.

11. *Id.* (emphasis added).

or more persons”<sup>12</sup>—with a comment to the definition noting that “[t]he word contains no implication of mental agreement.”<sup>13</sup> Because an agreement is necessary for the formation of a bargained-for exchange contract, the word *manifestation* is repeated again when stating the requirements for the formation of such a contract: “the formation of a contract requires . . . manifestation of mutual assent.”<sup>14</sup> A comment explains that *manifestation* is used to make clear that subjective intent to enter into a contract is unnecessary.<sup>15</sup> Another rule provides that “[t]he conduct of a party may manifest assent even though he does not in fact assent.”<sup>16</sup>

The definition of *bargain* also incorporates a fault standard. The definition is “an agreement to exchange promises or to exchange a promise for a performance or to exchange performances.”<sup>17</sup> By directly incorporating *agreement* and *promise*, the definition of *bargain* indirectly incorporates both the “reason to believe” standard and the “justify” standard. And the *Restatement* further implements a fault-based regime by directly using a “reason to know” standard (or, in one instance, “reason to understand”)<sup>18</sup> and by indirectly using a “reason to believe” standard through the use of the words *manifestation*, *manifest*, or *manifested* in numerous other restatements of black letter law.<sup>19</sup>

The prevalence of contract law’s use of the “reason to know” and “reason to believe” standard is unsurprising because such a standard implements the so-called objective theory of contract, under which parties’ subjective intentions are usually irrelevant and the parties’ rights and duties are determined objectively—based on what the parties manifested.<sup>20</sup> As Judge Jerome Frank famously stated, “[t]he objectivists transferred from the field of torts [and into the field of contracts] that stubborn anti-subjectivist, the ‘reasonable man.’”<sup>21</sup> And because of the prevalence of the

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12. *Id.* § 3.

13. *Id.* § 3 cmt. a.

14. *Id.* § 17(1).

15. *Id.* § 17 cmt. c.

16. *Id.* § 19(3).

17. *Id.* § 3.

18. *Id.* § 69(1)(b).

19. *See, e.g., id.* §§ 2(1), 3, 7, 15(1)(b), 16, 19(2), 20(1), 20(2), 21, 24, 26, 28(1), 28(2), 29, 38(1), 38(2), 39(1), 39(2), 42, 49, 50(1), 51, 53(3), 54(2), 56, 69(1)(a), 93, 94, 96, 98, 102, 103, 104, 112, 221, 248, 266.

20. *See* E. ALLAN FARNSWORTH, *CONTRACTS* 114–17 (4th ed. 2004) (explaining the distinction between the objective theory of contract and the subjective theory of contract).

21. *Ricketts v. Pa. R.R. Co.*, 153 F.2d 757, 761 (2d Cir. 1946) (Frank, J., concurring).

“reason to know” and “reason to believe” standard within contract doctrine, it is not an overstatement to say that contract law is primarily about sanctioning a party for negligent conduct—usually the negligent use of language. Thus, the principal distinction between contract law and tort law is not a distinction between voluntarily assumed duties and externally-imposed duties; it is a distinction based on the typical types of behavior that result in liability and the typical types of harm caused by such behavior. Contract law is primarily concerned with the negligent use of language that causes economic harm, whereas tort law is primarily concerned with negligent, non-verbal action that results in personal injury or property damage.

Contract law’s focus on fault is not limited to contract formation. For example, the defenses for non-performance are largely about fault. The Statute of Frauds precludes a plaintiff from holding a defendant liable when the plaintiff failed to obtain written confirmation of the bargain.<sup>22</sup> The defense of mistake excuses non-performance, but only if the mistaken party did not manifest an intention to bear the risk of the mistake, or should not, as a matter of law, bear the risk of the mistake.<sup>23</sup> In other words, if the mistaken party led the other party to believe the mistaken party was assuming the risk of the mistake, the mistaken party is liable.<sup>24</sup> Even if the mistaken party did not lead the other party to believe this, if the mistaken party was grossly negligent in making the mistake, the mistaken party remains liable.<sup>25</sup>

When a party induces another party to manifest assent by means of a misrepresentation, the victim is given the power to void the contract, essentially holding the misrepresenting party responsible for making the statement without confirming its truth.<sup>26</sup> But the victim cannot avoid the contract based on the

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22. RESTATEMENT (SECOND) OF CONTRACTS § 110 (1981).

23. *Id.* §§ 152, 153.

24. *See id.* § 154 (providing that “[a] party bears the risk of [the] mistake when the risk is allocated to him by agreement of the parties”). The standard to be applied in determining whether a party has agreed to bear the risk of the mistake is an objective standard. *See id.* § 154 cmt. b (“[H]e may . . . agree, by appropriate language or other manifestations, to perform in spite of mistake that would otherwise justify his avoidance.”); *id.* § 3 (defining *agreement* as “a manifestation of mutual assent on the part of two or more persons”); *see, e.g.*, *Wood v. Boynton*, 25 N.W. 42 (Wis. 1885) (holding that seller of stone that turned out to be an uncut diamond bore the risk of mistake when she told the buyer that she did not know what the stone was).

25. *Thrifty Payless, Inc. v. Americana at Brand, LLC*, 160 Cal. Rptr. 3d 718, 729 (Ct. App. 2013).

26. *See* RESTATEMENT (SECOND) OF CONTRACTS § 164(1) (1981) (“If a party’s manifestation of assent is induced by either a fraudulent or a material

misrepresentation if the victim's reliance on the misrepresentation was unjustified.<sup>27</sup> This rule therefore adopts a contributory fault standard, though the required degree of fault by the victim is quite high.<sup>28</sup> When a party induces a victim's assent through duress or undue influence, the resulting contract is voidable by the victim, holding the party responsible for improperly obtaining assent.<sup>29</sup> For a contract or one of its terms to be unenforceable under the doctrine of unconscionability, there must be either unfair surprise or lack of meaningful choice resulting in oppressive terms,<sup>30</sup> with the focus often on whether there has been bad behavior by one of the parties.<sup>31</sup> The doctrines of impracticability and frustration of purpose do not excuse non-performance if the non-performing party's own fault made performance impracticable or pointless.<sup>32</sup> With respect to damages, a party is not liable for losses that the non-breaching party could have avoided through reasonable efforts.<sup>33</sup> Thus, contract law, like tort law, is dominated by doctrines in which fault is an element.

Of course, an important distinction between contract law and tort law is that under contract law, when one uses language negligently and leads another to mistakenly believe a promise has been made—which, as shown above, is just one example of a fault standard in contract law—one can still avoid liability by performing as promised.<sup>34</sup> But this does not meaningfully distinguish contract law from tort law, because performing as promised simply means no harm has been suffered by the promisee, and, similarly, under tort law there is no claim without harm.<sup>35</sup> The promisor who negligently makes a promise but then

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misrepresentation by the other party upon which the recipient is justified in relying, the contract is voidable by the recipient.”).

27. See *id.* § 164 cmt. d.

28. See *Cousineau v. Walker*, 613 P.2d 608, 616 (Alaska 1980) (holding that recipient's reliance is only unjustified if it was “irrational, preposterous, or in bad faith”).

29. See RESTATEMENT (SECOND) OF CONTRACTS §§ 175, 177 (1981).

30. See generally *id.* § 208.

31. See *id.* § 208 cmt. d.

32. See *id.* §§ 261 (impracticability), 265 (frustration of purpose).

33. See *id.* § 350 (avoidable loss doctrine).

34. See *JP Morgan Chase v. J.H. Elec. of N.Y., Inc.*, 893 N.Y.S.2d 237 (App. Div. 2010) (stating that the elements of a claim for breach of contract are “the existence of a contract, the plaintiff's performance under the contract, *the defendant's breach of that contract*, and resulting damages” (emphasis added)).

35. See *Schuman v. Greenbelt Homes, Inc.*, 69 A.3d 512, 526–28 (Md. Ct. Spec. App. 2013) (holding that a claim in negligence requires the plaintiff to

performs is simply a person whose conduct fell below the required standard of care and who then took action to keep his carelessness from causing harm.

For example, consider a grocery store that fails to mop up rainwater that has accumulated just inside its front door on a rainy day and that also fails to put a wet-floor sign next to the water.<sup>36</sup> The store's failure to mop up the water or display a wet-floor sign is conduct below the required standard of care under tort law.<sup>37</sup> If a patron enters the store, reaches for a shopping buggy, and slips on the rainwater, injuring his neck and shoulders,<sup>38</sup> the grocery store will be liable in tort for negligence.<sup>39</sup> Assume, however, that the facts are slightly different: As the patron is falling, a grocery-store clerk, who happens to be standing next to the shopping buggies, catches the patron and neither the patron nor the clerk is harmed. The grocery store, despite its negligence, is not liable in tort because its negligence caused no harm.

Now, consider an employer who, through its president's negligent use of language, leads one of its employees to justifiably believe the employer and employee have entered into a contract for one year of re-employment.<sup>40</sup> If the employer fires the employee two months later without just cause, the employer will be liable for breach of contract.<sup>41</sup> These facts are not meaningfully different from the facts in the grocery store hypothetical in which the patron falls and is injured. Both the grocery store and the employer engaged in behavior that fell below the acceptable standard of care, causing harm to another person—the patron and the employee, respectively. The only difference is that the grocery store's conduct involved the negligent failure to mop up the water or place a wet-floor sign next to it, whereas the employer's conduct involved the negligent use of language.

Assume, however, that the employer, after becoming aware of its negligent use of language, retains the employee for one year. In such a case, the employer would not be liable for breach of contract despite its negligence because the employer performed its

prove, by a preponderance of the evidence, that the plaintiff was harmed by the defendant's conduct, and finding that the plaintiff failed to carry that burden).

36. See, e.g., *Burnett v. M & E Food Mart, Inc.* # 2, 772 So. 2d 393 (La. Ct. App. 2000).

37. See *id.* at 397–98.

38. *Id.* at 395.

39. *Id.* at 397–98.

40. *Embry v. Hargadine, McKittrick Dry Goods Co.*, 105 S.W. 777 (Mo. Ct. App. 1907).

41. *Id.*



promise and thereby avoided causing any harm to the employee. These facts are really no different from the altered facts in the grocery store hypothetical. The employer retaining the employee for the promised year is like the grocery-store clerk catching the falling patron. No harm, no foul.

One might argue that a fundamental difference between contract law and tort law is that contract law requires an intentional act. In other words, one must voluntarily choose to use language before one can be held liable for its negligent use. As noted by the *Restatement*: "A 'manifestation' of assent is not a mere appearance; the party must in some way be responsible for the appearance. . . . This is true even though the other party reasonably believes that the assent is genuine."<sup>42</sup> But tort law usually also requires an antecedent intentional act, even when liability ultimately flows from a subsequent failure to act, such as the failure to mop up the rainwater or display a wet-floor sign next to it. One must open a grocery store and then invite patrons into the store before being liable for not mopping up the rainwater or placing a wet-floor sign next to it. Similarly, one must drive a car down the street before being liable for striking a pedestrian, and one must perform a surgical operation on a patient before being liable for making the patient's condition worse. As noted by the *Restatement (Third) of Torts*, even though negligence can involve a person failing to take a reasonable precaution, it is preferable to state that the person is negligent for *engaging in an activity* without taking reasonable precautions.<sup>43</sup>

The general rule that tort law does not impose a duty to act shows that liability generally starts with an intentional act.<sup>44</sup> Although exceptions to this general rule have arisen, they can be traced to a voluntary act. For example, although real property owners have a duty to help guests and invitees,<sup>45</sup> one must choose to become a real property owner and then invite the guest or invitee onto the property. Although the law imposes a duty upon a person to extricate another from danger if the person created the danger, the person must engage in conduct to create the danger.<sup>46</sup>

It might be argued, however, that in contract law a person may intend to make a promise and then be prevented from performing as promised for reasons beyond the promisor's control, and yet still

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42. RESTATEMENT (SECOND) OF CONTRACTS § 19 cmt. c (1981) (internal citations omitted).

43. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 cmt. c (2010).

44. *La Raia v. Super. Ct.*, 722 P.2d 286, 289 (Ariz. 1986).

45. *Id.* at 290.

46. RESTATEMENT (SECOND) OF TORTS § 322 (1965).

be held liable. The *Restatement* notes: “Contract liability is strict liability. . . . The obligor is therefore liable in damages for breach of contract even if he is without fault and even if circumstances have made the contract more burdensome . . . than he had anticipated.”<sup>47</sup>

Though, in such a situation, the promisor’s negligence is not the failure to perform as promised, the promisor’s negligence is the failure to have qualified the promise by the event that rendered performance impossible or more burdensome. As noted by the *Restatement*:

The obligor who does not wish to undertake so extensive an obligation [strict liability] may contract for a lesser one by using one of a variety of common clauses: he may agree only to use his “best efforts”; he may restrict his obligation to his output or requirements; he may reserve a right to cancel the contract; he may use a flexible pricing arrangement such as a “cost plus” term; he may insert a *force majeure* clause; or he may limit his damages for breach.<sup>48</sup>

Also, contract liability is not truly strict liability. Under the impracticability doctrine, a promisor who fails to perform as promised because her performance was rendered impossible or impracticable as a result of an unanticipated event that was not her fault will generally only be liable if the language she used when contracting manifested an intention to still be liable.<sup>49</sup> Thus, liability (as opposed to the failure to perform) can still be traced to the promisor’s fault—having led the other party to believe that she would perform no matter what.

The remedies under contract law and negligence law might suggest, however, that the two areas of law are fundamentally different. Under negligence law, the remedy is to return the plaintiff to the status quo ante.<sup>50</sup> Under contract law, the remedy is to put the plaintiff in the position he would have been in had the defendant performed as promised—so-called expectation damages

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47. RESTATEMENT (SECOND) OF CONTRACTS ch. 11, intro. note (1981).

48. *Id.*

49. *Id.* § 261.

50. See Daniel Markovits, *Making and Keeping Contracts*, 92 VA. L. REV. 1325, 1361 (2006) (“The ordinary morality of harm, embodied for example in the law of torts, is backward-looking. The obligations it contemplates . . . are limited to preventing losses; and the remedies it recommends (for example, the damage awards contemplated in the law of torts) are limited to the compensation necessary to restore the status quo ante.”).

or benefit-of-the-bargain damages.<sup>51</sup> And this difference in remedies cannot be ignored because the expectation-damages rule is arguably "the distinctive hallmark of contract law."<sup>52</sup>

But Professor Lon Fuller famously, and persuasively, argued that contract law's standard remedy of expectation damages might be designed to protect the promisee's reliance on the promise, with expectation damages being awarded because reliance damages are often hard to prove and often the same as benefit-of-the-bargain damages.<sup>53</sup> Fuller explained:

[E]ven if our interest [in contract law] were confined to protecting promisees against an out-of-pocket loss, it would still be possible to justify the rule granting the value of the expectancy, both as a cure for, and as a prophylaxis against, losses of this sort.

It is a cure for these losses in the sense that it offers the measure of recovery most likely to reimburse the plaintiff for the (often very numerous and very difficult to prove) individual acts and forbearances which make up his total reliance on the contract. It [sic] we take into account "gains prevented" by reliance, that is, losses involved in foregoing the opportunity to enter other contracts, the notion that the rule protecting the expectancy is adopted as the most effective means of compensating for detrimental reliance seems not at all far-fetched. Physicians with an extensive practice often charge their patients the full office call fee for broken appointments. Such a charge looks on the face of things like a claim to the promised fee; it seems to be based on the "expectation interest." Yet the physician making the charge will quite justifiably regard it as compensation for the loss of the opportunity to gain a

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51. See *Hawkins v. McGee*, 146 A. 641, 644 (N.H. 1929) (holding that the general remedy for breach of contract is an amount of compensation designed to put the plaintiff in the position he would have been in had the defendant performed as promised, not an amount of compensation designed to put the plaintiff in the position he was in before the promise was made); RESTATEMENT (SECOND) OF CONTRACTS § 347 (1981) ("Subject to the limitations stated in §§ 350-53, the injured party has a right to damages based on his expectation interest . . . ."); *id.* § 344(a) (defining "expectation interest" as the plaintiff's "interest in having the benefit of his bargain by being put in as good a position as he would have been in had the contract been performed").

52. PETER BENSON, *THE THEORY OF CONTRACT LAW: NEW ESSAYS* 2, 3 (2001).

53. L. L. Fuller & William R. Perdue, Jr., *The Reliance Interest in Contract Damages: I*, 46 YALE L.J. 52 (1936).

similar fee from a different patient. This foregoing of other opportunities is involved to some extent in entering most contracts, and the impossibility of subjecting this type of reliance to any kind of measurement may justify a categorical rule granting the value of the expectancy as the most effective way of compensating for such losses.<sup>54</sup>

Fuller also argued that the justification for contract law's expectation-damages rule need not be limited to curing and preventing reliance losses, but might be justified by "a policy in favor of promoting and facilitating reliance on business agreements."<sup>55</sup> Fuller then explained this policy in a way fully applicable to the policy behind negligence law:

As in the case of the stop-light ordinance we are interested not only in preventing collisions but in speeding traffic. Agreements can accomplish little, either for their makers or for society, unless they are made the basis for action. When business agreements are not only made but are also acted on, the division of labor is facilitated, goods find their way to the places where they are most needed, and economic activity is generally stimulated. These advantages would be threatened by any rule which limited legal protection to the reliance interest [i.e., damages to return the promisee to the status quo ante]. Such a rule would in practice tend to discourage reliance. The difficulties in proving reliance and subjecting it to pecuniary measurement are such that the business man knowing, or sensing, that these obstacles stood in the way of judicial relief would hesitate to rely on a promise in any case where the legal sanction was of significance to him. To encourage reliance we must therefore dispense with its proof. . . . The juristic explanation in its final form is then twofold. It rests the protection accorded the expectancy on (1) the need for curing and preventing the harms caused by reliance, and (2) on the need for facilitating reliance on business agreements.<sup>56</sup>

In other words, the expectation-damages rule is arguably based not only on reimbursing the victim for harm caused, but also on encouraging reliance on bargains so as to promote efficiency.

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54. *Id.* at 60.

55. *Id.* at 61.

56. *Id.* at 61-62.

If Fuller's suggested rationales for expectation damages are accepted, they dissolve the apparent distinction between contract-law remedies and tort-law remedies. Both are designed to compensate for harm caused to the plaintiff and to encourage persons to engage in useful activities by guaranteeing that others with whom they come into contact while engaging in those activities will be held liable if those others are negligent and cause harm.

Whether contract law is primarily about fault or something else—such as autonomy or morality—has been a matter of contention over the past forty years.<sup>57</sup> But the objective theory of contract, which has “predominated in the common law of contracts since time immemorial,”<sup>58</sup> and the numerous uses of the “reason to know” and “reason to believe” standard in the black letter of contract law, lead to the inescapable conclusion that contract law's core is largely about fault. Professor Charles Fried's famous theory that contract law is primarily about the morality of keeping one's promises<sup>59</sup> crumbles under the objective theory of contract,<sup>60</sup> which provides that a person can be liable even if she did not intend to make a promise.<sup>61</sup> Professor Randy Barnett's similar theory that contract law is primarily about consent<sup>62</sup> is not really about consent at all—as that term is commonly understood—because his definition of *consent* includes an objective standard, referring to a “*manifestation* of an intention.”<sup>63</sup> Recognizing that contract law is primarily about fault does not mean that contract law should be assimilated into tort law, and that every contract doctrine should be based on fault (and none based on autonomy or morality), any more than every tort doctrine is or should be based

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57. For a discussion of the different theories of contract law, see Daniel P. O'Gorman, *Contract Theory and Some Realism About Employee Covenant Not to Compete Cases*, 65 SMU L. REV. 145, 157–77 (2012).

58. Joseph M. Perillo, *The Origins of the Objective Theory of Contract Formation and Interpretation*, 69 FORDHAM L. REV. 427, 428 (2000).

59. See FRIED, *supra* note 6, at 1 (“The promise principle, which in this book I argue is the moral basis of contract law, is that principle by which persons may impose on themselves obligations where none existed before.”).

60. See Atiyah, *supra* note 6, at 84 (“Every law student is taught from his earliest days that contractual intent is not really what it seems; actual subjective intent is normally irrelevant. It is the appearance, the manifestation of intent that matters. Whenever a person is held bound by a promise or a contract contrary to his actual intent or understanding, it is plain that the liability is based not on some notion of voluntary assumption of obligation, but on something else.”).

61. FARNSWORTH, *supra* note 20, at 115.

62. See Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986).

63. *Id.* at 304 (emphasis added).

on fault. It simply recognizes a fact: contract law, for the most part, is about fault.

Despite contract law being primarily about fault, judges, lawyers, and scholars still use language referring to the parties' intentions when describing it.<sup>64</sup> Professor Robert Hillman has discussed this discrepancy and argued that it is the result of persons describing contract law as they wished it could be, rather than as it is and must be.<sup>65</sup>

Thus, judges, lawyers, and scholars have simply failed to accept the hard truth that contract law is primarily—even if not exclusively—about fault (and, in particular, about negligence). As a result, whereas courts and scholars have devoted considerable attention in tort law to exploring when a party will (or should) be considered to have acted below the applicable standard of care, courts and scholars have devoted much less attention to the same issue in contract law. It is time to move past the debate concerning what contract law is primarily about and recognize that it is primarily about fault and to focus the discussion on when a party is, in fact, at fault under contract law.

## II. CONTRACT LAW'S "REASON TO KNOW" AND "REASON TO BELIEVE" FAULT STANDARD

This Part discusses contract law's "reason to know" and "reason to believe" fault standard. As previously discussed, this standard is just one of the many ways in which contract law implements a fault-based regime. The standard of care in these other situations might be different from situation to situation, making it inappropriate to set forth a single fault standard for all of them. But the "reason to know" and "reason to believe" standard seems to have been incorporated throughout many of the *Restatement's* black letter rules for the very purpose of having the same fault standard apply to each of those rules.

### *A. An Important Innovation by the Standard*

An important innovation of the *Restatement's* use of the "reason to know" and "reason to believe" standard with respect to communications is its focus, in many of the rules incorporating it, on what the speaker had reason to know or believe the recipient would infer, rather than on what the recipient had reason to know or believe. This was an innovation because courts traditionally

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64. See Hillman, *supra* note 6, at 510–12.

65. *Id.* at 515–17 (internal citations omitted).

phrased black letter rules regarding communications as being based solely on what a reasonable person in the *recipient's position*, or perhaps the position of a third-party observer, would infer from the communication.<sup>66</sup> For example, a court in a well-known case stated the following with respect to whether a communication was assent to a bargain or was just a joke: "[A] person cannot set up that he was merely jesting when his conduct and words would warrant a reasonable person in believing that he intended a real agreement."<sup>67</sup> Similarly, another court stated that determining whether an offer was made is based on "what an objective, reasonable person would have understood."<sup>68</sup> With respect to whether an offeree accepted an offer, one court in another well-known case stated that the test is whether "a reasonable man would believe that [the offeree] was assenting to the terms proposed by the other party."<sup>69</sup>

The *Restatement's* "reason to know" and "reason to believe" standard often focuses on whether the *speaker* would have reason to know or believe that the recipient would infer a particular intention by the speaker.<sup>70</sup> Of course, when the speaker is unaware of any characteristics of the recipient that the recipient does not share with the typical person, the speaker is justified in believing that the recipient does, in fact, have those characteristics.<sup>71</sup> In such a situation, the speaker has reason to believe the recipient will construe the speaker's words as a typical person would construe them. In that event, one can simply state the standard as how a typical person would construe the speaker's words.

But when the speaker knows or has reason to know that the recipient has characteristics that are different in kind or degree from the typical person, under the *Restatement's* focus on the speaker he is held to a standard based on what he has reason to believe *that particular recipient* will infer from his

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66. See Larry A. DiMatteo, *The Counterpoise of Contracts: The Reasonable Person Standard and the Subjectivity of Judgment*, 48 S.C. L. REV. 293, 332 (1997) ("The common law has generally framed its objective theory from the perspective of the *promisee*." (emphasis added)).

67. *Lucy v. Zehmer*, 84 S.E.2d 516, 522 (Va. 1954).

68. *Leonard v. PepsiCo, Inc.*, 88 F. Supp. 2d 116, 127 (S.D.N.Y. 1999), *aff'd*, 210 F.3d 88 (2d Cir. 2000).

69. *Embry v. Hargadine, McKittrick Dry Goods Co.*, 105 S.W. 777, 779 (Mo. Ct. App. 1907) (quoting *Smith v. Hughes*, 6 L.R.Q.B. 597, 607 (1871)).

70. RESTATEMENT (SECOND) OF CONTRACTS § 19 cmt. b (1981).

71. Reference is made to the "typical" person because the "reasonable person" of tort law is arguably not the typical or average person. See DIAMOND, *supra* note 1, at 49 & n.13 ("[T]he expected qualities of the reasonable person are not necessarily what is the average or even what most do in the community. . . . [T]he jury can, and probably often does, set a rather exacting standard of reasonableness.").

communication. In other words, if the speaker is aware that the recipient is more gullible than the typical person, the speaker has reason to believe that what the typical person would construe as a joke the recipient might construe as serious. In such a situation, it might be appropriate to hold the speaker responsible, and the *Restatement's* standard would permit such a result.<sup>72</sup>

Also, focusing solely on the perspective of a typical person in the recipient's position would not enable the court or jury to take into account whether the speaker had (or should have had) knowledge, or has intelligence, superior to that of a typical person.<sup>73</sup> Under negligence law's concept of the reasonable person, for example, "if a person in fact has knowledge, skill, or even intelligence superior to that of the ordinary person, the law will demand of that person conduct consistent with it."<sup>74</sup> Thus, to envision a single, typical person observing the transaction—whether from the vantage of the recipient of the communication or a third party—is to ignore the fact that whether a person is at fault is based on the circumstances of that particular person, circumstances that might be different from the circumstances of the person sitting across the bargaining table or a person observing the transaction.

### *B. The Restatement's Failure to Adequately Explain the Standard*

Unfortunately, courts and commentators have neglected the contours of contract law's "reason to know" and "reason to believe" standard. Perhaps this is because it is assumed that the standard is obvious—a person has reason to know or reason to believe something when a reasonable or typical person in the position of the party would believe that the fact's existence (reason to know), or its chance of occurring (reason to believe), is more likely than not. This would be consistent with the burden of proof in most civil cases. As explained by one court: "[I]n most civil cases, the lowest, ordinary burden of proof applies, requiring what is commonly referred to as a 'preponderance of the evidence.'

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72. See, e.g., THOMAS D. CRANDALL & DOUGLAS J. WHALEY, *CASES, PROBLEMS, AND MATERIALS ON CONTRACTS* 8 (6th ed. 2012) (Problem 2, involving a recipient of a communication whom the speaker knew had a low I.Q.).

73. See RESTATEMENT (SECOND) OF CONTRACTS § 19 cmt. b (1981) ("A person of superior intelligence has reason to know a fact if he has information from which a person of his intelligence would draw the inference.").

74. W. PROSSER & W. KEETON, *THE LAW OF TORTS* § 56, at 185 (5th ed. 1984).



[Under this standard], the jury must be satisfied to a reasonable certainty by the *greater weight of the credible evidence*.”<sup>75</sup>

Relying on the preponderance-of-the-evidence standard to conclude that contract law’s “reason to know” and “reason to believe” standard is a more-likely-than-not-standard (i.e., a greater weight of the evidence standard) confuses, however, the quantum of proof necessary to establish “reason to know” or “reason to believe” with the substantive definition of “reason to know” and “reason to believe” (i.e., the amount of knowledge required).<sup>76</sup> For example, a court could hold that a person is only considered to have reason to know a fact if a person would believe the chance of the fact existing was 70% or more, and yet still apply a preponderance-of-the-evidence standard to determine whether a person would believe there was a 70%-or-greater chance. In other words, evidence would have to be admitted to prove, more likely than not, that a person in the same position would have believed the chance of the fact existing was 70% or more. Accordingly, recognizing that the preponderance-of-the-evidence standard applies in most civil cases does not help give meaning to the phrases “reason to know” and “reason to believe.”

And neither does the phrase “reason to” provide much guidance on the applicable standard of care. The plain meaning of *reason*, as in “reason to act,” is “a rational ground or motive.”<sup>77</sup> Thus, applying the plain meaning of *reason* to the phrases “reason to know” and “reason to believe” means a “rational ground or motive to know” and a “rational ground or motive to believe.” *Rational*, however, is simply defined as “having reason or understanding.”<sup>78</sup> Thus, consulting the plain meaning of “reason to” gets us nowhere.

The *Restatement*, in a comment, provides a brief explanation of the “reason to know” and “reason to believe” standard.<sup>79</sup> Perhaps

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75. *Marquez v. Mercedes-Benz USA, LLC*, 815 N.W.2d 314, 324 (Wis. 2012) (emphasis added).

76. *See, e.g., NLRB v. Transp. Mgmt. Corp.*, 462 U.S. 393, 401 (1983) (holding that even though the General Counsel has the burden of persuasion by a preponderance of the evidence, it was not improper for the NLRB to only require a showing that the employer’s anti-union animus was a factor in the decision); *Cnty. Hosp. v. Fail*, 969 P.2d 667, 680 (Col. 1998) (noting, with respect to punitive damages in employment-discrimination cases, the distinction between “what level of [defendant’s] intent must be established” and “the quantum of proof required to establish that substantive level of intent”).

77. *MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY* 1037 (11th ed. 2003).

78. *Id.* at 1032.

79. Though the *Restatement*, in the comment, only expressly refers to “reason to know” and not to “reason to believe,” the comment applies to both

surprisingly, the *Restatement* indicates a person might have reason to know a fact exists (or will exist) even if a person would believe the chance of its existence (or future existence) is less than 50%, as long as there is a substantial chance it exists (or will exist):

A person has reason to know a fact, present or future, if he has information from which a person of ordinary intelligence would infer that the fact in question does or will exist. A person of superior intelligence has reason to know a fact if he has information from which a person of his intelligence would draw that inference. *There is also reason to know if the inference would be that there is such a substantial chance of the existence of the fact that, if exercising reasonable care with reference to the matter in question, the person would predicate his action upon the assumption of its possible existence.* . . . [T]he words “reason to know” are used . . . where the actor . . . would not be acting adequately in the protection of his own interests were he not acting with reference to the facts which he has reason to know.<sup>80</sup>

The comment states that a person has reason to know a fact when he would infer that it *does* exist, and then states there might *also* be reason to know where there is a substantial chance of its existence.

The fact that a 50%-or-less chance might be sufficiently substantial is supported by the statement that there is “reason to know” when “the actor . . . would not be acting adequately in the protection of his own interests were he not acting with reference to the facts which he has reason to know.” For example, assume a traveler has the choice of taking two different roads (Road *A* and Road *B*) to reach her destination, and the only difference between the roads is that Road *B*’s bridge crossing a river that cuts across both roads is out of commission 20% of the time, whereas Road *A*’s bridge is only out of commission 10% of the time. Also, assume that the traveler has no knowledge of whether either bridge is currently out of commission. The traveler would not be acting

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because it refers to having reason to know a fact “present or future.” RESTATEMENT (SECOND) OF CONTRACTS § 19 cmt. b (1981).

80. *Id.* (emphasis added). A similar standard has been adopted in *Black’s Law Dictionary*, which defines *reason to know* as follows: “Information from which a person of ordinary intelligence—or of the superior intelligence that the person may have—would infer that the fact in question exists or that there is a substantial enough chance of its existence that, if the person exercises reasonable care, the person can assume the fact exists.” BLACK’S LAW DICTIONARY 1381 (9th ed. 2009).

adequately in the protection of her own interest if she took Road *B* instead of Road *A*, even though it is more likely than not that Road *B*'s bridge is working.

The *Restatement* comment could have, of course, easily stated that a person has reason to know a fact exists (or will exist) when the person has reason to know its existence (or future existence) is more likely than not. Had such a standard been adopted, little explanation of the standard would be necessary. Such a standard might be difficult to apply in particular cases, but not because the standard itself is unclear. The *Restatement*, however, rejected such a standard, and instead used the vaguer "substantial chance" standard.

Another *Restatement* comment makes clear that this substantial chance standard is a negligence standard, when it states the following:

[E]ven though the intentional conduct of a party creates an appearance of assent on his part, he is not responsible for that appearance unless he knows or has reason to know that his conduct may cause the other party to understand that he assents. In effect there must be either intentional or *negligent* creation of an appearance of assent.<sup>81</sup>

And another comment refers to the person exercising "reasonable care."<sup>82</sup> Professor Arthur Corbin similarly recognized that the objective theory of contract was a negligence theory: "In the process of making a contract, the actual and proved intent of either of the parties should not be disregarded, unless he knowingly or *negligently* has misled another person to his injury."<sup>83</sup>

Adopting a "substantial chance" or negligence standard instead of a more-likely-than-not standard has the benefit of being a more flexible standard, enabling a court or jury to reach a just result when it might not otherwise be able to do so. The detriment, however, is that the standard is more difficult to apply than a more-likely-than-not standard, in turn making it more difficult for parties to predict how courts or juries will apply the standard to a given set of facts. In this sense, the choice between "substantial chance" or negligence and "more likely than not" is a choice between a so-called standard—a vague, flexible test—and a so-called rule—a

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81. RESTATEMENT (SECOND) OF CONTRACTS § 19 cmt. c (1981) (emphasis added).

82. *Id.* § 19 cmt. b.

83. ARTHUR L. CORBIN, CORBIN ON CONTRACTS: ONE VOLUME EDITION § 106, at 157 (1952) (emphasis added).

bright-line test—with each having the benefits and detriments of a standard or a rule, respectively.<sup>84</sup>

The *Restatement* comment, despite adopting the “substantial chance” or negligence standard, gives little explanation of what constitutes a “substantial chance,” simply stating that the chance is sufficiently substantial when “the [reasonably careful] person would predicate his action upon the assumption of its possible existence”; then stating that there would be “reason to know” when the person “would not be acting adequately in the protection of his own interests were he not acting with reference to the facts which he has reason to know”; and then suggesting it is a negligence standard.<sup>85</sup>

The *Restatement*’s “reason to know” and “reason to believe” standard was modeled on the “reason to know” standard in the *Restatement (Second) of Agency* and the *Restatement (Second) of Torts*, and the definition of “notice” in the pre-2001 version of Article 1 of the Uniform Commercial Code (U.C.C.).<sup>86</sup> The *Restatement (Second) of Agency* explains the standard as follows:

A person has reason to know of a fact if he has information from which a person of ordinary intelligence, or of the superior intelligence which such person may have, would infer that the fact in question exists or that there is such a substantial chance of its existence that, if exercising reasonable care with reference to the matter in question, his action would be predicated upon the assumption of its possible existence. The inference drawn need not be that the fact exists; it is sufficient that the likelihood of its existence is so great that a person of ordinary intelligence, or of the superior intelligence which the person in question has, would, if exercising ordinary prudence under the circumstances, govern his conduct as if the fact existed, until he could ascertain its existence or non-existence. The words “reason to know” do not necessarily import the existence of a duty to others to ascertain facts; the words

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84. See Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685 (1976) (“There are . . . two opposed modes for dealing with questions of the form in which legal solutions to the substantive problems should be cast. One formal mode favors the use of clearly defined, highly administrable, general rules; the other supports the use of equitable standards producing ad hoc decisions with relatively little precedential value.”).

85. RESTATEMENT (SECOND) OF CONTRACTS § 19 cmt. b (1981).

86. See *id.* (citing RESTATEMENT (SECOND) OF AGENCY § 9 (1958); RESTATEMENT (SECOND) OF TORTS § 12 (1965); U.C.C. § 1-201(25) (pre-2001 version)).

are used both where the actor has a duty to another and where he would not be acting adequately in the protection of his own interests were he not to act with reference to the facts which he has reason to know. One may have reason to know a fact although he does not make the inference of its existence which would be made by a reasonable person in his position and with his knowledge, whether his failure to make such inference is due to inferior intelligence or to a failure properly to exercise such intelligence as he has. A person of superior intelligence or training has reason to know a fact if a person with his mental capacity and attainments would draw such an inference from the facts known to him. On the other hand, "reason to know" imports no duty to ascertain facts not to be deduced as inferences from facts already known; one has reason to know a fact only if a reasonable person in his position would infer such fact from other facts already known to him.<sup>87</sup>

The *Restatement (Second) of Torts* provides that:

The words "reason to know" are used throughout the Restatement of this Subject to denote the fact that the actor has information from which a person of reasonable intelligence or of the superior intelligence of the actor would infer that the fact in question exists, or that such person would govern his conduct upon the assumption that such fact exists.<sup>88</sup>

Thus, neither the *Restatement (Second) of Agency* nor the *Restatement (Second) of Torts* provides much information beyond that provided in the *Restatement (Second) of Contracts*.

The *Restatement (Second) of Agency* comment does make clear, however, that a person can have "reason to know" even if he or she does not infer that the fact exists, and that the determination of whether a person has "reason to know" is based on the information in the person's possession. The comments in each of the three *Restatements* also vary slightly with respect to the standard to which the person is held when the person has below average intelligence. The *Restatement (Second) of Contracts* refers to "a person of ordinary intelligence," the *Restatement (Second) of Agency* refers not only to "a person of ordinary intelligence" but also "a reasonable person," and the *Restatement (Second) of Torts*

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87. RESTATEMENT (SECOND) OF AGENCY § 9 cmt. d (1958).

88. RESTATEMENT (SECOND) OF TORTS § 12(1) (1965).

refers to a person of "reasonable intelligence." It does not appear that these slightly different phrases are intended to be different standards, but because the *Restatement (Second) of Contracts* refers to "a person of ordinary intelligence," that is the phrase that will be used in this Article.

Unfortunately, Article 1 of the U.C.C., which provides in its pre-2001 version that "[a] person has 'notice' of a fact when . . . he has reason to know that it exists,"<sup>89</sup> does not provide any explanation of the standard in the Official Comment.<sup>90</sup> Accordingly, the *Restatement (Second) of Agency*, the *Restatement (Second) of Torts*, and the pre-2001 version of Article 1 of the U.C.C., upon which the *Restatement's* "reason to know" and "reason to believe" standard was based, do not provide any significant, additional information to help give greater meaning to the standard.

Thus, for example, it remains unclear if "the person" in the *Restatement* comment is Oliver Wendell Holmes's famous "bad man," who cares nothing about morality or causing harm to others and who acts only in self-interest.<sup>91</sup> The comment indicates that the person would have "reason to know" if he "would not be acting adequately in the protection of his *own interests* were he not acting with reference to the fact,"<sup>92</sup> but does not indicate that there are no other situations in which he would have reason to know. For example, is "the person" the reasonably careful person of tort law, who, unlike Holmes's bad man, takes into consideration the harm his or her actions might cause to others<sup>93</sup> and who is arguably more careful than the typical person?<sup>94</sup> And does the "substantial chance" standard vary based upon the particular contract doctrine

89. U.C.C. § 1-201(25) (pre-2001 version).

90. See U.C.C. § 1-201 cmt. 25 (failing to explain when a person "has reason to know that [a fact] exists").

91. See Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 459 (1897) (describing a bad man as "[a] man who cares nothing for an ethical rule which is believed and practised by his neighbors," and who cares only about the material consequences to himself of his actions).

92. RESTATEMENT (SECOND) OF CONTRACTS § 19 cmt. b (1981) (emphasis added).

93. See RESTATEMENT (SECOND) OF TORTS § 283 cmt. b (1965) ("The words 'reasonable man' denote a person exercising those qualities of attention, knowledge, intelligence, and judgment which society requires of its members for the protection of their own interests *and the interests of others*." (emphasis added)).

94. See DIAMOND, *supra* note 1, at 49 & n.13 ("[T]he expected qualities of the reasonable person are not necessarily what is the average or even what most do in the community. . . . [T]he jury can, and probably often does, set a rather exacting standard of reasonableness.").

being applied, or is it a one-size-fits-all standard? No answers are provided. In other words, the *Restatement* takes the position that the "reason to know" and "reason to believe" standard is a negligence standard, but provides little guidance on applying it.<sup>95</sup>

Presumably, under the *Restatement*, a party always has reason to know or reason to believe as long as a person of ordinary intelligence (or the superior intelligence of the party) in the party's position (i.e., having the same information) would believe there was a *greater-than-50%* chance that something exists or will exist. This can be gleaned from the comment's statement that there is reason to know if the person "has information from which a person of ordinary intelligence would infer that the fact in question does or will exist."<sup>96</sup>

### *C. Is the Standard Consistent with Neoclassical Contract Law?*

The *Restatement (Second) of Contracts* has been described as embodying the rules of neoclassical contract law,<sup>97</sup> as opposed to the rules of classical contract law that were embodied in the *Restatement (First) of Contracts*.<sup>98</sup> Professor Grant Gilmore argued that classical contract law's rules made it difficult to form a contract and difficult to get out of one, whereas neoclassical contract law made it easier to form a contract and easier to get out of one.<sup>99</sup> As Gilmore noted, "[e]vidently a free and easy approach to the problem of contract formation goes hand in hand with a free and easy approach to the problem of contract dissolution or

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95. Professor Farnsworth, one of the Reporters for the *Restatement*, includes a brief discussion of the "reason to know" standard in his hornbook, but he provides little explanation of the standard, other than to indicate that it is about fault. See FARNSWORTH, *supra* note 20, at 449. Farnsworth was not, however, the Reporter when the *Restatement's* "reason to know" comment was prepared. See Foreword to RESTATEMENT (SECOND) OF CONTRACTS (1981). Professor Robert Braucher, the Reporter at the time the comment was prepared, wrote an article discussing offer and acceptance in the *Restatement*, but the article provides no guidance on what "reason to know" or "reason to believe" means. See Robert Braucher, *Offer and Acceptance in the Second Restatement*, 74 YALE L.J. 302 (1964).

96. RESTATEMENT (SECOND) OF CONTRACTS § 19 cmt. b (1981).

97. See Jay M. Feinman, *Relational Contract Theory in Context*, 94 NW. U. L. REV. 737, 738 (2000) ("Neoclassical contract law—the law of the Uniform Commercial Code, the *Restatement (Second) of Contracts* . . .").

98. See Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 855 n.2 (1978) ("Classical contract law refers . . . to that developed in the 19th century and brought to its pinnacle . . . in the RESTATEMENT OF CONTRACTS (1932).").

99. GRANT GILMORE, *THE DEATH OF CONTRACT* (1974).

excuse—and vice versa.”<sup>100</sup> Professor Duncan Kennedy has explained that rules that make it difficult to form a contract and difficult to get out of one are based on notions of individualism, whereas rules that make it easy to form a contract and easy to get out of one are based on notions of altruism:

The individualist position is the restriction of obligations of sharing and sacrifice. This means being opposed to the broadening, intensifying and extension of liability *and* opposed to the liberalization of excuses once duty is established. This position is only superficially paradoxical. The contraction of initial liability leaves greater areas for people to behave in a self-interested fashion. Liberal rules of excuse have the opposite effect: they oblige the beneficiary of a duty to share the losses of the obligor when for some reason he is unable to perform. The altruist position is the expansion of the network of liability and also the liberalization of excuses.<sup>101</sup>

Additionally, neoclassical contract law favored standards over rules.<sup>102</sup>

Whether the *Restatement*'s use of the “substantial chance” or negligence standard is consistent with the generally recognized characteristics of neoclassical contract law depends on how the standard is applied. The “substantial chance” or negligence standard—which permits a finding that a person had “reason to know” or “reason to believe” a fact even if a person would believe its existence (or future existence) was less than 50%—will result in more contracts being formed if the standard applies to knowing a fact necessary to form a contract, but would result in fewer contracts being formed if it applies to knowing a fact that prevents formation. Characterizing the *Restatement*'s use of the “reason to know” and “reason to believe” standard as consistent with neoclassical contract law is difficult, however, because sometimes the standard is used with respect to a fact necessary to form a contract and at other times with respect to a fact that defeats formation.

For example, the definition of *offer* incorporates the “reason to believe” standard through the phrase “manifestation of willingness

100. *Id.* at 48.

101. Kennedy, *supra* note 84, at 1735.

102. See James W. Fox Jr., *Relational Contract Theory and Democratic Citizenship*, 54 CASE W. RES. L. REV. 1, 6 (2003) (“[W]here classical contract law was rule-based, neoclassical contract law is more willing to adopt standards.”).



to enter into a bargain."<sup>103</sup> The indirect use of the "reason to believe" standard increases the number of communications that will be offers because the standard is met as long as there was a substantial-enough chance that the offeree would believe that the offeror was willing to enter into a bargain.

But the second clause of the definition of *offer* requires that the offeree be justified in understanding that his assent will conclude a bargain without further action by the offeror.<sup>104</sup> And a subsequent rule makes clear that the offeree is unjustified in believing that the offeror intends to conclude a bargain without further action by the offeror if the offeree "knows or has reason to know that the person making [the communication] does *not* intend to conclude a bargain until he has made a further manifestation of assent."<sup>105</sup> Thus, as long as a person in the offeree's position would have believed that there was a substantial-enough chance that the offeror did *not* intend to conclude a bargain until making a further manifestation of assent, the communication is *not* an offer, even if it was a manifestation of willingness to enter into a bargain.

Accordingly, the first requirement of an offer applies the "reason to believe" standard to a fact necessary to *form* a contract, but the second requirement applies the "reason to know" standard to a fact that *prevents* formation. Thus, it is difficult to characterize the *Restatement's* definition of *offer* as either classical or neoclassical; it is a bit of both.<sup>106</sup>

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103. RESTATEMENT (SECOND) OF CONTRACTS § 24 (1981).

104. *Id.*

105. *Id.* § 26 (emphasis added).

106. The definition of *promise*, like the definition of *offer*, incorporates the "justify" standard. A *promise* is defined as "a manifestation of intention to act or refrain from acting in a specified way, *so made as to justify a promisee in understanding that a commitment has been made.*" RESTATEMENT (SECOND) OF CONTRACTS § 2(1) (1981) (emphasis added). If there was a manifestation of intention to act in a specified way, whether a promise was made would then depend on whether the recipient was justified in assuming the statement of intention was also a commitment. Whether this "justify" standard within the definition of *promise* adopts a "reason to know" standard similar to that in the offer context, such that a promisee is not justified in understanding that a commitment has been made if the promisee had reason to know the promisor did *not* intend to make a commitment, is unclear. Arguably, a promisee could be justified in understanding that a commitment has been made as long as there was reason to know that the promisor was intending to make a commitment. (The "reason to believe" standard must be used in the latter formulation of the test because it must be assumed that the promisee misconstrued the promisor's intention.) Unlike the *Restatement's* treatment of *offer*, with its more specific rule making clear that an offeree is not justified in understanding an offer has been made if there is reason to know the offeror did *not* intend to conclude a bargain without making a further manifestation of assent, there is no such

Perhaps the most interesting use of the “reason to know” standard is with respect to contract interpretation in a case involving a misunderstanding of a term. Under the *Restatement’s* rule of interpretation, a party is not bound by the meaning attached by the other party to a term unless the first party had a greater level of fault regarding the misunderstanding, with there being two different fault levels—the higher degree is when the party knew the other party attached a different meaning to the term, and the lower degree is when the party had reason to know that the other party attached a different meaning to the term.<sup>107</sup> If the parties had a material misunderstanding regarding a term and the level of fault between the parties was equal, or neither party was at fault because neither knew nor had reason to know the meaning attached by the other, there was no manifestation of mutual assent and hence no contract was formed.<sup>108</sup> The latter rule is often called the *Peerless* doctrine after the famous English case—*Raffles v. Wichelhaus*—in which there was a misunderstanding about which ship the parties intended in a contract for the sale of cotton to be shipped “ex *Peerless*.”<sup>109</sup>

It is commonly believed that this rule of interpretation involves determining which party was more at fault for the misunderstanding

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specific rule regarding *promise* to explain when a promisee is justified in understanding that a commitment has been made. This “justify” standard is not explained in the *Restatement* comment on *promise*, other than providing one example of when a promisee would not be justified in believing that a commitment has been made. See *id.* § 2 cmt. e (“Even if a present intention is manifested, the reservation of an option to change that intention means that there can be no promisee who is justified in an expectation of performance.”). The plain meaning of *justify* is “to prove or show to be just, right, or reasonable.” MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 680 (11th ed. 2003). The word *just* is not helpful because it simply begs the question. If the word *right* is used, then it would seem that the promisee or offeree is only justified if it turns out that the promisor did, in fact, intend to make a commitment, which would be inconsistent with the objective theory of contract. The word *reasonable* therefore seems to be the best fit for giving meaning to *justify* as that word is used in the definition of *promise*. This would mean that a promisee is justified in understanding that a commitment has been made as long as such an understanding was reasonable. And *reasonable* simply means “not extreme or excessive.” *Id.* at 1037. Ultimately, however, the *Restatement* leaves it unclear whether the “justify” standard in the definition of *promise* adopts a standard that asks whether the promisee had reason to know the offeror was *not* intending to make a commitment, or that asks whether the promisee had reason to know the offeror *was* intending to make a commitment.

107. RESTATEMENT (SECOND) OF CONTRACTS § 201 (1981).

108. *Id.* § 20(1).

109. (1864) 159 Eng. Rep. 375 (K.B.); 2 Hurl. & C. 906.

over the meaning of a particular term, with fault being assessed comparatively on a continuum. Professor William Young wrote, "if neither [party] is chargeable with carelessness, or one *not more than the other*, then there is no contract."<sup>110</sup> Judge Richard Posner explained the holding in *Raffles* as follows: "As there was no basis for thinking either party's mistake *more careless* than the other party's—or, stated differently, no reason to think one party's understanding of the contract *more reasonable* than the other's—the court held there was no contract."<sup>111</sup> Oliver Wendell Holmes's famous discussion of the *Peerless* doctrine seemingly adopts this comparative fault standard, noting that if there was only one ship *Peerless* and the buyer had intended to say "Peri" but instead said "Peerless," "he would have been bound."<sup>112</sup> If this explanation of the rules of interpretation is correct, the misunderstanding doctrine is consistent with neoclassical contract law because few misunderstandings will involve two plausible meanings that are equally reasonable. Thus, few bargains will fail to become contracts under the *Peerless* doctrine.

The *Restatement*, however, by incorporating the "reason to know" standard adopts a contributory-fault standard, not a comparative-fault standard. The *Restatement* provides that there is no manifestation of mutual assent if each party had "reason to know" of the meaning attached by the other party.<sup>113</sup> As previously explained, under the *Restatement*, a party has reason to know of a fact not only if the party has reason to know that it is more likely than not that the fact exists, but also "if the inference would be that there is such a *substantial chance* of the existence of the fact that, if exercising reasonable care with reference to the matter in question, the person would predicate his action upon the assumption of its possible existence."<sup>114</sup>

The distinction between the *Restatement's* contributory-fault standard and a comparative-fault standard can be illustrated by the issue in *Raffles*, using Holmes's example as a twist on the facts. In *Raffles* the parties entered into a contract for the sale of cotton to

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110. William F. Young Jr., *Equivocation in the Making of Agreements*, 64 COLUM. L. REV. 619, 630 (1964) (emphasis added).

111. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF THE LAW* 104 (6th ed. 2003) (emphasis added).

112. OLIVER WENDELL HOLMES, JR., *THE COMMON LAW* 242 (Little, Brown & Co. 1881) (1963).

113. See RESTATEMENT (SECOND) OF CONTRACTS § 20(1) (1981) (providing that "[t]here is no manifestation of mutual assent to an exchange if the parties attach materially different meanings to their manifestations and . . . each party has reason to know the meaning attached by the other").

114. *Id.* § 19 cmt. b (emphasis added).

arrive at Liverpool “ex Peerless” from Bombay.<sup>115</sup> The cotton arrived at Liverpool on a ship named *Peerless*, but the buyer refused to accept or pay for it.<sup>116</sup> When the seller sued the buyer for breach of contract, the buyer argued that he had intended the cotton to arrive on a ship named *Peerless* that sailed from Bombay in October, but the cotton arrived on a different ship named *Peerless* that sailed from Bombay in December.<sup>117</sup> The seller demurred to the buyer’s plea, thus admitting that the parties had each intended a different ship named *Peerless*.<sup>118</sup> When the buyer argued that “there was no consensus [sic] ad idem, and therefore no binding contract,” he was immediately stopped by the court, which declared that there must be a judgment for the buyer.<sup>119</sup>

Now, unlike the actual facts, assume that there is just one ship named *Peerless* and another ship named *Pierless*.<sup>120</sup> The buyer, unfamiliar with the shipping industry, knows only of the ship named *Pierless*, but the seller, familiar with the shipping industry, knows of both ships. The seller knows that 20% of the written references by persons to *Peerless* are intended to be references to *Pierless*. The buyer and seller enter into a written agreement for the sale of cotton from Bombay “ex Peerless.” The buyer intends the reference to be to the ship *Pierless*, which is leaving Bombay in October, and the seller intends the reference to be to the ship *Peerless*, which is leaving Bombay in December. Neither party, however, knows of the different meaning attached by the other. Has there been a manifestation of mutual assent?

Under the *Restatement*’s contributory-fault standard, the issue would be whether either or both of the parties were at fault for the misunderstanding and, if so, whether one was more at fault, but only two degrees of fault would be used—“know” and “reason to know” of the misunderstanding.<sup>121</sup> The buyer had reason to know that the seller intended the reference to be to the ship *Peerless*, even though he did not know of that ship. Most persons use words correctly, not incorrectly, and the written agreement referred to *Peerless*. Thus, he had information from which a person of ordinary intelligence would infer that the seller intended a ship different from the *Pierless*. As previously noted, Holmes believed the case would end here, with the meaning of *Peerless*, as used in the written agreement, meaning the ship *Peerless*. But under the

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115. (1864) 159 Eng. Rep. 375 (K.B.); 2 Hurl. & C. 906.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. Professor Charles Knapp deserves recognition for the name *Pierless*.

121. RESTATEMENT (SECOND) OF CONTRACTS § 20(1) (1981).

*Restatement's* "substantial chance" or negligence standard, the seller might have had reason to know that the buyer intended the reference to *Peerless* be to the ship *Pierless*. A 20% chance might be substantial enough to conclude that the seller had reason to know of the misunderstanding.

The "reason to know" contributory-negligence standard for interpretation therefore results in the formation of fewer contracts than under a comparative-negligence standard. Thus, the use of this standard is inconsistent with neoclassical contract law's emphasis on finding that a contract was formed. Whether this result was intended or even recognized by the drafters of the *Restatement* is unclear.

Accordingly, it is difficult to characterize the *Restatement's* use of the "reason to know" and "reason to believe" standard as either consistent or inconsistent with neoclassical contract law as a general matter. It will depend on how the standard is used in a particular black letter rule. The "substantial chance" or negligence standard is, however, at least consistent with neoclassical contract law's emphasis on standards over rules.

### III. THE HAND FORMULA

Unlike contract law, tort law has devoted considerable attention to defining negligence. Under tort law, "[a] person acts negligently if the person does not exercise reasonable care under all the circumstances."<sup>122</sup> And "[b]ecause a 'reasonably careful person' (or a 'reasonably prudent person') is one who acts with reasonable care, the 'reasonable care' standard for negligence [in tort law] is basically the same as a standard expressed in terms of the 'reasonably careful person' (or the 'reasonably prudent person')."<sup>123</sup> Oliver Wendell Holmes explained the rationale behind tort law's reasonably careful person standard:

[W]hen men live in society, a certain average of conduct, a sacrifice of individual peculiarities going beyond a certain point, is necessary to the general welfare. If, for instance, a man is born hasty and awkward, is always having accidents and hurting himself or his neighbors, no doubt his congenital defects will be allowed for in the courts of Heaven, but his slips are no less troublesome to his neighbors than if they sprang from guilty neglect. His

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122. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 (2010).

123. *Id.* § 3 cmt. a.

neighbors accordingly require him, at his proper peril, to come up to their standard, and the courts which they establish decline to take his personal equation into account. . . . The law considers, in other words, what would be blameworthy in the average man, the man of ordinary intelligence and prudence, and determines liability by that. If we fall below the level in those gifts, it is our misfortune; so much as that we must have at our peril, for the reasons just given.”<sup>124</sup>

Under negligence law, a person is not liable simply because she engages in conduct that creates a risk of harm to others, because “[a]ll conduct creates some risk.”<sup>125</sup> Rather, a person is only liable for conduct that involves “unreasonable risk creation,” i.e., “risks that a reasonable person would not [create].”<sup>126</sup> Limiting liability to harm caused through negligence is justified on the ground that it is unjust to hold someone liable for non-negligently caused harm, and on the ground that such a limitation will lead to the efficient level of accidents and precautions.<sup>127</sup>

Despite Holmes’s reference to the “average man,” tort law’s reasonably careful person “is not [in fact] to be identified with any ordinary individual, who might occasionally do unreasonable things; he is a prudent and careful person, who is always up to standard.”<sup>128</sup> As explained by the *Restatement (Third) of Torts*:

In cases in which the actor allegedly is negligent for not having adverted to the risk, the jury might determine that the reasonably careful person would advert to this risk nine times out of 10. Such a determination acknowledges that such an actor would not notice the risk one time out of 10. The function of the jury is to consider what the reasonably careful person would have done in the particular factual situation, not what that person would do over an extended period of time. Hence, if the probability is 90 percent that the reasonably careful person would have adverted to the particular risk, a finding that the actor was negligent is obligatory. Because the jury focuses on the conduct of the reasonably careful person in each particular case, the fallibility of average persons over a period of time is a reality the jury is not in a position to consider. Accordingly, tort law’s case-by-case focus makes it appropriate to say

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124. HOLMES, *supra* note 112, at 86–87.

125. DIAMOND, *supra* note 1, at 47.

126. *Id.* at 62.

127. *Id.*

128. PROSSER & KEETON, *supra* note 74, at 175.

that the reasonably careful person is infallible in a way that ordinary people are not.<sup>129</sup>

To determine whether a person's conduct has created an unreasonable risk of harm—and thus a risk that the reasonably careful person would not take—Judge Learned Hand, in *United States v. Carroll Towing Co.*, famously identified three factors to consider: the probability of harm; the gravity of the harm; and the burden of taking adequate precautions.<sup>130</sup> He then provided what came to be known as the Hand formula for determining whether a person acted negligently: “[I]f the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P: i.e., whether B less than PL.”<sup>131</sup> Thus, “[t]he Hand Formula posits that a reasonable person balances costs and benefits in light of prevailing values in matters of safety and safety costs.”<sup>132</sup> When a person's action causes more harm than good, there are squandered resources, and moral indignation might be justified.<sup>133</sup> In such a situation the actor should pay for the harm done, provided that it was foreseeable that the harm would outweigh the benefit. But when a person's action, or inaction, results in greater benefit than harm, and thus results in an overall benefit to society, there is no such moral indignation and “no occasion to condemn the defendant.”<sup>134</sup> The Hand formula is therefore correctly considered to be primarily utilitarian.<sup>135</sup>

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129. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 cmt. k (2010).

130. *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (2d Cir. 1947).

131. *Id.*

132. Stephen G. Gilles, *The Invisible Hand Formula*, 80 VA. L. REV. 1015, 1053 (1994).

133. Richard A. Posner, *A Theory of Negligence*, 1 J. LEGAL STUD. 29, 33 (1972).

134. *Id.*

135. Richard W. Wright, *Justice and Reasonable Care in Negligence Law*, 47 AM. J. JURIS. 143, 178 (2002). The Hand formula has been criticized as being morally perverse because its utilitarian cost-benefit analysis might render a person not liable for engaging in actions that our moral intuitions would tell us are wrong and avoid the person having to pay for harm caused simply because the benefit to the actor was greater than the harm caused to the victim. See generally William E. Nelson, *The Moral Perversity of the Hand Calculus*, 45 ST. LOUIS U. L.J. 759 (2001); see also Richard W. Wright, *Hand, Posner, and the Myth of the 'Hand Formula'*, 4 J. THEORETICAL INQUIRIES IN LAW 145, 146 (2003) (“Although some scholars once asserted that this aggregate-risk-utility definition of negligence is consistent with the principles of justice, almost all of them now acknowledge that it is a transparent implementation of the basic principles of utilitarianism and its modern offshoot, economic efficiency theory, and as such is in direct conflict with the principles of justice.”). The *Restatement (Third) of Torts* rejects a strict utilitarian approach, stating that it is appropriate

The Hand formula has been endorsed by the American Law Institute, “by the leading treatises, and by courts in most states.”<sup>136</sup> For example, the *Restatement (Third) of Torts* provides: “Primary factors to consider in ascertaining whether the person’s conduct lacks reasonable care are the foreseeable likelihood that the person’s conduct will result in harm, the foreseeable severity of any harm that may ensue, and the burden of precautions to eliminate or reduce the risk of harm.”<sup>137</sup>

The *Restatement (Third) of Torts* recognizes that these are just factors, and “in particular categories of cases the inquiry into reasonable care, or the conduct of the reasonably prudent person, requires attention to considerations or circumstances that supplement or somewhat subordinate the primary factors.”<sup>138</sup> The *Restatement (Third) of Torts* indicates that the primary factors are most relevant when the actor is aware of some risk but is willing to tolerate the risk because of the burden of preventing it.<sup>139</sup> When the actor fails to recognize a risk, “explicit consideration of the primary factors is often awkward, and the actor’s conduct can best be evaluated by directly applying the standard of the reasonably careful person.”<sup>140</sup>

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to ignore the benefits obtained by an actor engaging in conduct that is frowned upon by society. See RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 cmt. h (2010) (“In most circumstances, negligence law takes into account and credits whatever burdens of risk prevention are actually experienced by the actor and others. While negligence law is concerned with social interests, courts regularly consider private interests, both because society is the protector of private interests and because the general public good is promoted by the protection and advancement of private interests. Nevertheless, in certain negligence cases there may be burdens of risk prevention that courts properly discount or decline to acknowledge. For example, certain motorists—though hoping for and expecting a favorable outcome—may find it exciting to race a railroad train toward a highway crossing. Yet because society may not recognize that excitement as appropriate, it may be ignored by the jury in considering whether the motorist should have driven more conservatively.”).

136. Gilles, *supra* note 132, at 1015–16. See also RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 cmt. d, reporter’s note (2010) (“Leading torts treatises support the balancing approach to negligence. The approach is also highlighted in almost every torts casebook, most of which indeed present as a central case Judge Hand’s opinion in *United States v. Carroll Towing Co.* . . . A balancing approach to negligence has been accepted in judicial opinions in a large majority of jurisdictions. . . . Overall . . . a large number of judicial opinions support the balancing approach to negligence . . .” (internal citations omitted)).

137. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 (2010).

138. *Id.* § 3 cmt. d.

139. *Id.*

140. *Id.*



The Hand formula's burden factor takes into account not only the cost of precautions but also the benefits to be expected from the risky behavior.<sup>141</sup> Thus, determining the burden is multi-faceted, requiring "consideration of such things as the costs associated with avoiding the harm, alternatives and their feasibility, the inconvenience to those involved, and the extent to which society values the relevant activity."<sup>142</sup> The burden includes "endeavoring to gather more information before engaging in conduct, and also the burden the actor would have borne in making such an effort."<sup>143</sup>

Once the degree of burden is established, the foreseeable likelihood of harm must be multiplied by the foreseeable gravity of harm that might occur.<sup>144</sup> Even if the foreseeable likelihood of harm is small, negligence can be found if the foreseeable gravity of the harm is large and the burden of taking adequate precautions is slight.<sup>145</sup> With respect to the foreseeable likelihood of harm, it must have been foreseeable at the time of the conduct.<sup>146</sup> And with respect to the foreseeable gravity of the harm, it is not the harm actually suffered by the plaintiff, but any harm that was foreseeable at the time of the conduct.<sup>147</sup>

Because quantifying the various factors in the Hand formula will often be difficult in specific cases, the formula is not one that "generates determinative results."<sup>148</sup> It does, however, identify important factors to consider in deciding whether the actor was negligent.<sup>149</sup>

#### IV. WHY THE HAND FORMULA SHOULD APPLY TO CONTRACT LAW'S "REASON TO KNOW" AND "REASON TO BELIEVE" STANDARD

Accepting the *Restatement's* use of the "reason to know" and "reason to believe" standard, and accepting the *Restatement's* position that the standard is a negligence standard that might find

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141. *Id.*

142. *DIAMOND*, *supra* note 1, at 65.

143. *RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM* § 3 cmt. g (2010).

144. *See id.* § 3 cmt. e ("Conduct is negligent if its disadvantages outweigh its advantages, while conduct is not negligent if its advantages outweigh its disadvantages. The disadvantage in question is the magnitude of risk that the conduct occasions . . . . [T]he phrase 'magnitude of risk' includes both the foreseeable likelihood of harm and the foreseeable severity of the harm that might ensue.").

145. *Id.* § 3 cmt. f.

146. *Id.* § 3 cmt. g.

147. *Id.* § 3 cmt. h.

148. *Id.*

149. *Id.*

there was “reason to know” or “reason to believe” even when a person would believe the chance of a particular fact existing (currently or in the future) is less than 50%,<sup>150</sup> the Hand formula should apply to the standard for several reasons.

First, because the “reason to know” and “reason to believe” standard is vague, a test to give it greater definition would be useful. And because the standard is so prevalent throughout contract doctrines, providing greater definition to it is particularly important.

Second, the *Restatement* articulates a negligence standard, and the Hand formula is well established in law as the standard for determining whether a person has acted negligently.<sup>151</sup> Applying the Hand formula to contract law’s “reason to know” and “reason to believe” standard would therefore help promote uniformity in the law.

Third, the Hand formula’s utilitarian approach is arguably more suitable for contract law than tort law because contract law is primarily about facilitating exchange,<sup>152</sup> whereas tort law is largely about preventing physical harm. Thus, any moral objection to the Hand formula’s utilitarian approach has less weight with respect to contract law.

Fourth, as will be shown in the next Part through an application of the Hand formula to several contract-law doctrines, the factors considered under the Hand formula are factors that intuitively appear relevant to contract-law cases, but which would be ignored under a traditional contract-law analysis. Applying the Hand formula would therefore make contract law more consistent with generally held notions of morality, which in turn would make contract law more legitimate to the public.

Fifth, use of the Hand formula will incorporate a consideration of the foreseeable loss to the other party, and not simply focus on the self-interest of the actor (like Holmes’s bad man). This will increase overall societal welfare.

Sixth, because the Hand formula takes into account the burden (or lack thereof) of taking adequate precautions, parties will not only be judged by the information they have, but the information that is readily available to them.

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150. This Article does not take a position on whether this approach is correct from a normative standpoint. Such an approach is open to substantial criticism.

151. See *supra* note 136.

152. See Nathan B. Oman, *Markets As a Moral Foundation for Contract Law*, 98 IOWA L. REV. 183, 187 (2012) (noting that “contract law exists primarily to support markets”).

An anticipated objection to applying the Hand formula to the "reason to know" and "reason to believe" standard is that it will unnecessarily complicate the analysis of contract-law issues, and that its frequent inability to provide determinative results makes it not worth the effort. But the *Restatement's* "substantial chance" or negligence test for the "reason to know" and "reason to believe" standard has already complicated contract law and has made it difficult to provide determinative results to contract-law issues. The question is not whether the Hand formula is easy to apply or whether it provides determinative results in most cases; the question is whether applying the Hand formula will make a vague standard *easier* to apply and provide determinative results in *more* cases than applying the vague standard without it. And the answer to these questions is "yes." Greater definition is better than less definition.

#### V. APPLYING THE HAND FORMULA TO CONTRACT DOCTRINES

This Part explains how the Hand formula would apply in contract law, and then applies the formula to various black letter rules incorporating the "reason to know" and "reason to believe" standard, either directly through the use of the former phrase or indirectly through the use of the words *manifestation*, *manifest*, or *manifested*. For many of the black letter rules discussed, a well-known case will be used to illustrate how the Hand formula would apply. Because the Hand formula often does not provide determinative results, and because reasonable persons will often disagree on how the primary factors apply, this Part's principal purpose is not to show what the correct result should be in each case. Rather, its principal purpose is to show a new way of applying established contract doctrines.

##### *A. B, P, & L in Contract Law*

As previously discussed, under the Hand formula, the defendant was not negligent if the burden of avoiding the loss (*B*) was greater than the probability of foreseeable loss (*P*) multiplied by the foreseeable gravity of the loss (*L*). In contrast, the defendant was negligent if the burden of avoiding the loss (*B*) was less than the probability of foreseeable loss (*P*) multiplied by the foreseeable gravity of the loss (*L*). Thus,  $B > PL$  = not negligent;  $B < PL$  = negligent.

Before applying the Hand formula to contract-law doctrines, one must identify that to which *B*, *P*, and *L* refer in a contract setting. The Hand formula, when applied in contract law, would

focus on a party predicating his or her action upon the assumption of a fact's non-existence when the chance of its existence is somewhere between 1% and 50%. If the chance is greater than 50%, the party is conclusively presumed to have reason to know of its existence (or reason to believe of its future existence) and the Hand formula would not apply, and if it is 0%, there is no reason to know or reason to believe because there is no possibility of its existence. *L* would refer to the foreseeable loss when the party predicates his or her action upon the assumption of the fact's non-existence or its future existence and it turns out that the fact exists or comes into existence. *P* refers to the foreseeable probability that the party's assumption is incorrect and the fact exists or comes into existence—between 1% and 50%, depending on the circumstances. *B* refers to the burden of avoiding the foreseeable loss.

Although the referents might vary based upon the particular contract doctrine being considered, when the rule involves a communication, *L* will often refer to the foreseeable loss caused by the speaker using language carelessly. Such harm will usually take the form of reliance by the recipient based on the belief that the speaker intends to act in a particular way, when the actor in fact intends to act in another way or not act at all. *P* will usually refer to the foreseeable likelihood that the recipient of the communication will misconstrue the speaker's intentions. *B* will usually refer to the amount of effort it would have taken for the speaker to have used her language in a way that would have avoided the misunderstanding, or to have taken other action to avoid the harm caused by the misunderstanding—such as acquiring additional information before speaking. But, as previously noted, the referents will differ based on the particular contract doctrine under consideration.

### *B. Applying the Hand Formula to Specific Contract Doctrines*

Let us begin the application of the Hand formula to specific contract doctrines by applying it to a doctrine that will easily illustrate how the formula would justify the conclusion that an actor can be negligent when incorrectly assuming a fact does not exist, even though a person of ordinary intelligence would have believed there was a 50%-or-less chance of the particular fact existing: the contract doctrine relating to intoxication. Contract doctrine provides that “[a] person incurs only voidable contractual duties by entering into a transaction if the other party has *reason to know* that by reason of intoxication (a) he is unable to understand in a reasonable manner the nature and consequences of the

transaction, or (b) he is unable to act in a reasonable manner in relation to the transaction."<sup>153</sup>

Assume that a person who manifests assent to a face-to-face bargain is so intoxicated that he is unable to understand in a reasonable manner the nature and consequences of the deal. The non-intoxicated party knows that the other party is intoxicated, but based on the information the non-intoxicated party has, a person in the non-intoxicated party's position would believe the likelihood the intoxicated person is so intoxicated that he is unable to understand in a reasonable manner the nature and consequences of the proposed deal is just 25%. Although there is no need to immediately reach a deal, the non-intoxicated party manifests assent on the spot and she later seeks to enforce the contract, despite having no tangible reliance. In response, the intoxicated party argues that the contract is voidable because the non-intoxicated party had reason to know that he was so intoxicated he was "unable to understand in a reasonable manner the nature and consequences of the transaction."<sup>154</sup> In reply, the non-intoxicated party argues that she did not have reason to know that it was more likely than not that the intoxicated party was so intoxicated that he was unable to understand in a reasonable manner the nature and consequences of the transaction, and therefore the contract should not be voidable.

Most persons would probably believe that any resulting contract should be voidable by the intoxicated party. Applying the Hand formula to the "reason to know" standard in the intoxication rule produces this result because it shows that the reasonably careful person would have waited until the intoxicated person was sober before closing the deal.

The burden of avoiding any loss by ascertaining whether the fact existed, i.e., whether the intoxicated party was so intoxicated that he was unable to understand in a reasonable manner the nature and consequences of the transaction, would have involved waiting until the next day to confirm whether the now-sober party in fact wants to enter into the deal. This burden was slight because there was no urgency to forming the contract. Although a loss to the non-intoxicated party from not concluding the deal on the spot might be not obtaining a contract he desired and thus disappointed expectations, the loss is insignificant when one considers that contracts should be mutually beneficial, not simply beneficial for one party.

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153. RESTATEMENT (SECOND) OF CONTRACTS § 16 (1981) (emphasis added).

154. *Id.* § 16(a).

The foreseeable magnitude of loss from the non-intoxicated party predicated her action on the belief that the intoxicated party is not too intoxicated includes any harm that might be expected from a dispute over whether the resulting contract is voidable, and imposing on the intoxicated party a duty of performing an unintended promise (if the non-intoxicated party is not considered negligent, the contract will not be voidable). The foreseeable probability of loss was, however, small—just 25%. Importantly, though, the likelihood of loss is still enough when multiplied by the foreseeable magnitude of loss to outweigh the very small burden of waiting another day.

Accordingly, applying the Hand formula shows that the non-intoxicated party should be deemed to have had reason to know that the intoxicated party was so intoxicated that he did not understand the nature and consequences of the proposed transaction. The contract should therefore be voidable even though the chance of the fact existing was less than 50%.

The *Restatement* provides an illustration involving intoxication based on a modified version of the well-known case of *Lucy v. Zehmer*.<sup>155</sup> Under the illustration, either the offeror was not sufficiently intoxicated or, if he was, a person of ordinary intelligence would not have believed the chance was substantial enough. The illustration provides as follows:

*A* has been drinking heavily. *B*, who has also been drinking, meets *A*, offers to buy *A*'s farm for \$50,000, a fair price, and offers *A* a drink which *A* accepts. In drunken exhilaration *A*, as a joke, writes out and signs a memorandum of agreement to sell, gets his wife to sign it, and delivers it to *B*, who understands the transaction as a serious one. *A*'s intoxication is no defense to *B*'s suit for specific performance.<sup>156</sup>

If, however, *A* was in fact so intoxicated that he did not understand the nature and consequences of the transaction, and there were more facts that would have led *B* to have reason to know that there was a substantial chance *A* was that intoxicated (even if 50% or below), the resulting contract should be voidable if the Hand formula applies to the "reason to know" standard. And this conclusion likely comports with what most persons would believe would be a just outcome in such a case.

In fact, a case involving intoxication discusses the rule in terms of a cost-benefit analysis by the person who was not intoxicated.

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155. 84 S.E.2d 516 (Va. 1954).

156. RESTATEMENT (SECOND) OF CONTRACTS § 16, illus. 3 (1981) (emphasis added).

The court, discussing a settlement agreement signed by a person who was allegedly intoxicated at the time, but who signed it outside of the presence of the other party, noted the burden that would be placed on the other party if such a release was voidable:

Under such a proposition, for parties to have any confidence in their ability to enforce settlement agreements, they would have to take such drastic steps as administering a blood test to establish sobriety at the moment of signature or agreeing to enter into the waiver agreement before a judge who could observe the sobriety of the signing parties. Such a rule would place unnecessary burdens on both employees and employers who desire to settle their claims simply, efficiently, and independently of the courts, and undercut many of the goals of the voluntary settlement process.<sup>157</sup>

Note that the court relied not only on the burden of confirming whether the party who signed the release was intoxicated, but also on the benefits gained from settling disputes without court involvement.

The next doctrine that will be used to illustrate how the Hand formula would apply to contract law is the requirement that the formation of a contract include an offer.<sup>158</sup> An offer is "the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it."<sup>159</sup> The definition of *offer* indirectly incorporates the "reason to believe" standard because a manifestation of intention exists when a person "has reason to believe that the promisee will infer that intention from his words or conduct."<sup>160</sup> It also indirectly incorporates the "reason to know" standard because the recipient is not justified in understanding that

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157. *Gaub v. Prof. Hosp. Supply, Inc.*, 845 F. Supp. 2d 1118, 1131 (D. Idaho 2012). Thus, the *Restatement* provides the following illustration: "*A*, while in a state of extreme intoxication, signs and mails a written offer on fair terms to *B*, who has no reason to know of the intoxication. *B* accepts the offer. *A* has no right to avoid the contract." RESTATEMENT (SECOND) OF CONTRACTS § 16, illus. 1 (1981) (emphasis added).

158. See *Zheng v. City of New York*, 940 N.Y.S.2d 582, 586 (App. Div. 2012) ("To demonstrate the existence of an enforceable agreement, a plaintiff must establish an offer . . .").

159. RESTATEMENT (SECOND) OF CONTRACTS § 24 (1981).

160. *Id.* § 2 cmt. b. There is no suggestion in the *Restatement* that this standard for "manifestation of intention" would not apply to a "manifestation of willingness," and thus a person would manifest a willingness to enter into a bargain when she has reason to believe that the promisee will infer that willingness from his words or conduct.

his assent to the proposed bargain is invited and will conclude it if he has "reason to know" otherwise.<sup>161</sup> To demonstrate how the Hand formula would apply to offers, cases involving two different contexts will be discussed—jokes and preliminary negotiations.

*Lucy v. Zehmer* is perhaps the most celebrated case involving an alleged joke.<sup>162</sup> In *Lucy*, the plaintiff alleged that he and the defendant entered into a contract under which the defendant promised to sell his farm to the plaintiff in exchange for the plaintiff's promise to pay the defendant \$50,000 (apparently a fair price).<sup>163</sup> They allegedly entered into the contract at a bar while they were drinking alcohol, with the defendant manifesting assent by writing the terms of the deal on the back of a restaurant check.<sup>164</sup> The defendant argued that it had all been a joke, but the plaintiff alleged he (the plaintiff) had taken it seriously.<sup>165</sup> The issue, therefore, was whether, under the objective theory of contract, there had been a manifestation of mutual assent.<sup>166</sup>

Assuming the defendant was the offeror,<sup>167</sup> and applying the *Restatement's* definition of *offer*, the issue would be phrased as whether the defendant had reason to believe that the plaintiff would infer willingness by the defendant to enter into a bargain for the sale of the farm.<sup>168</sup> Using the *Restatement's* "substantial chance" or negligence standard, the question would *not* be whether a reasonable person in the plaintiff's position would have believed it was more likely than not that the defendant was serious, or whether a reasonable person in the defendant's position would have believed that the plaintiff would more likely than not take the defendant seriously. Rather, the issue would be whether (1) a person of ordinary intelligence in the defendant's position would have believed there was more than a 50% chance the plaintiff

161. *Id.* § 26.

162. 84 S.E.2d 516 (Va. 1954).

163. *Id.* at 517.

164. *Id.* at 517–18.

165. *Id.* at 517–20.

166. *Id.* at 520.

167. It is unclear which party was in fact the offeror in *Lucy v. Zehmer*. The court made reference to Lucy being the offeror. *See id.* at 522 ("Whether the writing signed by the defendants and now sought to be enforced by the complainants was the result of a serious offer by Lucy and a serious acceptance by the defendants, or was a serious offer by Lucy and an acceptance in secret jest by the defendants, in either event it constituted a binding contract of sale between the parties."). Arguably, however, there was no offer until Zehmer wrote the terms on the back of the restaurant check, and this Article will assume that is when an offer was first made, with the preceding events being preliminary negotiations.

168. RESTATEMENT (SECOND) OF CONTRACTS § 2 cmt. b (1981).



would take the defendant seriously *or*, if not, (2) whether there was a substantial-enough chance that a person of ordinary intelligence would take the defendant seriously, such that the reasonably careful person would have predicated his action based on the possibility that the plaintiff would take the defendant seriously.

Under the *Restatement*, if the court concludes that a person in the defendant's position would have believed there was more than a 50% chance the plaintiff would take the defendant seriously, there was a manifestation of willingness to enter into a bargain. The plaintiff's acceptance would therefore form a contract because if there was such a manifestation, the plaintiff was justified in assuming that "his assent to that bargain is invited and will conclude it."<sup>169</sup> In such a case, the defendant, to avoid liability, would have to demonstrate that the contract was voidable, perhaps under the doctrine of unilateral mistake.<sup>170</sup>

If, however, a person in the defendant's position would not have believed there was more than a 50% chance the plaintiff would take the defendant seriously, the Hand formula would apply to determine if there was a substantial-enough chance the plaintiff would take the defendant seriously, such that the defendant acted negligently. The foreseeable probability of loss is based on the probability that the plaintiff would take the defendant seriously. Let us assume that the foreseeable probability was high, but not more than 50% because otherwise the Hand formula would not be used, say exactly 50%. This might not be too far from the foreseeable probability in the actual case because many facts suggested the defendant was not serious—the location (a bar), the alcohol (both were drinking), and using the back of a restaurant check to make the alleged offer<sup>171</sup>—and many facts suggested the defendant was, in fact, serious—no laughing (as far as we know), putting the deal into writing (albeit on the back of a restaurant check), the discussion lasting around thirty to forty minutes, and an apparently fair price.<sup>172</sup>

The foreseeable magnitude of the loss relates to the reliance that could have been expected from the plaintiff relying on the

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169. *Id.* § 24.

170. *See id.* § 153 ("Where a mistake of one party at the time a contract was made as to a basic assumption on which he made the contract has a material effect on the agreed exchange of performances that is adverse to him, the contract is voidable by him if he does not bear the risk of the mistake . . . and (a) the effect of the mistake is such that enforcement of the contract would be unconscionable, or (b) the other party had reason to know of the mistake or his fault caused the mistake.").

171. *Lucy*, 84 S.E.2d at 518–20.

172. *Id.* at 517–18.

apparent offer, both in terms of disappointed expectations and wasted, tangible reliance. Here, the expected magnitude of loss was likely small. The type of foreseeable, tangible reliance was probably limited to the plaintiff determining whether there was satisfactory title and raising the \$50,000 (which the plaintiff would retain if the defendant refused to go through with the deal).<sup>173</sup> The foreseeable magnitude of loss must also take into account the possibility that the defendant will realize that the plaintiff has taken him seriously before he (the plaintiff) tangibly relies on the apparent deal, thus enabling the defendant to avoid this particular type of loss—wasted, tangible reliance by the plaintiff—before it occurs. Such a realization before tangible reliance would also reduce, though not eliminate, the harm from disappointed expectations—the sooner one learns the truth the less disappointment, presumably—and the chance of a dispute between the parties over whether a contract was formed—the plaintiff might take the position of “no harm, no foul.” In *Lucy*, the chance of this happening was high because the parties were negotiating face to face, and the defendant would have the opportunity to clear up any misunderstanding if it became apparent to the defendant before the plaintiff left the bar and started relying on the deal. And the likelihood the defendant would recognize that the plaintiff had taken it seriously—before the plaintiff left the bar—was high because jokes usually do not end on a serious note.

In fact, this is exactly what the defendant alleged happened. The defendant alleged that as soon as he realized the plaintiff had taken the intended joke seriously, he told the plaintiff, “Hell no, that is beer and liquor talking. I am not going to sell you the farm. I have told you that too many times before.”<sup>174</sup> This case thus fits within Professor P.S. Atiyah’s observation that “[f]requently, a promise-based claim is based on relatively short-lived expectations; for it is where the promisor has (for instance) made some mistake, or overlooked some fact, that he is most likely to attempt to withdraw his promise.”<sup>175</sup> And because the trial court ruled in the defendant’s favor, the appellate court was required to accept the defendant’s testimony as true unless it was clearly against the evidence, something often overlooked in discussions about the case.<sup>176</sup> Although considering

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173. The plaintiff’s duty to proceed with the sale was conditioned on title being satisfactory to him. *See id.* at 517 (noting that the alleged contract stated, “We hereby agree to sell to W. O. Lucy the Ferguson Farm complete for \$50,000.00, title satisfactory to buyer”).

174. *Id.* at 519.

175. *See* P.S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 4 (1979).

176. Although all of the testimony in *Lucy* was by deposition, *see* 84 S.E.2d at 518, a trial court’s factual findings in such a case are still presumed to be

that such after-the-promise events would be inappropriate in a Hand formula analysis, which focuses on what was foreseeable at the time of action, these facts show how the communication's context—face-to-face discussions—reduces the foreseeable magnitude of loss. Thus, the foreseeable magnitude of loss was actually quite small in *Lucy*. Accordingly,  $P$  multiplied by  $L$  does not seem to be very high, even if  $P$  is 50%.

The defendant's burden to avoid the misunderstanding involved him making it clear that it was all in jest before the plaintiff manifested assent. In one respect, this would seem to be minimal. All the defendant had to do was not joke around about selling the farm, particularly for as long as thirty to forty minutes, or make it clear it was all a joke before putting it in writing. There would, however, be some burden imposed on the defendant if he was expected to put an end to the joke sooner. There is surely a societal benefit to joking, and requiring someone in the defendant's position to make it clear that he is only joking usually decreases the benefit gained from joking around. Thus,  $B$  is perhaps more difficult to determine than  $PL$ .

As a result, whether  $B$  is in fact less than  $PL$  is debatable. But the Hand formula does not, of course, always provide a determinative answer to the question of whether a person acted negligently. It does, however, focus the inquiry on those factors that are often most relevant. Applying the Hand formula to *Lucy v. Zehmer* might not provide a clear answer to whether the defendant was negligent, but it identifies the types of questions that should be asked, and makes relevant the kinds of factors intuitively considered relevant, such as the likelihood of loss from joking around and the benefits of such behavior, which would not ordinarily be considered relevant in a contract-law analysis.

Another well-known contracts case involving an alleged joke is *Leonard v. PepsiCo, Inc.*<sup>177</sup> In *Leonard*, PepsiCo ran a television commercial to advertise its Pepsi Points program, under which consumers could trade Pepsi Points for various products, such as a jacket tattoo and a mountain bike.<sup>178</sup> Pepsi Points could be obtained either by purchasing Pepsi drinks or by paying ten cents

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correct. See *Ashby v. Dumouchelle*, 40 S.E.2d 493, 496 (Va. 1946) ("While a decree based upon depositions is not as strong and conclusive as one based on evidence heard *ore tenus*, it is presumptively correct, and cannot be disturbed if it is reasonably supported or sustained by substantial, competent, and credible evidence. In other words, the evidence must be clearly against the findings in order to justify a reversal.").

177. 88 F. Supp. 2d 116 (S.D.N.Y. 1999), *aff'd*, 210 F.3d 88 (2d Cir. 2000).

178. *Id.* at 118–19.

per point.<sup>179</sup> At the end of the commercial, a high-school student lands a military jet on school grounds, and the following words appear at the bottom of the screen: "HARRIER FIGHTER 7,000,000 PEPSI POINTS."<sup>180</sup> The plaintiff, who was "young,"<sup>181</sup> sent a check to buy enough Pepsi Points to get the jet, but PepsiCo refused to provide it, explaining that the commercial's reference to obtaining it was just a joke.<sup>182</sup> The plaintiff then sued PepsiCo for breach of contract,<sup>183</sup> and the trial court entered summary judgment in PepsiCo's favor.<sup>184</sup> The appellate court affirmed in a brief opinion.<sup>185</sup>

Assuming that a person in PepsiCo's position would not have believed there was a greater-than-50% chance someone young like the plaintiff (PepsiCo was obviously targeting young persons) would have taken the commercial's reference to a Harrier jet seriously, applying the Hand formula confirms that the trial court's decision was correct. Even if the likelihood of loss was high because many younger viewers would take the commercial's reference to a Harrier jet seriously (a debatable assumption), the foreseeable magnitude of loss was likely quite small. The likelihood a younger viewer would in fact take it seriously, then set out to obtain enough Pepsi Points, and then actually obtain enough to get the jet is surely very low, particularly because younger viewers were not likely to have the money to buy enough Pepsi Points for the jet.

Also, a person who sent in a check seeking to buy that many Pepsi Points to purchase the Harrier jet would be met with a letter from PepsiCo returning the check and explaining it was all a joke, which, of course, is exactly what happened. Although a person might buy a lot of Pepsi drinks to obtain Pepsi Points (though certainly not enough to get seven million points), the person would in fact have the Pepsi to drink. One would certainly not expect someone to take any other actions in the expectation of obtaining a Harrier jet, such as building a runway, and would particularly not expect this of the targeted audience of young people. Note that under a traditional contract-law analysis, the foreseeable magnitude of the loss would be irrelevant, but in *Leonard*, the fact that the foreseeable magnitude of loss is very slight seems

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179. *Id.* at 119.

180. *Id.*

181. *Id.*

182. *Id.* at 119–20.

183. *Id.* at 120–21.

184. *Id.* at 132.

185. *See Leonard v. PepsiCo, Inc.*, 210 F.3d 88 (2d Cir. 2000).

intuitively relevant to reaching a just result. Thus, *PL* is likely very low in *Leonard*, even if *P* is somewhat high.

In contrast, the burden on PepsiCo is perhaps considerable. The commercial's use of the Harrier jet created an image that persons who used Pepsi products are "cool." As recognized by the trial judge:

[T]he commercial suggests, as commercials often do, that use of the advertised product will transform what, for most youth, can be a fairly routine and ordinary experience. The military tattoo and stirring martial music, as well as the use of subtitles in a Courier font that scroll terse messages across the screen, such as "MONDAY 7:58 AM," evoke military and espionage thrillers. The implication of the commercial is that Pepsi Stuff merchandise will inject drama and moment into hitherto unexceptional lives. The commercial in this case thus makes the exaggerated claims similar to those of many television advertisements: that by consuming the featured clothing, car, beer, or potato chips, one will become attractive, stylish, desirable, and admired by all.<sup>186</sup>

To hold PepsiCo liable would mean that it and other advertisers would have to include a disclaimer making it clear in the advertisement that the jet's availability was just a joke, detracting from the commercial's impact. Arguably, however, such a burden is not as substantial as the burden in a case like *Lucy v. Zehmer* because more time is put into advertisements than a barroom conversation over drinks. In any event, *B* would seem to be higher than *PL*, and the Hand formula supports the court's conclusion in *Leonard*, which is that there was no offer.

Next, consider the issue of preliminary negotiations. The rule is that "[a] manifestation of willingness to enter into a bargain is not an offer if the person to whom it is addressed knows or has *reason to know* that the person making it does not intend to conclude a bargain until he has made a further manifestation of assent."<sup>187</sup> Assume a case in which an apparent offer has been made during negotiations—that is, the alleged offeror has manifested a willingness to enter into a bargain—and a person of ordinary intelligence in the position of the recipient would believe there is a less-than-50% chance that the alleged offeror only intends to conclude a bargain upon making a further manifestation of assent. Assume further that the alleged offeror does not, in fact, intend to

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186. *Leonard*, 88 F. Supp. 2d at 128.

187. RESTATEMENT (SECOND) OF CONTRACTS § 26 (1981) (emphasis added).

conclude a bargain until making a further manifestation of assent. To determine whether the chance is substantial enough, the Hand formula would be applied. And to see how it would apply, the well-known case of *PFT Roberson, Inc. v. Volvo Trucks North America, Inc.* will be used.<sup>188</sup>

In *PFT Roberson*, the plaintiff, which operated a fleet of long-haul trucks and trailers, and the defendant, a truck manufacturer, began negotiations with the goal of entering into a fleet agreement, which is a comprehensive contract providing for the supply and maintenance of trucks, and the defendant thus manifested a willingness to enter into a bargain.<sup>189</sup> Many draft agreements were exchanged but none was signed.<sup>190</sup> Ultimately, the plaintiff sued the defendant for breach of contract, asserting the parties reached a binding agreement on certain items in an email in which the defendant identified those particular items the parties had “come to agreement on.”<sup>191</sup>

Assuming a person in the plaintiff’s position would believe there was a less-than-50% chance that the defendant intended to conclude a bargain on those items only upon a further manifestation of assent, the Hand formula would apply to determine if the chance was substantial enough. The foreseeable likelihood of loss depends upon how likely it was that the defendant did not intend to reach a deal until the parties had reached an agreement on all of the terms under discussion. This chance was likely high, even if it was not greater than 50%. Sophisticated parties usually do not intend to conclude a deal piecemeal and by email. The foreseeable magnitude of loss of the plaintiff predicated its action on the belief the defendant intended to conclude a deal at that time was also high because it could result in wasted reliance expenditures by the plaintiff and foregone opportunities; cause transaction costs disputing whether a contract was formed; and potentially bind the defendant to a contract it did not intend to enter into. Also, as the court recognized, permitting a contract to be concluded when there is doubt as to whether the parties are still in preliminary negotiations comes with a future cost:

Often the parties agree on some items . . . while others . . . require more negotiation. If any sign of agreement on any issue exposed the parties to a risk that a judge would deem the first-resolved items to be stand-alone contracts, the

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188. 420 F.3d 728 (7th Cir. 2005).

189. *Id.* at 728–29.

190. *Id.* at 729.

191. *Id.*

process of negotiation would be more cumbersome (the parties would have to hedge every sentence with cautionary legalese), and these extra negotiating expenses would raise the effective price (for in a competitive market the buyer must cover all of the seller's costs).<sup>192</sup>

In contrast, the burden on the plaintiff is slight because the plaintiff easily could have obtained clarification as to whether the defendant, by its email, intended to conclude a deal on the terms upon which the parties had already reached an agreement. Accordingly, in the typical case in which the issue is whether the parties have formed a contract or are still engaging in preliminary negotiations, the burden of confirming whether a contract has been reached will often be less than the foreseeable likelihood of loss and the foreseeable magnitude of loss.<sup>193</sup>

Next, consider the issue of an acceptance. The "reason to believe" standard applies indirectly to the issue of whether an acceptance has been made because an acceptance "is a *manifestation* of assent to the terms [of the offer] made by the offeree in a manner invited or required by the offer."<sup>194</sup> To show how the Hand formula would apply to the issue of whether an acceptance was made, the well-known case of *Embry v. Hargadine, McKittrick Dry Goods Co.* will be used.<sup>195</sup>

In *Embry*, the plaintiff employee alleged that in response to him telling the president of the defendant employer on December 23 that he only had until January 1 to find other employment and would quit then and there unless given a one-year contract, the president responded, "Go ahead, you're all right. Get your men

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192. *Id.* at 731.

193. The *Restatement's* preliminary negotiations rule, which makes it difficult to form an agreement because the "substantial chance" or negligence standard applies to the offeree having reason to know the offeror did *not* intend to conclude a deal until a further manifestation of assent, also applies to advertisements. See RESTATEMENT (SECOND) OF CONTRACTS § 26 cmt. b (1981). This helps implement the general rule that advertisements are not offers. See *id.* ("Advertisements of goods by display, sign, handbill, newspaper, radio or television are not ordinarily intended or understood as offers to sell. The same is true of catalogues, price lists and circulars, even though the terms of suggested bargains may be stated in some detail."); *id.* § 26, illus. 1 ("A, a clothing merchant, advertises overcoats of a certain kind for sale at \$50. This is not an offer, but an invitation to the public to come and purchase." (emphasis added)). Whether advertisements should be treated under a separate rule that uses the "reason to know" standard differently is an interesting policy question, but is beyond the scope of this Article, which accepts the *Restatement* rules as adopted.

194. *Id.* § 50(1) (emphasis added).

195. 105 S.W. 777 (Mo. Ct. App. 1907).

out, and don't let that worry you."<sup>196</sup> The plaintiff alleged that the president's response constituted an acceptance of the plaintiff's offer of reemployment for one year.<sup>197</sup>

Assuming that a person in the president's position would have believed there was less than a 50% chance that the plaintiff would construe his response as an acceptance, the Hand formula would apply to determine if the president had reason to believe that the plaintiff would construe his response as assent to the plaintiff's offer. The foreseeable likelihood of loss depends on how likely it was that the plaintiff would construe the response as assent. In this situation, it appears that the likelihood would be high because the language suggests assent.

The foreseeable magnitude of loss is high because the plaintiff told the president that if he was not reemployed by January 1, he would lose the opportunity to find alternative employment. Accordingly, the foreseeable magnitude of loss from the president predicating his action on the belief that the plaintiff would not construe his planned response as an acceptance—and thus not being more clear in his language—is the plaintiff being left unemployed, perhaps for close to a year, depending on when the defendant terminates the plaintiff. Also, because the president was the offeree, there would not be as much of an opportunity to avoid the tangible harm as there would be if the president was the offeror, because one would not necessarily expect a response from the plaintiff that made it clear how the plaintiff understood the defendant's response. This is particularly true because the president told the plaintiff to get back to work, indicating the discussion was over. Also, if the misunderstanding was not cleared up in a little over a week (by January 1), the tangible harm would be done.

The burden on the president to avoid the loss would have been small because he easily could have used language that was unambiguous, and unlike *Lucy* and *Leonard*, there is no benefit to being unclear in this situation. Accordingly, the burden is less than the foreseeable likelihood of loss multiplied by the foreseeable magnitude of loss, and the president therefore had reason to believe his response would be construed as an acceptance.

The above cases provide just a few examples of how the Hand formula would apply to contract rules incorporating the "reason to know" and "reason to believe" standard. These examples demonstrate, however, that even though the Hand formula often does not provide determinative results, application of the three

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196. *Id.* at 777.

197. *Id.*



factors focuses attention on facts intuitively considered relevant to such issues. The same type of analysis could be used for any of the *Restatement* rules incorporating the "reason to know" and "reason to believe" standard, and doing so will provide for greater consistency within the rules of contract law.

### CONCLUSION

Contract law is largely a law of negligence, yet the applicable standard of care expected of parties has not been well defined. The *Restatement* implements a negligence standard primarily—though not exclusively—through the use of a "reason to know" and "reason to believe" standard in many of its black letter rules. The *Restatement*, however, provides little guidance regarding applying this standard, other than indicating that it is a negligence standard. If this is so, negligence law's Hand formula should be used to determine when a party had "reason to know" or "reason to believe" something. The Hand formula is the accepted method for determining whether a person is negligent under tort law, and its utilitarian approach is arguably more suited for contract law than tort law, because of the former's emphasis on exchange. The Hand formula also uses factors that intuitively seem relevant to resolving contract law issues, but which have traditionally been considered irrelevant under contract law. And by adopting the Hand formula as the test for when a party has "reason to know" or "reason to believe" a fact under contract law, a vague standard will be given greater clarity.