

Good Faith and Profit Maximization

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Modern economics is said to have started with Adam Smith. Like modern economists, he begins with the idea that people pursue their own self interest. He then shows that the pursuit of self interest in the end benefits society.

According to Smith, each person, acting in his own self interest, realizes that he must appeal to the self interest of others:

"[I]t is in vain for him to expect [help] from their benevolence only. He will be more likely to prevail if he can interest their self-love in his favour, and show them it is for their own advantage to do for him what he requires of them. Whoever offers to another a bargain of any kind, proposes to do this. Give me that which I want, and you shall have this which you want. . . . It is not from the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from their regard to their own interest. We address ourselves, not to their humanity but to their self-love. . . ."

The result, according to Smith, is the division of labor from which the wealth of nations arises. Similarly, self-interest leads an entrepreneur to maximize the "produce of industry" which Smith describes as "what [industry] adds to the subject or materials upon which it is employed. In proportion as the value of this produce is great or small," he says, "so will likewise be the profits of the employer." The larger the profits, the greater the benefit he confers on society. Nevertheless, the entrepreneur does not intend to benefit society. According to Smith, "by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention."

I would like to compare Adam Smith's approach with that of the Catholic Church's leading moral theologian, St. Thomas Aquinas. I will take some time presenting St. Thomas' approach because it is important for us to be clear about what it entails and does not entail. I will then ask which of these two approaches, that of Smith and the modern economists, or that of St. Thomas, is the most helpful if one wants to understand the law that governs most modern societies.

St. Thomas believed that a merchant or entrepreneur might ethically pursue profit, but he did not identify profit with self-interest. He believed, following Aristotle, that there is an ultimate end to human existence, and that pursuit of that end is man's true self interest.

External things are valuable but only to the extent to which they contribute to that ultimate end. The entrepreneur's pursuit of profit is rightful to the extent profit is not the entrepreneur's ultimate end. It is rightful if he seeks profit "for the upkeep of his household, or for the assistance of the needy" or "for some public advantage, for example, lest his country lack the necessaries of life," and he accepts the profit "not as an end but as payment for his labor."

Similarly, according to St. Thomas, when a person contracts, he should not merely seek his own economic advantage. Following Aristotle, St. Thomas distinguished the virtue of distributive justice, which gives each person a fair share of the resources that society has to divide, and commutative justice, which preserves that share. A contract of exchange is an act of voluntary commutative justice. Certainly each party obtains something of greater value to him personally than that which he gives in return. But for the exchange to be fair, the parties must trade at a just price, a price that preserves each party's share of resources so that neither becomes richer or poorer.

It clear that, for St. Thomas himself and later writers in the Thomistic tradition, the price at which the parties should trade -- the just price -- was the market price. St. Thomas himself thought that even the high price of grain in a famine was the just price of grain under famine conditions. Later writers in the tradition explained that market price, and consequently the just price, had to fluctuate from day to day and from region to region to reflect factors that they called need, scarcity and cost. These factors were much like the ones that modern economists describe by the terms supply and demand. Here, then, St. Thomas and his followers were looking at the same phenomenon as Smith and the modern economists: people trade at a market price, and market prices fluctuates in response to these factors. But where Smith and the economists see only self-interest appealing to self-interest, St. Thomas and his followers saw justice. A market price that responded to need, scarcity and cost was also a fair price.

To explain why this price was fair, St. Thomas and his followers merely said that the market price must fluctuate to reflect need, scarcity and cost. For them, that was a sufficient explanation. These writers did not understand markets the way modern economists do. Nevertheless they saw, as a matter of common sense, that if grain becomes scarce, the price of grain must rise. Therefore it is not unjust to demand more money for grain when grain is scarce. The price of grain must rise if there are to be markets. Moreover, the person who buys and loses when prices later fall could equally well have gained if prices had risen. As the Thomist theologian Domingo de Soto explained in the 16th century, while a merchant loses if "bad fortune buffets him, for example, because an unexpected abundance of goods mounts up," he gains if "fortune smiles on him and later there is an unexpected scarcity of goods." "For as the business of buying and selling is subject to fortuitous events of many kinds," Soto concluded, "merchants ought to bear risks at their own expense, and, on the other hand, they may wait for good fortune."

In their view, commutative justice was violated when a person received terms less favorable than the market offered. Such a person might be physically cut off from the

market, like a person at sea contracting for a rescue from the only ship in sight. Or he might not know the market price. The Thomist theologian Lessius, writing in the 16th century, called these circumstances "necessity" and "ignorance." To charge someone a higher price because of his necessity or ignorance is unfair.

In the Thomistic tradition, this concept of a fair exchange explained not only the price at which the parties should trade but the rules that should govern their exchange. An illustration is the way St. Thomas explained a rule familiar to him from Roman law: the rule that a seller was liable for defects in the goods he sold. If he were not liable there would be a violation of commutative justice. The buyer would have paid too much for goods that are defective. In later centuries, jurists such as Luis de Molina and Jean Domat, who had been strongly influenced by St. Thomas, noted a qualification. The seller could disclaim liability for defects if he also lowered his price to compensate the buyer for the risk the goods would be defective.

To sum up, in the Thomistic view, there were certain inherent risks that must be born by somebody. Prices will fluctuate. Goods will sometimes be defective. It is not unjust for such risks to be born by someone who is compensated for bearing them. Such a contract is equal at the time it is made. In contrast, it is not right to profit by imposing a risk on someone who is not compensated for bearing it because of his ignorance or necessity.

We can now consider which approach, that of Adam Smith or that of St. Thomas, is more useful for understanding modern law. If we imagine a world in which no one is necessitous or ignorant, the law would be much the same by either approach. If everyone could use the market and everyone knew the market price, no one would expect a less favorable price. If every buyer knew the risk that products would be defective, no one would buy unless he were compensated for assuming this risk. It would be like buying a car with vinyl rather than leather upholstery. No one will do so unless the price is lowered enough to induce him to take vinyl.

In competitive markets, then, absent necessity or ignorance, even rapacious people could only contract on fair terms. From a Thomistic perspective, we should not be surprised. From a Thomistic perspective, as we have seen, a contract can justly impose risks and burdens on a party if they must be born by somebody, and the party who bears them is compensated for doing so. In a competitive market, absent ignorance and necessity, no one will assume a risk or burden that need be born by nobody or for which he has not been paid enough to induce him to assume it.

Therefore, to see the implications of a Thomistic approach for law, we must ask what happens when the self-interested person is able to obtain better terms than he otherwise could because the other contracting party is necessitous or ignorant. Does the law let him keep the extra profit he makes? Or does the law stop him?

In most modern legal systems the law stops him when it is practicable to do so. The one prominent exception may be English law, and even the English sometimes say that their reluctance to intervene is based on practical concerns about certainty rather than

principle. In most other countries, the law intervenes in the cases mentioned by St. Thomas: that is, when prices deviate from the market price, or sellers try to escape liability for defects without proportionately reducing their prices. The law also intervenes in many other cases as well to prevent what modern jurists call violations of good faith and unconscionable or inequitable transactions. The cases in which the law intervenes are remarkably similar in different modern legal systems even though modern jurists do not have a theory to explain the intervention. If one asks what these cases have in common, the best answer, in my view, is that they are also violations of commutative justice as that concept was understood by St. Thomas.

To begin with, modern legal systems commonly give relief when prices deviate greatly from the market price. In the United States, the Uniform Commercial Code authorizes a court to give relief when a contract is "unconscionable." An American court did so, for example, when a man bought a freezer from a door-to-door salesman for nine hundred dollars plus a three hundred dollar finance charge. Such a freezer sold retail for \$ 300. In Germany, the Civil Code authorizes relief when one party exploits the "distressed situation, inexperience, lack of judgment or grave weakness of will" of another to obtain advantages in "striking disproportion" to what he gives in return. A German court gave relief, for example, to a man who sold his share of a business for a fraction of its value because he needed ready cash. In France, the Civil Code grants relief only to one who sells land at a low price. Nevertheless, courts have given relief for fraud or duress or mistake even to people who were not the victims of fraud or duress in the ordinary sense and whose only mistake was to pay a high price. For example, one French court found "fraud" when the victor in a law suit, who was not lied to, sold his rights for a fraction of their value. Another court gave relief for "mistake" when the only mistake was to pay too much for a lease of agricultural property that required major work before it could become productive.

Some adherents of the law and economics movement explain the relief courts give in terms of efficiency rather than fairness. Landes and Posner argue that the reason that courts give relief to the captain of a ship in distress who promised a huge amount to his only possible rescuer is to prevent shipowners from investing too much in safety equipment that would enable the ship to rescue itself. This approach does not explain why judges and other non-economists sympathize with the plight of the captain. Certainly, it is not because they want to optimize investment in safety equipment. Moreover, this approach does not explain all of the instances in which courts give relief. They do so when no feasible precaution would have prevented the ship from needing a rescue. They do so when the advantaged party exploited the ignorance rather than the necessity of the victim.

Some jurists admit that relief is given because the contract is unfair, but they sidestep the problem of explaining how a price can be unfair. They claim that relief is not given merely because the price too high or too low. Nearly always, some weakness of the other party was exploited. The weaknesses these writers mention sound like instances of the two general ones mentioned by Thomist writers: the person exploited was necessitous, in the sense that he could not use the market, or ignorant of the market price. American

writers have referred to the exploitation of such weaknesses as "procedural unconscionability" as distinguished from the "substantive unconscionability" of the unfair price itself.

It is surely true that no one will pay more or charge less than the market price unless he is necessitous or ignorant. But one cares about these weaknesses only because they prevent a person from obtaining the market price. If he contracted at the market price, he will not be given relief however ignorant or necessitous he may have been. Procedural unconscionability matters, then, only because it leads to substantive unconscionability. So the question again arises, why the market price is fair. St. Thomas had an answer.

Again, modern legal systems typically intervene in the other case described by St. Thomas: the sale of defective goods. If the parties have made no other provision, civil law systems such as France and Germany continue to follow the Roman rule that the seller is liable for defects. In the 18th century, English courts adopted the opposite rule: *caveat emptor*, but that rule was first undermined and then abolished. Under the American Uniform Commercial Code, every seller is taken to warrant his goods against defects if the parties make no express provision.

Suppose, however, that the seller expressly disclaims liability for defects. Under the law of most countries, sometimes he can do so, and sometimes he cannot. The clearest case in which he cannot is when he tries to escape liability for defective products that hurt people. In the United States, such a disclaimer of liability was held to be "unconscionable" nearly forty years ago. In the member states of the European Community, such disclaimers are prohibited by a European Union Directive.

The reason, some have said, is that a person who signs a printed contract containing a disclaimer of liability may not understand it and may have no real choice. Again, Americans speak of "procedural unconscionability." But that cannot be the complete explanation. The printed contract contains dozens of provisions which the law will honor, however dim the purchaser's understanding of them, and however little real choice the purchaser had. But the law will not allow the seller to disclaim responsibility for defects that cause personal injury.

St. Thomas' ideas about liability for defects can give us a better explanation. St. Thomas said that the seller should be answerable for defects since otherwise the buyer will have paid too much for what he gets. Writers influenced by St. Thomas such as Molina and Domat added that the seller could disclaim liability provided that he reduced his price sufficiently to compensate the buyer for the risk the goods would be defective. Let us ask, then, when a seller would be willing to reduce his price by that amount. It depends on who can best bear the risk of the consequences if the product is defective, the buyer or the seller. If the buyer can bear this risk at lower cost, the seller will gain by disclaiming liability and reducing the price by this amount. If the seller can bear this risk at lower cost, he will never pass it to the buyer if he has to reduce his price by an amount sufficient to compensate the buyer for bearing it. He would rather bear it himself.

The risk that a defective product will cause personal harm is usually one that the seller is in the best position to bear. The seller is most likely to know the risk that his product will be defective and is best able to reduce the risk. Moreover, every customer who buys from him is likely to be exposed to roughly the same risk of physical injury. Since the risk is a recurring one for the seller it is more calculable for him, like the risks run by a casino that plays many games of blackjack or an insurance company that insures many houses.

If, however, the seller is best able to bear this risk, it cannot be that when a sophisticated seller transfers this risk to the buyer, he has reduced his price by an amount sufficient to compensate the buyer for bearing it. If the seller is allowed to disclaim liability, the buyer will bear the risk without receiving compensation. There will be, in St. Thomas' terms, a violation of commutative justice.

A Thomistic perspective therefore helps us understand why modern legal systems typically do not allow such a disclaimer for personal harm caused by defective products. It also helps to explain why modern legal systems usually will allow the disclaimer when the injury is not to one's person but to commercial property or to one's profits. The extent to which a defect in goods will harm commercial property or profits varies enormously from one buyer to the other. It is no longer a recurring risk, that arises to roughly the same extent in every sale, nor can the seller necessarily foresee its magnitude or control it better than the buyer, who knows what his own property is worth and how his profits might be protected. It is quite possible that the risk is most easily borne by the buyer, and therefore, that there is no violation of commutative justice.

Were this a longer speech, I would like to go on to show how these same considerations explain other instances in which the law will not enforce some provision of the parties' contract. In many instances, one party is trying to transfer a risk or burden to the other that he can best bear himself, and therefore, he could not be compensating the other party fairly for bearing it. Instead, since I have only a short time, I will discuss other types of cases in which the law requires the parties to act fairly or in good faith. I will try to show why St. Thomas' ideas about commutative justice provide the best explanation of these as well.

Some of the cases I have in mind, the contract gives one of the parties a certain right, but the law will not let him use this right unfairly. Jurists have spoken of an "abuse of right." In other cases, the express language of the contract does not place one of the parties under a duty to do or not to do something, but the law says he must do it or not do it anyway. Jurists have spoken of a "duty to cooperate" with the other contracting party. In still other cases, the contract commits some matter to the discretion of one of the parties, and the law says he cannot use his discretion unfairly. Jurists have spoken of an "abuse of discretion." For our purposes it is not important to define the boundaries of these categories for, if I am right, the same principle applies to them all. When courts intervene, there has been a violation of commutative justice as that concept was understood by St. Thomas. The examples I give will be taken from each of these categories.

Sometimes, we can see that a violation of commutative justice has occurred by applying the same analysis as we did in discussing defective products. I will begin by describing some instances, and then how this analysis applies to them. A contracting party who has legitimate doubts whether the other party can perform sometimes has the right to demand assurances that he will. American jurists have said it would be bad faith to demand assurances that are excessive. A contracting party may have no express duty to provide information to the other party. French jurists have said that he must do so nevertheless when the burden to him is small and the importance of the information in assisting the other party to perform is great. In another case, a manufacturer was under no express contractual duty to stock spare parts for a machine it sold. A German court held it must do so because of the severity of the consequences if it failed to do so. Another contract gave the American company General Motors complete discretion to reject, for aesthetic reasons, a metal shed that was to be built at an assembly plant. An American court would not let GM reject the shed on the grounds that the surface had an uneven appearance when viewed in bright sunlight at an acute angle. A series of contracts with distributors allowed the French branch of Volkswagen to decide where their facilities would be located. A French court held that Volkswagen could not use this power to allow a distributor to locate where it would undercut the exclusive rights that Volkswagen had granted another distributor.

Although these cases are quite various, in all of them, the contract, if interpreted literally, allows one party to do or refuse to do something that will benefit him to a small extent while harming the other party greatly. It cannot be that the party who was to suffer the harm was adequately compensated for doing so. In order to compensate him, the advantaged party would have to pay more than the benefit he himself would obtain. Therefore, if we interpret the contract literally, there will be a violation of commutative justice because a burden is placed on someone who is not compensated for bearing it.

If we like, we can present this conclusion as a matter of interpretation of the parties' contract. We can say that words are not to be interpreted literally when they lead to a result that the parties clearly could not have intended. Courts often do talk this way, one suspects, because they wish to avoid mentioning considerations of fairness or commutative justice. But if we look beneath the surface, we can see that this analysis in terms of the intentions of the parties really depends upon considerations of fairness. In the first place, the court is not asking what intentions the parties actually had but rather, what intentions they would have had if they had been fair people, or if neither party had been able to exploit the other's ignorance or necessity. In the cases just described, a party would not win if he proved that he was a rapacious person who had drafted the contract precisely to take advantage of the other party who was too dumb to notice. In the second place, the way the court knows that the parties could not have intended the result in question is that this result burdens the disadvantaged party so severely that one cannot believe he was adequately compensated. The courts see the unfairness of the result, and then conclude that the parties would not have intended it.

In cases of the kind just described, we could infer a violation of commutative justice from the size of the gains and losses of the parties: we cannot believe that the party who had

little to gain adequately compensated the party who had much to lose. In another kind of case, commutative justice is violated because one of the parties has a way to escape the consequences of the contract if they displease him later on. He is like a card player who wants to collect if he wins but renege on the bet if he loses. He is speculating at the other party's expense.

Sometimes, even though the contract seems to be binding on both parties, one party can try to escape its force by manipulating some right the contract gives him. This, too, has been found a violation of good faith. For example, a buyer has the right to the goods in the condition the contract specifies. American courts have held that a buyer acts in bad faith if he repudiates a contract for some trivial flaw in the goods because prices have fallen and he wants to escape the contract. To take a French example, suppose a buyer had the right to withdraw from a contract unless his orders were filled on time. It would be a violation of good faith for him to deliberately place an order during vacation so that the seller would default. In German law, contracts are often not valid unless certain formalities have been complied with which prove that the contract was made. Courts have held it is bad faith for a party to repudiate a contract for noncompliance with the formality when he knows perfectly well that the contract was actually entered into. Sometimes, a party tries to escape by doing something the contract does not expressly forbid. Courts have held he has violated a duty to cooperate. For example, an American court held that one who hires a broker to buy property cannot then circumvent the broker by buying it directly. Very often, the party who wishes to renege exploits a provision of the contract that places some matter within his discretion. Again, courts stop him when it is clear that he is using the provision merely to renege. If a contract allows a person to buy whatever quantity of a commodity he requires at a fixed price, he cannot say he requires none of it when the market has fallen. If the contract gives him an option to terminate, he cannot use this option in circumstances in which the other party could fairly expect him to be committed.

In yet another kind case, the violation of commutative justice is even more obvious: one party tries to appropriate some benefit that belongs to the other party without paying for it, or to charge him without conferring anything of corresponding benefit. I once met an executive who told me he was keeping his competitors out of foreign markets he wished to exploit by setting up bogus and seemingly independent companies which would enter into contracts with the competitors for the exclusive right to market the competitors' products in these markets. The companies would then make no efforts to do so. I asked him if he thought this conduct ethical. He said that in business, ethics shouldn't matter, as long as he abided by the law. I then told him that his conduct was not lawful in any legal system I knew of. If he wanted his competitors to stay out of a market, he would have to pay them to do so. He looked crestfallen.

Similarly, in those cases discussed earlier in which courts hold that a party is under a duty to cooperate, the party cannot charge an excessive amount in return for this cooperation. Similarly, German courts have held that one cannot cause or condone a breach in order to extract a penalty provided for by the contract. American courts have held one cannot use

an option to terminate to avoid paying an employee a commission he has already worked to earn.

All of these cases, I have argued, involve violations of commutative justice as that concept was understood by St. Thomas. Most modern jurists do not explain them that way. Some jurists think these cases are so heterogeneous that no single principle can explain them. Some German jurists say we should not expect to find such a principle. Robert Summers, an American jurist, says that the term "good faith" is an "excluder": that is, a term that cannot be defined and which rules out a heterogeneous series of cases of "bad faith." Even if no single principle were involved, however, surely there must be some set of principles that explains what is the matter with such conduct. Otherwise courts would have no reason to intervene. These jurists list typical instances of "bad faith," but they do not explain what these principles might be.

Other jurists, as already mentioned, claim that all these cases involve a problem of interpretation. A court must ask how the parties, at the time of contracting, would have resolved a problem that they did not think about at that time. Many cases, surely, can be viewed in that way. But some cannot. Sometimes, when a court is quite sure that one party took advantage of the other, it will intervene despite the express terms of the contract, as when it refuses to allow a disclaimer of liability for defects in goods that cause personal harm. Nevertheless, as mentioned earlier, the fundamental problem is that in order to interpret the contract, the court must ask how fairminded people would have resolved a problem they never thought about. In order to do so, the court needs a standard of fairness. It cannot simply look to the intentions of the parties since, on a matter they never considered, they had no intentions.

Some German jurists have recognized as much, saying that there must be principles of fairness that are imminent in the contract, although they are not at all clear what these principles might be. The one attempt I know of to identify such a principle is that of a leading Italian jurist Alberto Trabucchi. He says that the law of good faith is really an attempt to secure equality in exchange so that the value of what one gives equals that of what one receives. I think he is right. As I have tried to show, that principle explains most of the cases in which courts give relief. But if use that idea, we are talking about commutative justice whether we use that term or not.

Let us now come back to Adam Smith. He may say that an entrepreneur seeks merely his own profit. But that would be very poor advice for a lawyer to give his client. As we have seen, the law of good faith is a catalog of instances in which one cannot seek one's own profit at someone else's expense.

Nevertheless, at least in my opinion, the science of economics founded by Adam Smith is a true science and one that has made great progress in the two centuries since he wrote. We might ask, then, how this progress has been possible if the science is really founded on an assumption that would lead a businessman who took it seriously into serious legal difficulties within a week. The reason is that when Smith and the economists speak of self-interest, they really do not mean self-interest in the sense of

doing whatever one thinks is to one's own advantage. They are not philosophers. They are not careful about defining the concept of self interest. The cases they have in mind are not the cases I have discussed in which it is possible to take advantage of someone's ignorance or necessity. They would have a hard time showing that the pursuit of self interest in those cases is of any social benefit.

When they speak of self interest, they usually have in mind two discrete situations in which a person seeks an economic advantage. In both of them, the quest for this advantage was approved both by St. Thomas and by modern law. It was approved by St. Thomas because, in these situations, seeking an economic advantage was beneficial to the individual, if he acted with the right intention, as well as to the society, and it entailed no injustice. In one situation, people enter into contracts, each trying to obtain something of more benefit to himself personally than what he gives up. St. Thomas said that the law of contract is instituted so that people can do so. In the second situation, entrepreneurs seek profit. St. Thomas said that they were entitled to their profit as a reward for the benefit they conferred on society. Beginning with these two situations, modern economists draw supply and demand curves, work out the theory of the firm, determine equilibrium levels of prices, and all the other truly wonderful conclusions of their science.

In these two situations, people do pursue their own economic advantage, and the pursuit of that advantage is socially beneficial. But it simply does not follow that outside these two situations, people only pursue their own economic advantage, or even usually pursue it exclusively, or that the exclusive pursuit of self interest would be of benefit to anyone, even themselves. The rules of an athletic competition are set up so that, subject to certain rules, the athlete should do all he can to win. The rules are set up for the benefit of the sport, the spectators, and the athlete who truly wants to excel. With the purposes in mind, one can understand the rules. With the rules in mind, one can understand the injunction that the athlete should do everything he can to win the race. Indeed, one can urge the athlete to do so just as one can urge the business manager to try his best to make a profit. In the context of the purposes and rules that define his job, that is what his job is all about. But the injunction makes sense only within the that context. It does not mean that the athlete should drug the competitors or bribe the referee or that the manager should engage in the various activities the courts have condemned as in bad faith.

And so with Adam Smith. If we limit his remarks about the pursuit of self interest to situations in which it is morally legitimate and socially beneficial to pursue one's economic advantage, it is no great wonder he can begin with those situations and show, without shocking our moral sensibilities, that the pursuit of self interest is socially beneficial. But what if we move outside those situations to others, in which the ignorance or necessity of people can be exploited? Modern law gives a remedy. And it is much easier to understand why it does on the principles of St. Thomas than on those of Adam Smith just because before St. Thomas approved of an action, he first wanted to know both whether it was socially beneficial and whether it was just.