Mutual Misunderstanding in Contract¹

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ABSTRACT: It is accepted throughout the common law that unenforcement is appropriate in cases involving mutual misunderstanding. The explanation usually given is that mutual misunderstanding precludes the formation of a contract. It follows from this that unenforcement is necessary and inevitable; indeed, there is simply no contract to enforce. Curiously, however, in cases involving mutual misunderstanding the parties themselves usually believe and behave as if they have settled upon a knowable and enforceable agreement from the outset. It is typically only sometime later that the mutual misunderstanding between the parties comes to light. In this article I question the wisdom of the widely accepted common law rule surrounding mutual misunderstanding. I present and defend an alternative legal rule that significantly improves upon the efficiency of the results in cases involving mutual misunderstanding. The rule I propose would allow each party to an agreement founded on mutual misunderstanding to have the option to enforce his or her reasonable understanding of the agreement vis-à-vis the other party. This rule can be shown to preserve the reasonable expectations of the parties, promote reliance on promises, and provide implicit insurance against the risk that a mutual misunderstanding will interfere with the realization of expected contractual surplus.

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I. Introduction

Perhaps the most famous case of mutual misunderstanding is the 1864 English case of *Raffles v. Wichelhaus.* In *Raffles v. Wichelhaus,* the parties agreed in writing to buy and sell cotton arriving in Liverpool “ex Peerless from Bombay,” only to discover later that there were two ships answering to that description arriving at slightly different times. The English Court of Exchequer refused to enforce the agreement on account of the latent ambiguity associated with the name “Peerless.” Since that time it has been generally accepted in Anglo-American common law that unenforcement is the natural outcome in cases involving such mutual misunderstandings. The explanation most commonly given is that a mutual misunderstanding interferes with and precludes the formation of a contract. If this is true, it follows from this explanation that unenforcement is both necessary and inevitable; there is simply no contract to enforce.

There are some puzzles that emerge from this doctrine on its face. One is that the parties themselves almost always reasonably believe and behave as if they have settled upon an enforceable agreement from the outset. It is typically only sometime later—such as upon the arrival of the second Peerless ship in *Raffles v. Wichelhaus*—that the mutual misunderstanding comes to light. If a court refuses to enforce any obligations between the parties on the basis that no contract was ever formed, in many cases one of the parties will experience an unexpected windfall and the other an unexpected deprivation *ex post* as a result of relying on the apparent agreement. A second puzzle is that if a court finds that one party’s interpretation should be favored over the other’s interpretation—on the basis that one party’s interpretation is more reasonable, for example—then the court will typically enforce the agreement in keeping with those favored terms, despite the consistency of this situation with one in which each party equally reasonably believes in different terms. This highlights the fiction involved in refusing to enforce agreements based on a mutual misunderstanding. Regarding mutual misunderstanding as a problem of contract formation is a convenient fiction, but it is also flawed. Can the common law do a better job of addressing mutual misunderstanding? I believe the answer is yes.

In this article I show that although unenforcement yields appropriate and not undesirable results in some circumstances, it entails bizarre and unsuitable consequences in others. I present

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3 See the discussion in Parts II.A and III, *infra.*
and defend an alternative legal rule that significantly improves upon the efficiency of the results in most (if not all) cases involving mutual misunderstanding. The rule I propose would allow each party to an agreement founded on mutual misunderstanding to enforce his or her reasonable understanding of the agreement vis-à-vis the other party. Instead of assuming that there must be just one agreement that can either be legally enforced or not, it is more consistent with a desire to give effect to the reasonable expectations of the parties to allow each party to sue to enforce his or her reasonable understanding of the agreement vis-à-vis the other party. The proposed rule preserves the parties’ reasonable expectations, promotes reliance on promises, and provides implicit insurance against the risk that a mutual misunderstanding will interfere with the realization of a party’s expected contractual surplus. The proposed rule may also improve *ex post* bargaining by reducing the incentives to litigate where there has been a mutual misunderstanding.

Before indicating how the article proceeds, it is perhaps appropriate to emphasize what this article is not addressing. This article is not about contractual interpretation *per se*. There is already a well-developed literature in law and economics regarding the tradeoffs associated with different approaches to interpretation.\(^4\) This literature is tangential to the current issue, namely, what to do about cases involving mutual misunderstanding. Regardless of the interpretive approach one adopts, it is always possible that one will ultimately be left with an agreement that from the perspective of the adjudicator admits of two equally reasonable understandings of the terms that had been agreed to between the parties. This article is about what to do when this “two equally reasonable interpretations” issue occurs, regardless of how one discovers or comes to recognize that there has been a mutual misunderstanding. The initial diagnosis or determination of a mutual misunderstanding is centrally a matter of interpretation. What to do about it, however, is not at all an issue of interpretation; it is a remedial issue. Analyzing this residual remedial issue and improving on current efforts is the aim of this article.

This article also does not present an economic analysis of mutual mistake in contract law. Mutual mistake involves somewhat different considerations from those relating to mutual misunderstanding.\(^5\) In mutual misunderstanding cases, it is the terms of the contract that are

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\(^5\) See Eric Rasmusen and Ian Ayres, “Mutual and Unilateral Mistake in Contract Law” (1993) J. Legal Studies 309 at 310, fn. 2, where the authors draw the distinction between mutual misunderstanding and mistake thusly, “Still
understood by the parties differently; in mistake cases, on the other hand, the nature of the contractual obligations as between the parties are apparently, at least insofar as is relevant, clear and unambiguous, but the underlying factual beliefs about the world of one or both of the parties are, as it turns out, mistaken.\(^6\)

The article proceeds as follows. In Part II.A I illustrate that there is broad doctrinal consensus throughout the Anglo-American common law that agreements founded on a mutual misunderstanding fail at the point of contract formation and cannot be enforced. Given the broad consensus surrounding the result, it should perhaps not be surprising that there are competing justifications offered in support of the conclusion.\(^7\) In Part II.B, I argue that the arguments in favor of the result can generally be crudely classified as being either subjectivist or objectivist. I contend, further, that while the subjectivist view is an intuitively attractive, it is ultimately a mythical basis for contractual enforcement and ought to be rejected in favor of the objectivist approach. Once establishing the dominance of the objectivist approach, however, I suggest that it does not necessarily lead to the unenforceability result embraced by the common law; through a failure of legal imagination the common law has overlooked a superior objectivist alternative. Part III illustrates how the current doctrine surrounding mutual misunderstanding has been applied by the courts in three well-known cases and, in order to generalize the results, a fictional fourth case. These illustrations are intended to show that although the current rule yields acceptable consequences in some circumstances, in others it leads to results that are inappropriate and inefficient. Part IV presents in greater detail the argument in support of the neglected objectivist alternative. Part V shows how the proposed legal rule would resolve the three well-known cases and the fictional fourth case of Part III, and argues that these resolutions dominate those associated with the current common law approach. Part VI concludes.

\(^6\) Ibid.

\(^7\) It is frequently the case that results can be justified from a number of competing theoretical perspectives. For an account of this idea written in the context of securing the stability of constitutional institutions, see John Rawls, “The Idea of an Overlapping Consensus” (1987) 7(1) Oxford Journal of Legal Studies 1.
II. Mutual Misunderstanding: Common Law Doctrine and Justifications

A. Common Law Doctrine

The legal approach to mutual misunderstanding has not been perfectly consistent. Nevertheless, throughout the common law most of the courts considering the issue have held that there should be no enforcement in cases of agreements founded on mutual misunderstanding. In the UK the decision in *Raffles v. Wichelhaus* has frequently been followed and continues to be relevant. Within the past decade it has been cited with approval by the UK Court of Appeal. Although the case itself is only infrequently referred to in Canadian law, its result has generally been followed. Similar approving treatments of *Raffles v. Wichelhaus* can be found in both Australia and New Zealand case law.

The American case law regarding mutual misunderstanding is the most developed, and has also been consistent with the treatment of the *Raffles v. Wichelhaus* case. The approach in the United States to the issue of mutual misunderstanding is set out in § 20 “Effect of Misunderstanding” of the *Restatement of the Law of Contracts* (Second):

(1) There is no manifestation of mutual assent to an exchange if the parties attach materially different meanings to their manifestations and
    (a) neither party knows or has reason to know the meaning attached by the other; […]

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8 See, for example, G. H. Treitel, *The Law of Contract, 11th ed.* (London: Sweet & Maxwell, 2003) at 286. The recent judgment of the English Court of Appeal in *Great Peace Shipping Ltd. v. Tsavliris Salvage (International) Ltd.*, [2002] 4 All E.R. 689 (C.A.) made clear in *obiter* that in the view of the Court of Appeal the approach adopted in *Raffles v. Wichelhaus* is still applicable. At para. 29 of the judgment of the Court, Lord Phillips M.R. states that, “*Raffles v. Wichelhaus* was a case of latent ambiguity. More commonly an objective appraisal of the negotiations between the parties may disclose that they were at cross-purposes, so that no agreement was ever reached. In such a case there will be a mutual mistake in that each party will erroneously believe that the other had agreed to his terms. This case is not concerned with the kind of mistake that prevents the formation of agreement.”

9 See, for example, *Witze (Guardian ad litem of) v. Dalgliesh*, [1995] B.C.J. No. 403 (B.C.S.C.) (applying *Raffles v. Wichelhaus* in setting aside a settlement agreement that was ambiguous on its face and given the course of negotiations regarding a term providing a release); *British Columbia (Minister of Transportation and Highways) v. Reon Management Services Inc.*, [2001] B.C.J. No. 2500 (B.C.C.A.) (applying *Raffles v. Wichelhaus* to set aside a settlement agreement left ambiguous the amount of compensation for expropriated property). However, see also, *Hanley v. The Canadian Packing Company*, [1894] O.J. No. 4 (contract for the purchase and sale of a “car of hogs”, seller sending a double-decker car of hogs, buyer insisting a single-deck car was understood, finding that “car” was ambiguous and that the seller had the option of sending either a double or single-decked car of hogs). Stephen Waddams writes in *The Law of Contracts, 4th ed.*, (Toronto: Canada Law Book, 1999) at ¶ 90 of the state of Canadian law: “In such a case where the parties are at cross-purposes and neither has reason to know the other’s meaning there will be held to be no contract.” In support of this proposition, he cites a number of decisions, including: *Angevarre v. McKay* (1960), 25 D.L.R. (2d) 521 (Co. Ct.); *Baker v. Guaranty Savings & Loan Ass’n, [1931] 1 D.L.R. 968, [1931] S.C.R. 199; Morrison v. Burton* (1955), 15 W.W.R. 667 (Alta. S.C.); *Omnium Securities Co. v. Richardson* (1884), 7 O.R. 182 (Ch. D.); *Hay v. Green* (1916), 11 O.W.N. 97 (S.C. App. Div.).

10 [cite to Australian and New Zealand authorities]

11 The section reads in full:
This general approach to the problem of mutual misunderstanding had been codified much earlier in the original *Restatement of the Law of Contracts*\(^{12}\) in 1932. The common ground between the two *Restatements* is that where parties attach different meanings to their manifestations and neither party knows or has a reason to know that the other party has another meaning in mind, the apparent agreement will be unenforceable.\(^{13}\) There is a remarkable degree of consistency in the treatment of cases involving mutual misunderstanding in the common law, from the UK, to Canada,\(^{14}\) to Australia, to New Zealand, and finally, as has been shown, in the

\[\text{§ 20 Effect of Misunderstanding:}\]

(1) There is no manifestation of mutual assent to an exchange if the parties attach materially different meanings to their manifestations and

(a) neither party knows or has reason to know the meaning attached by the other; […]

(b) each party knows or each party has reason to know the meaning attached by the other.

(2) The manifestations of the parties are operative in accordance with the meaning attached to them by one of the parties if

(a) that party does not know of any different meaning attached by the other, and the other knows the meaning attached by the first party; or

(b) that party has no reason to know of any different meaning attached by the other, and the other has reason to know the meaning attached by the first party.

\(^{12}\) *Restatement of the Law of Contracts* (American Law Institute, 1932). *Raffles v. Wichelhaus* would fall under the description of § 71(a)

\[\text{§ 71 Undisclosed Understanding of Offeror or Offeree, When Material Except as stated in §§ 55, 70, the undisclosed understanding of either party of the meaning of his own words and other acts, or of the other party’s words and other acts, is material in the formation of contracts in the following cases and in no others:}\]

(a) If the manifestations of intention of either party are uncertain or ambiguous, and he has no reason to know that they may bear a different meaning to the other party from that which he himself attaches to them, his manifestations are operative in the formation of a contract only in the event that the other party attaches to them the same meaning.

(b) If both parties know or have reason to know that the manifestations of one of them are uncertain or ambiguous and the parties attach different meanings to the manifestations, this difference prevents the uncertain or ambiguous manifestations from being operative as an offer or an acceptance.

(c) If either party knows that the other does not intend what his words or other acts express, this knowledge prevents such words or other acts from being operative as an offer or acceptance.

George Palmer has contended at length that the shift in language from the original to the Second Restatement undesirably changed the rules regarding misunderstanding by simultaneously limiting and expanding the doctrine inappropriately, most cases of mutual misunderstanding are dealt with the same way under either approach. George Palmer, “The Effect of Misunderstanding on Contract Formation and Reformation Under the Restatement of Contracts Second” (1966) 65 *Mich. L. Rev.* 33 at 33.

\(^{13}\) According to Corbin, “If the parties gave different meanings to the words of a fully 'integrated' contract, either party who sues for enforcement in accordance with his own meaning has the burden of proving that the other party knew or had reason to know what that meaning was and that he himself had no reason to know that the other party gave the words a different meaning.” See Arthur Linton Corbin, 1 *Corbin on Contracts* § 4.10 (1993), at 619, fn. 6.

\(^{14}\) This is essentially the Canadian view as well. See Waddams, *supra* note 9 at ¶ 90.
There is, however, a significant debate surrounding why this outcome is so widely perceived to be the appropriate legal disposition of this kind of dispute.

**B. Justifications of the Common Law Approach**

The conventional common law approach of finding that apparent agreements are unenforceable when associated with a mutual misunderstanding has frequently been justified through subjectivist “will theories” of contract formation. With almost equal frequency, however, the result has been justified by objectivists as reflecting a failure of the parties—from a so-called third-party or objective standpoint—to reach an enforceable agreement. Despite the fact that there is a startlingly consistent view in the literature that the Court of the Exchequer in Raffles v. Wichelhaus reached the correct legal result, there is a fierce debate regarding the nature of the reasons supporting the result. Are the apparent agreements in cases of mutual misunderstanding unenforceable because the “wills” of the parties do not coalesce or meet properly, as subjectivists insist, or are such agreements nullities because there is no one understanding of the agreement that can be regarded as controlling the relationship between the parties as contended, broadly speaking, by objectivists? In what follows the decision in Raffles

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15 In addition to the preceding discussion of the American view, § 205 of the legal encyclopedia AmJur 2d states: “§ 205 Mistake as to subject matter: Mutual mistake consists of a clear showing that both contracting parties misunderstood the fundamental subject matter or terms of the contract. Thus, if there is a misunderstanding in the language that relates to the object of the agreement so that one party understands it is buying one thing and the other party thinks it is selling another thing, no meeting of the minds occurs and no contract is formed. However, the mistake of only one of the parties to a contract as to the subject matter does not affect its binding force and ordinarily affords no grounds for its avoidance.” See 17A Am Jur 2d CONTRACTS § 205. The other major American legal encyclopedia, Corpus Juris Secundum, makes similar observations regarding the law of mutual misunderstanding provides as follows (citations and footnotes have been omitted): “§ 36. Common intention: A common intention, a meeting of the minds, on all the terms thereof, is essential to an agreement; and no portion of the terms may be left unsettled. In order that there may be an agreement, the parties must have a distinct intention common to both and without doubt or difference. Until all understand alike, there can be no assent, and, therefore, no contract. Both parties must assent to the same thing in the same sense and at the same time, although, according to some courts, not at the same instant. Their minds must meet as to all the terms, and it follows that the minds of the negotiating parties must meet on the identity of those to be bound before there is an enforceable contract. All contracts must be good or bad in their inception and must not depend on subsequent contingencies. If any portion of the proposed terms is not settled, or no mode is agreed on by which it may be settled, there is no agreement. It is not necessary, however, that all of the terms of the contract be settled by a single act, but the parties may settle on one term at a time, and their contract becomes complete when the last term is agreed on. The agreement may be binding if the parties agree on the essential terms and seriously understand and intend the agreement to be binding on them notwithstanding all the details are not definitely fixed. The fact that differences subsequently arise between the parties as to the construction of the contract, or the fact that one party subsequently proposes a modification of the contract which the other declines, is not of itself sufficient to affect the validity of the original contract or to show that the minds of the parties did not meet with respect thereto.” See 17 C.J.S. Contracts § 36.

v. Wichelhaus will be discussed as an example of the application of each of the justifications, not least because the debate between subjectivists and objectivists in the context of mutual misunderstanding has so frequently made reference to the case.

1. The Subjectivist Justification of Raffles v. Wichelhaus

Subjectivism in the law of contract formation has deep roots. It is associated with (among many others) Hugo Grotius, the French legal theorist Robert Joseph Pothier, and the German jurist, Friedrich Carl von Savigny. It has been traced to Roman law. Its intuitive appeal is difficult to forswear. The subjectivist justification for the result in mutual misunderstanding cases is based on a claim that the parties never, in substance, actually agree about what they are promising each other and because they do not in fact “will” the same agreement, the apparent agreement cannot be enforced. There was never consensus ad idem.

Applying the subjectivist approach to the facts of Raffles v. Wichelhaus, “Peerless” cannot mean “Peerless” simpliciter. There is a latent ambiguity, as Peerless must mean either

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17 See Hugo Grotius, Rights of War and Peace (William Whewell translation, 1853) (1625) at 192-204.
18 See Robert Joseph Pothier, A Treatise on the Contract of Sale (L.S. Cushing translation, 1839) (1762) at 17: “The consent of the parties, which is of the essence of the contract of sale, consists in a concurrence of the will of the seller, to sell a particular thing to the buyer, for a particular price, and of the buyer, to buy of him the same thing for the same price.”
21 This was the argument being made by counsel for the defendant in Raffles v. Wichelhaus at the point he was cut off by the Court of Exchequer and a verdict was announced for the defendant. It is tempting therefore to assume that this is the basis for the court’s decision. Indeed, a number of commentators insist that this is the ground upon which the Court of Exchequer granted judgment for the defendant, despite no reasons having been offered by the court. Grant Gilmore states, “The failure of the judges, who had given Milward [counsel for the plaintiff seller] such a hard time, to put any questions to Mellish [counsel for the defendant buyer] suggests that they were entirely content to let the case go off on the purely subjective failure of the minds to meet at the time the contract was entered into.” See Grant Gilmore, The Death of Contract (Columbus: Ohio State University Press, 1974) at 39. More recently, Melvin Eisenberg wrote, “if both parties subjectively meant the December Peerless, Buyer should have been deemed in breach; and Seller should have been deemed in breach if both parties subjectively meant the October Peerless. Holmes had it backwards: the result in Peerless is correct because they meant different things, not because they said different things.” See Melvin Eisenberg, “The Emergence of Dynamic Contract Law” (2000) 88 Calif. L. Rev. 1743 at 1759. See also Jan Vetter, “The Evolution of Holmes, Holmes and Evolution” (1984) 72 Calif. L. Rev. 343, who at 356 remarks of the Raffles v. Wichelhaus case: “The decision can be read, indeed is most plausibly read, as resting on the subjective theory.” Richard L. Barnes has contended that, “The Raffles case is one where the court must look at subjective intent.” See Richard L. Barnes, “Rediscovering Subjectivity in Contracts: Adhesion and Unconscionability” (2005) 66 La. L. Rev. 123 at 139. Charles Fried is among the many others who have mounted similar arguments based on a lack of correspondence of the subjective intent of the parties. See Charles Fried, Contract as Promise: A Theory of Contractual Obligation (1981), states generally of the Raffles v. Wichelhaus case and some related examples that “the court cannot enforce the will of the parties because there are no concordant wills.” Val. D. Ricks, “American Mutual Mistake: Half-Civilian Mongrel, Consideration Reincarnate” (1998) 58 La. L. Rev. 663 in fn. 60 at 674, remarks that, “In Raffles the parties’ minds truly did not meet subjectively, and that failure prevented contract formation.”
“Peerless I” or “Peerless II” (if pressed a subjectivist would presumably admit that it could refer to any ship of that name, if a contracting party subjectively believed that there was yet another vessel of the same name that was the one on which the cotton would arrive). The key for the subjectivist seems to be that there is no single set of terms that the parties ever commonly willed or intended to govern their bargain at any one point in time. To the subjectivist, although the parties ostensibly assented to trading the cotton arriving on the “Peerless,” they each intended and understood different things by the use of the term, and therefore no enforceable contract came into being; simply put, there was no meeting of the minds.

2. The Objectivist Justification of Raffles v. Wichelhaus

A second justification of the conclusion that the agreement ought not to be enforced is objectivist. At least from the time that David Hume was writing during the Scottish Enlightenment, objectivists have rejected the subjectivist approach as being conceptually and pragmatically unsound. Oliver Wendell Holmes Jr. perhaps put it best in 1897 in The Path of the Law: “the making of a contract depends not on the agreement of two minds in one intention,

22 The original and most famous proponent of this approach is Oliver Wendell Holmes. Holmes described the objectivist approach as follows.

“[Suppose that a document] does not disclose one meaning conclusively according to the laws of language. Thereupon we ask, not what this man meant, but what those words would mean in the mouth of a normal speaker of English, using them in the circumstances in which they were used, and it is to the end of answering this last question that we let in evidence as to what the circumstances were. But the normal speaker of English is merely a special variety, a literary form, so to speak, of our old friend the prudent man. He is external to the particular writer, and a reference to him as the criterion is simply another instance of the externality of the law.”


23 David Hume explained that,

“It is evident, that the will or consent alone never transfers property, nor causes the obligation of a promise (for the same reasoning extends to both), but the will must be expressed by words or signs, in order to impose a tie upon any man. The expression being once brought in as subservient to he will, soon becomes the principal part of the promise; nor will a man be less bound by his word, though he secretly give a different direction to his intention, and withhold the assent of his mind. But though the expression makes, on most occasions, the whole of the promise, yet it does not always so; and one who should make use of any expression, of which he knows not the meaning, and which he uses without any sense of the consequences, would not certainly be bound by it. Nay, though he know its meaning, yet if he use it in jest only, and with such signs as evidently show, that he has no serious intention of binding himself, he would not lie under any obligation of performance; but it is necessary, that the words be a perfect expression of the will, without any contrary signs. Nay, even this we must not carry so far as to imagine, that one, whom, by our quickness of understanding, we conjecture, from certain signs, to have an intention of deceiving us, is not bound by his expression or verbal promise, if we accept of it; but must limit this conclusion to those cases where the signs are of a different nature from those of deceit. All these contradictions are easily accounted for, if justice arise[s] entirely from its usefulness to society; but will never be explained on any other hypothesis.”

but on the agreement of two sets of external signs—not on the parties having meant the same thing but on their having said the same thing.”

To an objectivist, the concept of *consensus ad idem* is regarded as a useful colloquialism to describe the process of contract formation. It is by necessity a fiction because individual contracting parties can *never* be certain that the other party has precisely the same understanding regarding the terms of an agreement, and the presence of a legal obligation cannot depend upon the subjective understanding of what one means, but only on what one can reasonably be taken to have communicated. This is necessarily the case; by virtue of having separate minds, each contracting party has no direct access to the subjective understanding of the terms of the agreement possessed by the other party. The most that one party can do to access the other party’s intent is to carefully observe what the other party says and does in light of that party’s own understanding of communication, language, and human nature. And *a fortiori* a court supposedly attempting to discern whether the parties in fact reached *consensus ad idem* is fundamentally disadvantaged, since the court cannot step into the subjective understanding of even one of the parties. The subjective understanding of each party is an informational advantage that each naturally has over the adjudicator. For obvious strategic reasons, this subjective understanding is also knowledge that a party cannot readily establish as a matter of evidence.

Assuming that the case can be conclusively made for the objectivist approach for pragmatic reasons, and that the fiction of the subjectivist approach to the origin of legal obligation has been exposed (or, indeed, exposed yet again), how is it that the apparent agreement in *Raffles v. Wichelhaus* would fail for the objectivist? Objectivists differ somewhat

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25 This is true for an even more fundamental reason—that of contractual incompleteness. Since it is impossible to draft a complete contract, it is impossible to reach agreement on all the matters that fall outside the explicit ambit of the terms of an agreement. For an excellent development of the idea that it is not the contract that fills in the gaps in the agreement reached between the parties, but the events of the world itself that does so implicitly, see Brian Langille and Arthur Ripstein, “Strictly Speaking, It Went Without Saying” (1996) 2(2) Legal Theory 63.

26 For a sustained argument in support of this contention, see David Goddard, “The Myth of Subjectivity” (1987) 7 Legal Studies 263. Goddard explains at 269:

> For a practice of promising to conduce to the general good, it must be possible to rely on promises. If they are not to be relied upon, and may not give rise to (justified) claims for performance, or criticism for non-performance, then the practice is pointless: but then, whether or not the practice has been invoked must be determinable from the promisee’s viewpoint, and the existence and extent of an obligation must be decided by the signs made—the moves in the language game to which the promisee is party—and not by some concealed intention or speaker-meaning.

27 I refer simply to “legal obligation” because I would like to set aside the question of moral obligation, which I do not take a view on here.
on the precise nature of the justification. In his own discussion of the *Raffles v. Wichelhaus* case, Holmes explained that,

> It is commonly said that such a contract [one involving mutual misunderstanding] is void, because of mutual mistake as to the subject matter, and because therefore the parties did not consent to the same thing. But this way of putting it seems to me misleading. The law has nothing to do with the actual state of the parties’ minds. In contract, as elsewhere, it must go by externals, and judge parties by their conduct. If there had been but one “Peerless,” and the defendant had said “Peerless” by mistake, meaning “Peri,” he would have been bound. The true ground of the decision was not that each party meant a different thing from the other, as implied by the explanation that has been mentioned, but that each said a different thing. The plaintiff offered one thing, the defendant expressed his assent to another.\(^{28}\)

In *The Death of Contract* Grant Gilmore states that “Even for Holmes this was an extraordinary tour de force.”\(^{29}\) Gilmore contends that, “The magician who could 'objectify' *Raffles v. Wichelhaus* could, the need arising, objectify anything."\(^{30}\) Gilmore goes on, rhetorically perhaps, to question why the result of the case has to be justified on an objectivist basis. To be more precise, Gilmore queries why it was so important to Holmes that the result of the case be justifiable from this objectivist perspective.

In my view, the answer to the challenge posed by Gilmore is that there is no defensible alternative justification—the subjectivist perspective is a mythical basis for legal obligation and, in the context of this justificatory vacuum, some type of non-subjectivist justification is necessarily required for the result.\(^{31}\)

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\(^{28}\) As quoted in Gilmore, *supra* note 21 at 40-41.

\(^{29}\) *Ibid.* at 41.

\(^{30}\) *Ibid.*

\(^{31}\) In a different context Holmes put the justification of the result in *Raffles v. Wichelhaus* somewhat differently:

> “By the theory of our language, while other words may mean different things, a proper name means one person or thing and no other. If language perfectly performed its function, as Bentham wanted to make it, it would point out the person or thing named in every case. But under our random system it sometimes happens that your name is *idem sonans* with mine, and it may be the same even in spelling. But it never means you or me indifferently. In theory of speech your name means you and my name means me, and the two names are different. They are different words. *Licet idem sit nomen, tamen diversum est propter diversitatem personae.* In such a case we let in evidence of intention not to help out what theory recognizes as an uncertainty of speech, and to read what the writer meant into what he has tried but failed to say, but, recognizing that he has spoken with theoretic certainty, we inquire what he meant in order to find out what he has said. It is on this ground that there is no contract when the proper name used by one party means one ship, and that used by the other means another. The mere difference of intent as such is immaterial. In the use of common names and words a plea of different meaning from that adopted by the court would be bad, but here the parties have said different things and never have expressed a contract.” [Footnotes omitted].
In explaining the general result of unenforceability in cases involving mutual misunderstanding Stephen Waddams makes an analogy to cases in which a promisor’s message is altered in transmission by one for whose conduct the promisor is not responsible. Waddams explains that non-enforcement in cases of mutual misunderstanding “may result in the defeat of the plaintiff’s reasonable expectation, but it is not an expectation for which the defendant can be held responsible for the latter had no reason to anticipate it. The defendant has simply not promised what the plaintiff understood, any more than has the sender of a message that is altered en route.”

On Waddams’ explanation, it is unclear why the defendant cannot in fact be held responsible for the plaintiff’s reasonable understanding of what it was that the defendant actually did and said in the situations leading to the mutual misunderstanding. Indeed, the Raffles v. Wichelhaus case differs crucially and substantially from a case in which an outside agency tampered with the message of the defendant in transit. In a typical case of mutual misunderstanding, the parties have each reasonably interpreted and formed an understanding of the actual words and actions of the other party in forming their own expectations. There is nothing obviously or prima facie problematic with holding a promisor responsible for the meaning that the promisee reasonably associated with the actual (as opposed to the altered) words and actions of the promisor.

III. Illustration of the Operation of the Current Rule

In order to establish that the current approach to the law of mutual misunderstanding is prima facie problematic, this Part will analyze the consequences associated with the application of the rule that in the following three well-known common law cases: (a) Raffles v.

See Holmes, supra note 22 at 418.

“Of course, the purpose of written instruments is to express some intention or state of mind of those who write them, and it is desirable to make that purpose effectual, so far as may be, if instruments are to be used. The question is how far the law ought to go in aid of the writers. In the case of contracts, to begin with them, it is obvious that they express the wishes not of one person but of two, and those two adversaries. If it turns out that one meant one thing and the other another, speaking generally, the only choice possible for the legislator is either to hold both parties to the judge's interpretation of the words in the sense which I have explained, or to allow the contract to be avoided because there has been no meeting of minds. The latter course not only would greatly enhance the difficulty of enforcing contracts against losing parties, but would run against a plain principle of justice. For each party to a contract has notice that the other will understand his words according to the usage of the normal speaker of English under the circumstances, and therefore cannot complain if his words are taken in that sense.”

See Holmes, ibid, at 419.

32 Waddams, supra note 9 at ¶ 90.
Wichelhaus;\(^{33}\) (b) Frigaliment Importing Co. v. B.N.S. International Sales Corp.;\(^{34}\) and (c) Oswald v. Allen.\(^{35}\) In each case, treating the apparent agreement as void leads to some undesirable consequences for at least one of the parties. These consequences are more significant in some types of cases, such as Raffles v. Wichelhaus, than in others, such as Oswald v. Allen. A fictional fourth case is also presented, which is intended to illustrate in general the range of outcomes associated with the current common law rule, and to show that the undesirable results reached in the three specific cases discussed are not idiosyncratically associated with the facts in those cases in particular, and that in fact the problems with unenforcement in cases of mutual misunderstanding are systematic and general.

A. Raffles v. Wichelhaus

Raffles v. Wichelhaus involved a written agreement to buy and sell 125 bales—about 50,000 lbs—of a certain grade of Indian cotton “to arrive ex Peerless from Bombay” in Liverpool, England.\(^{36}\) The total cost of the cotton specified in the agreement at the time was £3,593 (equivalent to about $500,000 today).\(^{37}\) It was apparently unknown to the parties at the time they entered into the agreement in 1862 there were two different ships named Peerless that were sailing from Bombay—one in October\(^ {38}\) (the “Peerless I”) and one in December\(^ {39}\) (the “Peerless II”). Although it is not entirely clear from the report of the case, it seems the buyer believed he had contracted to buy cotton that would be arriving on Peerless I.\(^ {40}\) It is clear, on the other hand, that the seller believed that he had contracted to sell cotton that would be arriving on Peerless II. When the Peerless I docked in Liverpool on February 18, 1863, cotton was fetching a price in the market that was lower than the price the buyer had agreed to pay under the

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\(^{33}\) Supra note 2.


\(^{35}\) 417 F.2d 43 (2d Cir. 1969).

\(^{36}\) These facts come from an excellent historical account of the case by A.W. Brian Simpson, “Contracts for Cotton to Arrive: The Case of the Two Ships Peerless” (1990) 11 Cardozo L. Rev. 287 at 288.

\(^{37}\) A conversion tool available at http://www.measuringworth.com/ converts £3,593 in 1864 to £245,067.78 using the retail price index and £317,828.57 using the GDP deflator. [The site recommends this tool be cited this way: Lawrence H. Office, “Five Ways to Compute the Relative Value of a UK Pound Amount, 1830 - 2006” MeasuringWorth.Com, 2007.] At the current exchange rate of approximately $2 = £1 reported by http://www.xe.com/, this would be equivalent to about $500,000 in 2006 terms.

\(^{38}\) This was the Peerless (Major) according to Simpson, supra note 36 at 295.

\(^{39}\) This was the Peerless (Flavin) according to Simpson, ibid.

\(^{40}\) According to Simpson, this is not clear from the law reports or from the pleas; the buyer was silent on his belief that it was the first or second Peerless; ibid. at 289.
agreement. Assuming that the buyer did believe that the cotton would be arriving on Peerless I, he would have been pleasantly surprised when the seller did not demand performance. The buyer remained silent, apparently believing he had avoided a significant trading loss from what he would have considered to be the seller’s default. The Peerless II arrived in Liverpool two months later on April 19, 1863. The prevailing market price for cotton had increased in the past two months, but remained slightly below the price specified in the agreement. The seller contacted the buyer to make arrangements for delivery and settlement. The buyer refused to take delivery of the cotton, objecting that because there were two ships named Peerless the agreement could not be enforced on the seller’s terms. The seller sued to enforce his understanding of the agreement. The court sided with the defendant buyer and refused enforcement. The suit was dismissed without reasons.

The *Raffles v. Wichelhaus* case has been widely discussed in English-speaking law school classrooms since 1864. It was given a high profile by Oliver Wendell Holmes Jr., who made reference to the case in at least two of his significant works and used it to illustrate his objective theory of contract formation. This high profile has continued since. In his discussion of the *Raffles v. Wichelhaus* case in *The Death of Contract* in 1974, Grant Gilmore described the case as “to the ordinary run of case law as the recently popular theatre of the absurd is to the ordinary run of theatre.” Gilmore was undoubtedly right to observe that the facts of the case are interesting for the bizarre nature of the misunderstanding involved. The case has more to offer than an amusing tale of speculation and misunderstanding, however. The case also lucidly illustrates a central problem with the way in which common law courts have addressed mutual misunderstandings.

Consider the consequences of the unenforceability result reached in *Raffles v. Wichelhaus*. The buyer was able to avoid the losses associated with his unsuccessful speculation in cotton by raising in his defense the latent ambiguity of the agreement. Strangely, if the seller and buyer had both thought that the ship was the Peerless I, then the buyer would have lost and the seller gained an amount (say X) greater than if they both understood that the ship was the Peerless II.

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41 Simpson reports it as being around 15d. per bale, as compared with an agreement price of 17 ¼d. *Ibid.* at 320.
42 Simpson pegs it at around 16 ¾d. per bale as compared with 17 ¼d.; *ibid.* at 321.
43 The court interrupted the argument by counsel and granted judgment for the defendant from the bench.
44 See, for example, Holmes, *supra* note 22; and Oliver Wendell Holmes Jr., *The Common Law* (1881) at 309-310.
45 See Gilmore, *supra* note 21 at 35-44.
Peerless II (say ½X). However, because the buyer successfully argued that there should be no enforcement because of the ambiguity, the buyer lost nothing (i.e., neither X nor ½X) even though the speculation he believed he had engaged in was unsuccessful under either account. Correspondingly, because the seller was not able to enforce his reasonable understanding of the agreement, he was not able to realize the profit of ½X that he expected. To put it another way, the buyer’s defense in the *Raffles v. Wichelhaus* case amounts to a claim that because the court cannot reliably determine whether he should have lost X or ½X, he should not lose anything. Similarly, since the seller was unable to show that he was entitled to gain X or ½X, he was not able to recover anything. That the law should permit this type of claim to prevail seems to fail as a matter of commonsense, but this is precisely the effect of the current rule surrounding mutual misunderstanding.

**B. Frigaliment Importing Co. v. B.N.S. International Sales Corp.**

The *Frigaliment Importing* case involved a dispute arising between a buyer and seller of chickens. The buyer was a corporation based in Switzerland and the seller was an export company operating out of the State of New York. The Swiss buyer and the New York seller had apparently agreed in writing in two separate agreements to buy and sell a large quantity of frozen chicken. The dispute surrounded the meaning of the word “chicken” as it was used in the two agreements. The Swiss buyer argued that its understanding was that the contracts were to buy younger chickens suitable for “broiling or frying,” whereas the New York seller argued that the contracts were for chickens more broadly construed (e.g., as a species of animal), including the less desirable older chickens, which were more suitable for “stewing.”

The two agreements both described the chicken to be bought and sold as follows: “US Fresh Frozen Chicken, Grade A, Government Inspected, Eviscerated 2½-3 lbs. and 1½-2 lbs. each, all chicken individually wrapped in cryovac, packed in secured fiber cartons or wooden boxes, suitable for export.”[47] In total the two agreements called for the sale of 125,000 lbs. of 2½-3 lb. chickens at $0.33 per lb., and 50,000 lbs. of 1½-2 lb. chickens, the first 25,000 lbs. at $0.365 and the other 25,000 lbs. at $0.37 per lb. The seller shipped chickens to the buyer in Switzerland. The 1½-2 lb. chickens were young chickens, suitable for broiling or frying. The 2½-3 lb. chickens that were delivered were mature chickens, however. The buyer objected,

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[47] *Frigaliment Importing, supra* note 34 at 117.
insisting on its understanding that young 2½-3 lb. chickens had been promised. The seller ignored the objection, and the Swiss buyer sued in New York for damages.

Justice Friendly was confronted with the question as to whether the parties had an agreement for “broilers and fryers” (“young chickens”) or “stewing chickens” (“mature chickens” or “fowl”). The evidence was decidedly mixed. Justice Friendly canvassed the arguments and evidence on both sides before concluding:

When all the evidence is reviewed, it is clear that defendant believed it could comply with the contracts by delivering stewing chicken in the 2 1/2-3 lbs. size. Defendant's subjective intent would not be significant if this did not coincide with an objective meaning of “chicken.” Here it did coincide with one of the dictionary meanings, with the definition in the Department of Agriculture Regulations to which the contract made at least oblique reference, with at least some usage in the trade, with the realities of the market, and with what plaintiff’s spokesman had said. Plaintiff asserts it to be equally plain that plaintiff’s own subjective intent was to obtain broilers and fryers; the only evidence against this is the material as to market prices and this may not have been sufficiently brought home.48

Interestingly, Justice Friendly disposed of the case on the basis that the plaintiff buyer had not sufficiently made out its case that the defendant seller had breached the agreements by supplying mature chickens instead of young chickens. On the facts and the evidence it seems that either view was equally reasonable, but that the plaintiff merely failed to show that its view of the agreements ought to supplant the view of the defendant. Curiously, this manner of disposing of the case is inconsistent with the approach taken in the Restatement. The manner in which Justice Friendly decided the case had the effect of allowing enforcement on the understanding of the terms adopted by the New York seller.49

If instead the approach taken in the Restatement had been adopted, then there would have been nothing to enforce as between the buyer and the seller. It would have been open to the plaintiff buyer to assert (but not enforce) its right to buy “young chickens,” yet the defendant seller could equally assert (but not enforce) its right to sell “fowl” in the agreed quantities at the agreed prices. The part of the agreements over which there was apparently no ambiguity—that the 1½-2 lb. chickens were “young chickens”—would also have been found to be void and would have been unenforceable.

48 Id. at 121.
49 Some authors have suggested that this may be due to a bias on the part of a New York court to decide in a manner consistent with New York businesses (insert cite).
We are told in the judgment that in late April, 1957, the prevailing market price for 2½-3 lb. broilers was between $0.35 and $0.37 per lb. The price for the same size “fowl” was $0.30 per lb. The agreed price under the agreements for the 2½-3 lb. “chickens” was $0.33 per lb. If the two agreements were simply set aside as unenforceable, the approach suggested by the Restatement, and hence neither party was forced to carry out its obligations under the agreements, then the seller would have lost out on its expected surplus of $0.03 per lb. of fowl as compared with the market price (on its subjective view of the agreement). Similarly, the buyer would lose out on savings of $0.02 to $0.04 per lb. of young chicken (on its subjective view of the agreement). On net, the reasonable understandings of the buyer and the seller essentially would have canceled each other out in terms of damages, at least with respect to the part of the agreements dealing with the 2½-3 lb. “chickens.” On the other hand, the part of the agreements dealing with the young 1½-2 lb. chickens would also be unenforceable, which would lead to the loss of whatever contractual surplus may have been associated with these terms.50

On the way Justice Friendly decided the case, the disposition was one-sided. The New York seller received a higher than market price for the larger 2½-3 lb. “fowl” it had supplied, and a market price for the young 1½-2 lb. chickens it supplied. Functionally, the New York seller was rewarded and the Swiss buyer was punished for the mutual misunderstanding for which the two parties were equally responsible.

C. Oswald v. Allen

At issue in Oswald v. Allen was whether an agreement between the buyer and the seller contemplated the sale of all of the Swiss coins shown to the buyer by the seller, or only the coins appearing in a specific set of Swiss coins. The events leading to the apparent misunderstanding are straightforward. Dr. Oswald, the Swiss buyer, and Mrs. Allen, the American seller, had entered into negotiations to buy and sell coins. Dr. Oswald was in the United States and visited a bank branch where Mrs. Allen stored her two coin collections, the (a) Swiss Coin Collection; and (b) the Rarity Coin Collection. Mrs. Allen had separate safety deposit boxes for each of the collections. She had shown Dr. Oswald the Swiss Coin Collection first, and he had made hand-

50 Of course, if the trade involving the 1½-2 lb. “young chickens” were still mutually advantageous, one might well expect the parties to immediately reenter a contract to buy and sell the same quantity of these chickens. The true loss would be the loss of the ability to rely on the fixed price specified in the earlier agreements, since if the market prices for “young chickens” of that size had shifted, any new contract price would be set in the shadow of these changed market conditions.
written notes regarding the many coins in the collection. Mrs. Allen then showed Dr. Oswald some Swiss specimens from her second collection—the Rarity Coin Collection.

On the return trip by automobile from the bank branch, Dr. Oswald and Mrs. Allen agreed, in discussions carried out through Dr. Oswald’s brother (since Dr. Oswald himself spoke virtually no English), that Mrs. Allen would sell “the Swiss coins” to Dr. Oswald for $50,000. According to the trial judge, Dr. Oswald “believed that he had offered to buy all Swiss coins owned by the defendant while defendant reasonably understood the offer which she accepted to relate to those of her Swiss coins as had been segregated in the particular collection denominated by her as the ‘Swiss Coin Collection’.” Of the interaction between Dr. Oswald and Mrs. Allen, the Second Circuit reported, “Apparently the parties never realized that the references to ‘Swiss coins’ and the ‘Swiss Coin Collection’ were ambiguous.” Indeed, the Court continued, “The trial judge found that Dr. Oswald thought the offer he had authorized his brother to make was for all of the Swiss coins” whereas “Mrs. Allen thought she was selling only the Swiss Coin Collection and not the Swiss coins in the Rarity Coin Collection.” As a result, the trial judge held that there was no contract reached for the sale of any of the coins because there was no meeting of the minds between Oswald and Allen.

At the Second Circuit Court of Appeals, Moore J. explained that in characterizing the exchange between the parties as inherently ambiguous, “The trial judge based his decision upon his evaluation of the credibility of the witnesses, the records of the defendant, the values of the coins involved, the circumstances of the transaction and the reasonable probabilities.” In addition, Moore J. added that, “Such findings of fact are not to be set aside unless ‘clearly erroneous.’” The findings of fact were not to be clearly erroneous, and the trial result of unenforceability was affirmed.

Refusing to enforce this agreement is prima facie not terribly problematic in this case. What can we infer about the parties’ valuations from the report of the case? To begin with, the fair market value of the Swiss Coin Collection was probably at least somewhat lower than the $50,000 price offered by Oswald, which would explain why Allen was willing to accept the offer initially. In addition, the market price of all the Swiss coins in the Swiss Coin Collection and the Rarity Coin Collection was probably more than $50,000, which would explain why Oswald was

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51 Supra note 35 at 44.
52 Id. at 44-45.
53 Id.
willing to make of offer of that amount. The net effect of refusing to enforce the agreement is that the court is effectively arbitrarily setting the surplus (i.e. the overvaluation) expected by the seller equal to the surplus (i.e. the undervaluation) expected by the buyer:

$$50,000 - FMV_{\text{SwissCoinCollection}} = FMV_{\text{AllSwissCoins}} - 50,000$$

In these circumstances, without additional facts, one might well accept that this is a reasonable outcome to the case. Each side misunderstood the other, and if the misunderstandings were equally reasonable, then arbitrarily returning each party into the position they occupied before the apparent agreement was concluded is reasonable. It seems that neither party relied on the agreement to any extent. Moreover, if the parties remain willing to enter into a transaction to transfer some or all of the Swiss coins, they may recontract to consummate the transfer at a mutually acceptable price.

Indeed, it is unclear that in cases involving mutual misunderstandings relating to the transfer of property that one party or the other is going to systematically benefit and the other will systematically be disadvantaged, particularly when the property is not one in which there is a rapidly shifting, liquid market, such as the market for cotton, and where the property is going to be transferred almost immediately, such as with a contemplated spot transaction for the Swiss coins. In these circumstances, it is less likely that one side will make a strategically motivated argument that there was ambiguity about the terms that had been agreed.

It turns out, however, that there may have been a strategic motive underlying Mrs. Allen’s reluctance to carry out the transaction after all. On April 24, 1964, just 16 days after the original meeting between Oswald and Allen, Allen’s husband told Oswald’s agent that, “his wife did not wish to proceed with the sale because her children did not wish her to do so.”\textsuperscript{54} This suggests that her reservation price for the sale of the Swiss Coin Collection (and also “all the Swiss coins”) had shifted upward after the apparent agreement had been concluded. In this case, perhaps Oswald did make a better deal than Allen. If this is correct, then there may be good reasons to not simply equate the buyer and seller’s surpluses, as the Second Circuit’s decision effectively did. Allen may have been acting as strategically in framing her defense as had the buyer in \textit{Raffles v. Wichelhaus}.

\textsuperscript{54} Id. at 44.
D. The Fictional Case of Candy and Uncle Sam

Consider how the current common law rule would apply to the following facts. At the outset (t=0), Candy (the buyer) and Uncle Sam (the seller) enter into a forward agreement to trade a specified quantity of an agricultural commodity on a specific date following the upcoming growing season (t=1). The sale of the commodity is to occur at a specified price of $100 per ton. The buyer, Candy, is situated in Canada, and the seller, Uncle Sam, is situated in the United States.

Assume that in light of all the circumstances of the negotiation and conclusion of the agreement, Candy believes that the $100 per ton price specified in the contract refers to a purchase price of 100 Canadian dollars. Assume that Uncle Sam believes otherwise, and that his belief is equally reasonable in light of all the circumstances of the negotiation and conclusion of the agreement. Indeed, Uncle Sam believes that the $100 per ton price specified in the forward agreement refers to US dollars.\(^55\)

Assume further that the exchange rate between the dollars is 1:1 at t=0 and that the currency futures markets are predicting that the two dollars will remain at parity at t=1. Thus, at the time they enter into the forward agreement, Candy and Uncle Sam have beliefs about the price term that are economically equivalent; neither party is enriched nor economically disadvantaged in expected value terms. However, owing to the differing reasonable understandings of the currency of the $100 per ton price term, there is a misunderstanding regarding the allocation of risk of currency fluctuations.

There are two major risks that this forward agreement apparently addresses. The first major risk that the forward agreement addresses is the possibility that the spot price of the commodity will be higher or lower than the forward agreement price at the date specified in the agreement for performance.\(^56\) The second major risk addressed in the agreement is currency

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\(^{55}\) Admittedly, the assumption that the parties exactly equally reasonably think that the agreement is in the currency of their imagination is a strong one, particularly in this example where it seems that currency risk is obvious and that any party engaging in large transactions of this kind would be alert to the risk. However, this is intended as an example of mutual misunderstanding and a clear illustration of the serious consequences that may attend the currently dominant approach to the law in this area.

\(^{56}\) More specifically, Candy, the buyer, expects that she will benefit from the agreement if the spot price on the future date exceeds $100 per ton (assume for now that the currencies remain at parity), since in that case Candy may complete the transaction with Uncle Sam and immediately resell the commodity on the spot market for a gain relative to the agreed price. Candy will lose from the agreement if the spot price is less than $100 per ton (again, assume parity) at t=1, since in this case the same commodity will be available for a lower price on the spot market. This possibility, of course, is precisely what motivates Uncle Sam to enter into the agreement. Under the agreement Uncle Sam is protected against the risk that the spot price at t=1 will be lower than the price specified in the agreement.
risk. By assumption, Candy reasonably believes that the agreed $100 per ton price is
denominated in Canadian dollars. Candy thus accepts the risk that the Canadian dollar will
strengthen against the US dollar, which will mean, all else the same, a higher effective price for
the purchase of the commodity, since the US dollar price will be correspondingly lower.
Similarly, Uncle Sam reasonably believes that the agreed price is denominated in US dollars,
which entails precisely the opposite consequences.

With respect to each risk, the outcomes that can potentially arise in the commodity
market and in the currency market can be characterized as being below expectations, at
expectations, or above expectations. More specifically, in the commodity market, suppose that
at t=1 commodity prices can be at one of three levels: (i) high (probability = ¼); (ii) normal
(probability = ½); or (iii) low (probability = ¼). With the currencies trading at parity, if the
commodity market is high, the real price of the commodity will be 150% of the forward
agreement price; if the commodity market is in a normal state the price will be 100% of the
forward agreement price; and if the commodity market is in a low price state the price will be
50% of the forward agreement price.

Similarly, in the currency market, suppose that the value of the US dollar in Canadian
dollars will be in one of three states at t=1: (i) stronger than is expected (probability = ¼); (ii)
parity, as is expected (probability = ½); or (iii) weaker than is expected (probability = ¼). If the
US dollar is stronger than expected, then $1 US will buy $1.50 CDN. If the US dollar performs
as is expected, the currencies will trade at parity. If the US dollar is weaker than expected, then
$1 US will buy just $0.67 CDN.

Combining the possibilities of the interaction of the currency market with the commodity
market results in the following matrix of nine possible outcomes in the two relevant markets at
t=1:

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57 This means that Candy, the buyer, will benefit if the Canadian dollar weakens relative to the US dollar, since the
effective cost of the commodity will be lower than it would be if US dollars had been specified.
58 Specifically, Uncle Sam will benefit if the US dollar strengthens against the Canadian dollar, since Candy will be
forced to part with more valuable US dollars to purchase Uncle Sam’s agricultural commodity.
59 Assume that the relative changes in the value of the two currencies are not differentially affected insofar as the
price of the relevant commodity is concerned. This ensures that the price of the commodity will be at the midpoint
of the values of the two currencies.
Table 1: Possible States of the World, Outcome Matrix

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>$120 US, $180 CDN</td>
<td>$150 US / CDN</td>
<td>$180 US, $120 CDN</td>
<td></td>
</tr>
<tr>
<td>Normal</td>
<td>$80 US, $120 CDN</td>
<td>$100 US / CDN</td>
<td>$120 US, $80 CDN</td>
<td></td>
</tr>
<tr>
<td>Low</td>
<td>$40 US, $60 CDN</td>
<td>$50 US / CDN</td>
<td>$60 US, $40 CDN</td>
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</tbody>
</table>

These nine possible states of the world, along with the reasonable expectations of Candy and Uncle Sam in each state, are presented in Tables 2 and 3.

Table 2: Candy’s Reasonable Expectation in All States of the World

<table>
<thead>
<tr>
<th>State of the Markets at t=1</th>
<th>Probability</th>
<th>Candy’s Subjective Reasonable Expectation</th>
<th>Price to pay per ton</th>
<th>Net result per ton</th>
</tr>
</thead>
<tbody>
<tr>
<td>State #</td>
<td>Commodity</td>
<td>US Dollar</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>High</td>
<td>Strong</td>
<td>1/16</td>
<td>$100 CDN ($67 US)</td>
</tr>
<tr>
<td>2</td>
<td>High</td>
<td>Normal</td>
<td>1/8</td>
<td>$100 CDN ($100 US)</td>
</tr>
<tr>
<td>3</td>
<td>High</td>
<td>Weak</td>
<td>1/16</td>
<td>$100 CDN ($150 US)</td>
</tr>
<tr>
<td>4</td>
<td>Normal</td>
<td>Strong</td>
<td>1/8</td>
<td>$100 CDN ($67 US)</td>
</tr>
<tr>
<td>5</td>
<td>Normal</td>
<td>Normal</td>
<td>1/4</td>
<td>$100 CDN ($100 US)</td>
</tr>
<tr>
<td>6</td>
<td>Normal</td>
<td>Weak</td>
<td>1/8</td>
<td>$100 CDN ($150 US)</td>
</tr>
<tr>
<td>7</td>
<td>Low</td>
<td>Strong</td>
<td>1/16</td>
<td>$100 CDN ($67 US)</td>
</tr>
<tr>
<td>8</td>
<td>Low</td>
<td>Normal</td>
<td>1/8</td>
<td>$100 CDN ($100 US)</td>
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<tr>
<td>9</td>
<td>Low</td>
<td>Weak</td>
<td>1/16</td>
<td>$100 CDN ($150 US)</td>
</tr>
</tbody>
</table>

Both parties believe reasonably that there is an agreement in place that has addressed both commodity risk and currency risk. Neither party is surprised by or unaware of the currency risk. It is just that each party believes that the price that has been agreed is in Canadian dollars (Candy’s belief) or US dollars (Uncle Sam’s belief).^60^ 

Table 3: Uncle Sam’s Reasonable Expectation in All States of the World

<table>
<thead>
<tr>
<th>State of the Markets at t=1</th>
<th>Probability</th>
<th>Uncle Sam’s Subjective Reasonable Expectation</th>
<th>Price to receive per ton</th>
<th>Net result per ton</th>
</tr>
</thead>
<tbody>
<tr>
<td>State #</td>
<td>Commodity</td>
<td>US Dollar</td>
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<td></td>
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<tr>
<td>1</td>
<td>High</td>
<td>Strong</td>
<td>1/16</td>
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<td>2</td>
<td>High</td>
<td>Normal</td>
<td>1/8</td>
<td>$100 US ($100 CDN)</td>
</tr>
<tr>
<td>3</td>
<td>High</td>
<td>Weak</td>
<td>1/16</td>
<td>$100 US ($67 CDN)</td>
</tr>
<tr>
<td>4</td>
<td>Normal</td>
<td>Strong</td>
<td>1/8</td>
<td>$100 US ($150 CDN)</td>
</tr>
<tr>
<td>5</td>
<td>Normal</td>
<td>Normal</td>
<td>1/4</td>
<td>$100 US ($100 CDN)</td>
</tr>
<tr>
<td>6</td>
<td>Normal</td>
<td>Weak</td>
<td>1/8</td>
<td>$100 US ($67 CDN)</td>
</tr>
<tr>
<td>7</td>
<td>Low</td>
<td>Strong</td>
<td>1/16</td>
<td>$100 US ($150 CDN)</td>
</tr>
<tr>
<td>8</td>
<td>Low</td>
<td>Normal</td>
<td>1/8</td>
<td>$100 US ($100 CDN)</td>
</tr>
<tr>
<td>9</td>
<td>Low</td>
<td>Weak</td>
<td>1/16</td>
<td>$100 US ($67 CDN)</td>
</tr>
</tbody>
</table>

^60^ Because each of the parties has a different reasonable understanding of the currency in which the price is to be paid, each party has differing, equally reasonable beliefs about how the currency risk is being allocated according to their understanding of the forward agreement.
Given the latent ambiguity in the forward agreement regarding the price term, consider the litigation incentives that Candy and Uncle Sam have in each of the nine states of the world in the presence of the current common law rule. These incentives are outlined in Table 4, below. Candy has an incentive to claim performance by Uncle Sam in states 1, 2 and 3, because Candy has made what has turned out to be a winning speculation on the state of the commodity market in the forward agreement. The commodity market in states 1, 2, and 3, is in a high price state.

Table 4: Candy and Uncle Sam’s Litigation Incentives

<table>
<thead>
<tr>
<th>State of the Markets at t=1</th>
<th>Probability</th>
<th>Candy’s Incentives</th>
<th>Uncle Sam’s Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>State #</td>
<td>Commodity</td>
<td>US Dollar</td>
<td>Probability</td>
</tr>
<tr>
<td>1</td>
<td>High</td>
<td>Strong</td>
<td>1/16</td>
</tr>
<tr>
<td>2</td>
<td>High</td>
<td>Normal</td>
<td>1/8</td>
</tr>
<tr>
<td>3</td>
<td>High</td>
<td>Weak</td>
<td>1/16</td>
</tr>
<tr>
<td>4</td>
<td>Normal</td>
<td>Strong</td>
<td>1/8</td>
</tr>
<tr>
<td>5</td>
<td>Normal</td>
<td>Normal</td>
<td>1/4</td>
</tr>
<tr>
<td>6</td>
<td>Normal</td>
<td>Weak</td>
<td>1/8</td>
</tr>
<tr>
<td>7</td>
<td>Low</td>
<td>Strong</td>
<td>1/16</td>
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<tr>
<td>8</td>
<td>Low</td>
<td>Normal</td>
<td>1/8</td>
</tr>
<tr>
<td>9</td>
<td>Low</td>
<td>Weak</td>
<td>1/16</td>
</tr>
</tbody>
</table>

Correspondingly, Uncle Sam would benefit from being released from the forward agreement in states 1, 2, and 3, since the spot price is higher than the forward agreement price. To be released from the forward agreement, Uncle Sam has an incentive to argue that there was a mutual misunderstanding in the forward agreement rendering it unenforceable. That is, we can fully anticipate that in response to Candy’s claim to payment in states 1, 2 and 3, Uncle Sam will argue that Candy cannot show on a balance of probabilities that Candy’s reasonable understanding that the forward agreement contemplated a price of $100 CDN per ton is the “correct” interpretation.

Similarly, we can predict that the litigation incentives of Candy and Uncle Sam will be reversed if states 7, 8 or 9 arise. In these states, Uncle Sam will have made a winning speculation that the spot price at t=1 is less than the price of $100 per ton in the forward agreement (regardless of which currency is stipulated). Uncle Sam will claim payment of $100 US per ton, consistent with his understanding of the forward agreement. In response, Candy will argue that Uncle Sam cannot show that her understanding of US dollars should prevail over
Candy’s equally reasonable understanding of Canadian dollars. As such, Candy will argue that the forward agreement, interpreted as an obligation to pay in US dollars, is unenforceable by Uncle Sam as against Candy.

Interestingly, the litigation incentives of Candy and Uncle Sam are consistent if states 4, 5, or 6 arise. In the simplest case, state 5, neither party wins or loses from the forward agreement because the currencies and the commodity price in the spot market at t=1 is precisely what was predicted at the time they entered into the forward agreement at t=0. In state 4, each Candy and Uncle Sam benefits from their own reasonable subjective interpretation of the forward agreement. That is, Candy believes that she is entitled to pay $100 CDN per ton for the commodity and, because the prevailing spot market price at t=1 is $120 CDN, Candy benefits to the tune of $20 CDN per ton. Also in state 4, Uncle Sam believes that he is entitled to receive $100 US per ton for the commodity and, because the prevailing spot market price at t=1 is $80 US, Uncle Sam benefits at the rate of $20 US per ton of the commodity. Thus, in state 4, each party will feel entitled to recover from the other on the basis of their reasonable, subjective understanding of the price term in the forward agreement. In state 6, Candy will not wish to enforce the agreement, because Candy will understand that she is obligated to pay $100 CDN per ton for the commodity, whereas it will be trading in the spot market at t=1 at $80 CDN per ton, leading to an expected loss of $20 CDN per ton for Candy. Similarly, in state 6 Uncle Sam will not want to enforce the forward agreement, because he will understand that he will be paid $100 US per ton for the commodity, but the spot price will be $120 US per ton, meaning that Uncle Sam will do better in the spot market than through enforcement of his interpretation of the forward agreement.

What are the likely consequences of these payoffs and the litigation incentives they engender? In states 1-3, Uncle Sam will want to avoid his own interpretation of the agreement. In states 7-9, Candy will want to avoid her own interpretation of the agreement. The parties will only ever agree on the desirability of enforcing their own individual interpretations of the agreement in states 4-6. In state 4 each will want to enforce their own interpretation of the agreement (and avoid enforcement of the other’s interpretation). In state 5, the parties will be indifferent to performance. In state 6, each party will want to avoid their original understanding of the agreement (and, counter-intuitively, would welcome enforcement on the other’s understanding of the terms).
Based on the current common law rule, then, the parties will only ever *prima facie* share an incentive to enforce the agreement in state 4. However, if *Candy* anticipates this, and thinks that a court might enforce *both* reasonable understandings of the forward agreement, then *Candy* might prefer to argue that the agreement is unenforceable because the gain of $20 CDN per ton to *Candy* through enforcement will be exceeded by *Uncle Sam*’s gain of $20 US per ton to be paid by *Candy*. In this case, then, even in state 4, enforcement of the forward agreement would be resisted by one of the parties (assuming that each party wields *a de facto* veto on enforcement in these circumstances, as is suggested by the current common law rule).

The net result is that even though the parties share the same reasonable expectation with respect to the risks in the commodity market, and have in expected terms economically equivalent (though opposing) risks in the currency market, there is no state of the world in which the parties would both want the forward agreement enforced on their own understanding of the agreement *ex post*.61 Thus, in light of the current state of the common law regarding mutual misunderstanding, we can predict that there would be no enforcement.

That there are significant grounds to question the wisdom of this outcome emerges clearly. *Candy* and *Uncle Sam* could not be clearer in agreeing that they are allocating the commodity market risk. *Candy* is hoping for a strong commodity market at t=1, and *Uncle Sam* will be relieved if the commodity market is weak at t=1. The ambiguity arises only in how they are allocating the currency market risk.

The problem posed by the current legal rule is most clearly seen in the case where the currency market risks do not materialize on either side; that is, where the US dollar and Canadian dollar are still trading at parity at t=1. In this case, we can expect that *Candy* will resist the enforcement of the forward agreement if state 8 materializes (weak commodity market and normal currency market), even though the ambiguity about the allocation of the currency risk has no bearing at all on the outcome for *Candy* at t=1. *Candy* will argue that the misunderstanding militates against enforcement of the forward agreement in order to avoid a loss relating to a risk that was clearly understood as being allocated between the parties—the commodity market risk. If this argument succeeds, as it probably would under §20 of the Restatement and the common law of contracts more generally, then *Candy* will experience an unanticipated windfall at *Uncle Sam*’s expense. Of course, the roles will be completely reversed if state 2 (strong commodity market...
market and normal currency market) obtains at $t=1$. In the context of a strong commodity market and a normal currency market, *Uncle Sam* will realize that he will receive a higher price if he is able to sell on the spot market at $t=1$. Thus, he will have an incentive to argue that due to the genuine misunderstanding relating to the allocation of risk in the currency market, that the forward agreement is not enforceable.

The current rule makes enforceability of agreements dealing with risks that *have* been allocated turn on the absence of any latent ambiguities in other material terms in the agreement. Crucially, because parties believe that they have addressed both commodity market risk and currency market risk, and had inconsistent but equally reasonable beliefs about one of them, a court will hold that neither risk was addressed in an enforceable manner by the agreement. The current legal rule supports the conclusion that one latent ambiguity is enough to spoil the entire agreement.

Worse still, these litigation incentives exist even when the parties *did* actually have the same understanding of the terms at the time they entered into the agreement. This is an *ex post* strategic behavior problem. If one of states 1-3 or 7-9 materializes, the losing party will have an incentive to scrutinize the terms of the original agreement in order to discover a latent ambiguity that might be sufficient to preclude enforcement of the agreement by the other party. Thus the current rule invites strategic conduct *ex post* regarding false claims of misunderstanding at the initial stage. This does not necessarily have to be malevolent on the part of the disputant. It may have been the case that at the time they entered into the agreement they simply did not identify the latent ambiguity, and faced with the undesirable outcome associated with the ambiguity have resolved that they never would have agreed to the term as understood by the other party if they had expressly confronted the latently ambiguous term.

In addition, not enforcing the apparent agreement in any circumstances interferes with the reasonable expectations of the parties. Considered narrowly from the perspective of the parties, *Candy* and *Uncle Sam*, the central costs of the current rule of unenforceability are those of having to bear risks that each party believed had been hedged. For the party that would prefer enforcement (in states other than 5 and 6, where neither party would demand enforcement), the manifested *ex post* loss is equal to the value of the winning speculation (as revealed at $t=1$) and whatever would have been its cost at $t=0$. Of course, there is no way to mitigate this loss at $t=1$ since the state of the markets has already been observed and the uncertainties in the market have
been resolved. Exactly offsetting this, however, in terms of **ex post** outcome is that the party that prefers unenforcement of the forward agreement (or both, as in state 6) will benefit because they avoid the loss that they otherwise would have realized on the purchase or sale of the commodity.\(^{62}\)

The fact that the parties did enter into an agreement, and believed themselves bound until the misunderstanding was revealed after the fact is clear evidence that there was some surplus associated with their own understanding of the agreement **ex ante**. The current rule makes enforceability of agreements dealing with risks that have been allocated turn on the absence of any latent ambiguities in other terms in the agreement. Crucially, because parties believe that they have addressed both commodity market risk and currency market risk, and had inconsistent but equally reasonable beliefs about one of them, a court will hold that neither risk was addressed in an enforceable way by the agreement. In other words, the problem with the current legal rule is that one latent ambiguity is enough to spoil an entire agreement.

**IV. Rethinking the Current Rule: The Neglected Objectivist Alternative**

Despite the questionable desirability of the results associated with the current common law rule, as outlined in the discussion of the cases in the preceding section, the intuitive response and the one that the legal scholars have almost universally adopted is that unenforcement of agreements forged upon a mutual misunderstanding follows logically and inexorably. However, there are at least three compelling consequential reasons to question the merits of this conclusion suggested by the foregoing analysis. First, because parties typically prefer enforcement to non-enforcement of their agreements, they will want to ensure that there are no latent ambiguities embedded in their agreements. As such, they will tend on the margin to overinvest in drafting and redrafting provisions in order to ensure that there is a reduced chance of a latent ambiguity upsetting their agreement.\(^{63}\) In general, one would predict that the extent of the overinvestment problem will depend on the relationship between the marginal costs of abating the probability of

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\(^{62}\) Contractual surplus is never knowable directly, but is rather inferred indirectly from the fact that parties have settled on an agreement and have manifested an intention to be bound. It is therefore difficult to precisely quantify the losses associated with the rule that mutual misunderstanding leads to an unenforceable agreement, but indubitably there are some.

\(^{63}\) It may be possible that because of overconfidence or self-serving bias that parties tend to currently under-invest in contractual specificity **ex ante**. If this is the case, then the current legal rule might simply reduce the inefficiency associated with the current behavioural tendencies. This is somewhat speculative, but does have some empirical support: [cite to Macaulay and others].
a latent ambiguity rendering the agreement unenforceable as compared with the marginal benefit of increasing the probability that the agreement will be enforced as each party understands it. This in turn will depend on the distribution of the expected contractual surplus anticipated by the parties. If the contract is one that will potentially yield a large realized surplus for one of the parties and large realized losses for the other party (such as an insurance contract or a futures contract) the incentives for the losing party to escape the agreement *ex post* will be significant, which will result in a correspondingly greater benefit to avoiding latent ambiguities and therefore exacerbate this overinvestment problem.

Second, the current legal rule invites *ex post* strategic behavior on the part of parties who, after having entered into a contract, discover that the bargain is a losing one. In these circumstances, parties will be able to avoid the loss if they can cobble together a differing reasonable understanding of the agreement. Suppose that the buyer in the *Raffles v. Wichelhaus* case at the time of entering into the agreement believed that there was only one Peerless, the Peerless II. Suppose he then casually learned of the Peerless I, such as by accidentally seeing it at the port upon its arrival. Upon learning of the Peerless I, he would naturally fear that the seller had intended the Peerless I, if the market was unfavorable for him at that moment. If the market was unfavorable to the buyer, and the seller did indeed think it was the Peerless I and was prepared to deliver the cotton at that time, then the buyer would have an incentive to argue, truthfully, that he thought it was the Peerless II they had agreed to. It is also possible that the market would be favorable to the buyer, and the seller did indeed think it was the Peerless I and was prepared to deliver the cotton at that time, then the buyer would have an incentive to argue, truthfully, that he thought it was the Peerless II they had agreed to. In that case, if the seller thought all along it was the Peerless I and not the Peerless II, and the market was favorable for the buyer, the buyer might be tempted to play along and accept the seller’s interpretation, giving up the possibility of an even greater profit when the Peerless II arrives, but locking in profits. Whether the buyer would have an incentive to acquiesce in the seller’s belief in the Peerless I would depend on the buyer’s expectations regarding the likely distribution of profits at the time of the expected arrival of Peerless II.⁶⁴

This strategic concern is not confined to the *Raffles v. Wichelhaus* case. In *Fricaliment*, for example, it is not clear that the buyers would have complained about the provision of mature chickens rather than young chickens if the market price for chicken generally had spiked

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⁶⁴ Conceptually, the decision of the buyer would turn on whether the profits to be realized by feigning belief that it was Peerless I exceeded the price the buyer would assign to the right to buy later, upon arrival of the Peerless II.
upwards after they had entered into the agreement (assuming that they would have expected the contract to be set aside in the event of the latent ambiguity being used by the seller to invoke that result). In *Oswald v. Allen*, too, there is a suggestion in the report of the case that that Mrs. Allen sought grounds to avoid the verbal agreement only after her children expressed reservations about the sale of the Swiss coins. 65 Finally, it apparent from the discussion of the general case involving the agricultural commodity sale between Candy and Uncle Sam that they have strategic incentives to try to enforce or avoid the agreement depending on what happens ex post in the commodity and currency markets, as depicted in Table 4 in Part III.D, above.

Third, because the possibility of a latent ambiguity can never be ruled out entirely, parties will not be able to rely fully on promises that have been made to them. The institution of contract will be weakened to an extent associated with the prevalence of mutual misunderstandings—both real (arising spontaneously and organically from the negotiation process) and artificial (cobbled together strategically ex post by a party with a losing bargain). The fact that parties will tend to overinvest in contract specificity ex ante will tend to reduce the absolute chilling effect of latent ambiguities affecting confidence in and reliance on agreements, but this ex ante overinvestment will not completely eliminate this effect. To the extent that contract law is inclined to protect reasonable expectations of promises, it seems the law regarding mutual misunderstanding runs against the current.

Recognizing that either reasonable understanding of the agreement cannot prevail over the other understanding should not necessarily entail the conclusion that there is nothing to enforce. Proponents of this conclusion seem to accept that the plaintiff must show on a balance of probabilities that the plaintiff’s understanding of the agreement is more reasonable than what the defendant understood. This assumption is unwarranted. A different approach might well be taken.

If it were regarded as sufficient that the promisee only show that the promisor’s words and actions were reasonably interpreted by the promisee and that they were intended to be relied upon and were in fact relied upon, then the promisee should be entitled to sue the promisor for enforcement of what the promisee believed the promisor to have promised. Such a legal rule would mitigate the tendencies toward (i) overinvestment in contractual specificity ex ante; (ii) ex

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65 This can be regarded as an ex post shock to her reservation price for the coins and is conceptually consistent with a similar fluctuation in the market price.
post strategic behavior; and (iii) interference with the reasonable expectations of the parties. It is also (at least arguably) consistent with the approach of the American courts to § 90 of the Restatement of the Law of Contracts (Second). Nothing in the analysis here turns on whether the proposed rule is consistent with § 90 of the Restatement. It is worthwhile to note, however, that the evolution and development of contract law in the U.S., at least, appears to be headed in the direction consistent with the rule proposed here for responding to the problems posed by mutual misunderstandings.

Under the proposed rule, parties would not have an incentive to overinvest in contractual specificity ex ante because they would be secure in the knowledge that if their interpretation is reasonable, then it will be enforceable vis-à-vis the other party. As long as a party’s understanding is reasonable, they will not have to fear that some lurking latent ambiguity will cause their understanding of agreement to be unenforceable. Moreover, parties will have a strongly attenuated incentive to claim that there was a mutual misunderstanding at the time of the agreement. No longer will a demonstration that there was a latent ambiguity be enough to entirely avoid losses arising under the agreement. Finally, the reasonable expectations of the parties are overtly respected by this legal rule. All reasonable expectations will be protected so that the institution of contract in enforcing promises and protecting reasonable reliance is not unduly or unintentionally weakened.

The all-or-nothing approach adopted in the current law regarding mutual misunderstanding (i.e., either enforceable on just one understanding of the agreement or not at all) gives parties an incentive to litigate where their views diverge on the substance of the agreement, especially where for one party large losses would result from the counterparty’s reasonable understanding of the agreement. Under the proposed rule, however, the incentive to litigate to the end would be considerably lessened, since the net positions of the parties will frequently be much closer together than they would be with the current rule. That is, there would be considerably less room for different beliefs to lead to dramatically divergent views

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66 My colleague Peter Benson has contested the claim that § 90 of the Restatement can be used in this way on the basis that it is inconsistent with corrective justice, although I see no reason why § 90 of the Restatement cannot lead to the precise approach I advocate here on the basis of the manner in which it is drafted. Benson’s claim is that the promisor has not done anything “wrong” and so cannot be held responsible, be “corrected,” for unknowingly engendering reasonable expectations in the promisee that differed from the promisor’s own.

67 As long as on net there is recovery for at least one of the parties, they will still have an incentive to bring suit. The attenuating factors will include additional legal costs, as well as fear of the counter-suit.
surrounding expected payoffs. This increases the probability that the costs of litigation will be regarded as unjustified to a rational litigant.

One might imagine arguments to the effect that there are corresponding benefits to the requirement that there be just one agreement that is either enforced or not. For example, it may be the case that the parties benefit from the increased attention paid to drafting agreements \textit{ex ante} in that there is an increased chance that they have reached terms that are mutually beneficial. It is more difficult, however, to imagine that there would be advantages to promoting incentives for \textit{ex post} opportunistic claims of mutual misunderstanding or to undermining confidence in contract enforceability.

V. Application of the Proposed Legal Rule

A. Raffles v. Wichelhaus

Analyzing \textit{Raffles v. Wichelhaus} under the proposed legal rule suggests that the observed results would be much less remarkable than they are under the current rule. The buyer would be permitted to sue the seller for enforcement on the buyer’s reasonable understanding of the agreement, which would entail delivery of cotton on the Peerless I. Even with this right, however, the buyer would not sue to enforce his reasonable understanding of the agreement, because he would have incurred losses on this understanding. To avoid the losses, the buyer simply needs to not claim enforcement vis-à-vis the seller. The seller, on the other hand, would choose to exercise his claim to sue the buyer for damages on the seller’s understanding. The seller would no longer fall prey to the argument that the buyer believed he lost X and not $\frac{1}{2}X$ and therefore should lose nothing. The buyer would lose $\frac{1}{2}X$ instead of X. The buyer would still be ahead of where he reasonably expected to be, but the seller would be precisely in the position he

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68 This results from the discontinuity associated with a finding that two interpretations are equally likely (unenforcement) and that one interpretation should be favored (enforcement on those terms).
69 In the model proposed by George Priest and Benjamin Klein, “The Selection of Disputes for Litigation,” 13 J. Legal Stud. 1 (1984), the difference in the outcomes that would be reached would be significantly narrowed, resulting in fewer cases being brought. [double-check this]
70 One possible advantage would be that parties invest more in ensuring that they are in agreement about what it is they are undertaking to do vis-à-vis each other in order to ensure that there is an expected economic surplus associated with the agreement. If as an empirical matter it is unlikely that parties will be able to engage in profitable transactions, then one might be concerned that there will be an avalanche of surplus reducing agreements entered into on the basis of mutual misunderstanding. If these are all enforced on the basis of the reasonable understanding of each party, then the proposed rule could conceivably be wealth and welfare reducing. On the other hand, to the extent that parties could contract out of the effects of the proposed rule, as is likely, then this concern would be strongly diminished in importance.
expected to be in under the agreement. If, on the other hand, both the buyer and the seller would
benefit from their reasonable understandings of the agreement, then they would expect to
successfully sue each other. To some extent the damages would offset, and the party whose
reasonable expectation was more positive than the other’s would receive a positive amount.
Each party’s reasonable expectation would be respected. Finally, if both buyer and seller would
have losses from their reasonable understandings of the agreement, then neither would sue to
have their reasonable understanding enforced. Each would perceive themselves to be better off
with unenforcement.

B. Frigaliment Importing Co. v. B.N.S. International Sales Corp.

In Frigaliment, the New York seller would no longer prevail only on its own terms. Instead, the Swiss buyer would also be able to prevail on the Swiss corporation’s own reasonable
understanding that the 2½-3 lb. chickens would be young chickens rather than mature chickens.
The result would be that the parties would still buy and sell the 125,000 lbs. of young chickens
(this part of the agreement was common to both understandings). In addition, the 50,000 lbs. of
disputed “young” or “mature” 2½-3 lb. chicken would be renegotiated in light of the parties’
entitlements. The buyer would be entitled to young chickens at the stated price, and the seller
would be entitled to supply mature chickens at the stated price. The net result, one would expect,
is that the seller would provide the young chickens at a price that split the difference between the
prevailing market prices for young and mature chickens. Also possible is an outcome in which
mature chickens are provided, but there is a lower price paid for them by the buyer to reflect the
lower market value of these mature chickens as compared with the young ones. In either case
the outcome would retain the contractual surplus associated with the 125,000 lbs. of 1½-2 lb.
young chickens, not unduly punish the Swiss buyer and reward the New York seller for the
mutual misunderstanding, and move the difference between the parties much closer ex post,
making settlement more likely (since it would increase the ratio between litigation costs and
expected value of prevailing at trial).

C. Oswald v. Allen

In Oswald v. Allen, Dr. Oswald would be able to insist on the sale of all the Swiss coins
shown by Mrs. Allen to him in exchange for $50,000. Mrs. Allen, correspondingly, would be
able to insist on receiving $50,000 for only the coins appearing in her Swiss Coin Collection, and
avoid having to transfer the Swiss coins from the Rarity Coin Collection. Since there is only one set of coins to be transferred, however, both understandings of the agreement could not be enforced. Dr. Oswald should be entitled to sue for specific performance based on his understanding of the agreement, which would have the effect of Mrs. Allen transferring all the Swiss coins from both the Swiss Coin Collection and the Rarity Coin Collection in exchange for payment of $50,000. Mrs. Allen would then have a conflicting claim to the return of the Swiss coins from the Rarity Collection, while retaining the $50,000 paid for the Swiss coins. Therefore one would expect that a dispute would naturally arise about the valuation of the Swiss coins that Dr. Oswald believed he had purchased from the Rarity Coin Collection. After the fact, Dr. Oswald would have an incentive insist that the coins were of low value so as to minimize the amount he would have to pay to compensate Mrs. Allen for their loss. Mrs. Allen, equally, would have an incentive to insist the coins had a high value in order to increase the amount of compensation.

One efficient way to resolve this conflicting dispute would be to impose a shotgun clause between the parties—with Mrs. Allen making an offer to buy or sell the disputed coins at a fixed price to Dr. Oswald (or vice-versa). Alternatively, if the court had confidence in the robustness and liquidity of the market for the disputed coins, there could be an order that if the parties failed to agree on a price for the disputed coins that they would be sold at auction with the proceeds of sale being split between the parties.71

D. The Fictional Case of Candy and Uncle Sam

In the fictional case of Candy and Uncle Sam, allowing each party to enforce on each others’ reasonable understanding of the agreement would secure for each party the outcomes associated with their litigation incentives outlined in Table 4 of Part III.D, above. As explained above, in eight of the nine states of the world under the current common law rule there would be no enforcement of the agreement ex post, since in all states except for state 4, one or both parties would prefer for the agreement not to be enforced, and each party wields a de facto veto on enforcement since they can each plead in their defense the mutual misunderstanding regarding the currency of the transaction.

71 Even if the market were not terribly liquid or robust, if indeed Mrs. Allen’s higher valuation for the coins was a result of her children urging her not to sell, one might expect that the children would win such an auction. Of course, the court would be wise to invite both Mrs. Allen and Dr. Oswald to submit bids in the public auction to ensure that the individual with the highest valuation would wind up with the disputed coins.
The outcomes in states 1-3 and 7-9 are straightforward under the proposed rule. In states 1-3, Candy would sue to enforce the agreement on her own understanding and Uncle Sam would not. In states 7-9, the roles would be reversed and Uncle Sam would sue to enforce his understanding of the agreement and Candy would not. This would preserve the contractual surplus for the party making the “winning” speculation in the forward agreement, and force the party making the “losing” speculation to satisfy the successful party’s expectation.

The outcomes in states 4-6 are not as obvious. In state 4, both Candy and Uncle Sam would want the agreement to be enforced on their own understanding. Under the proposed rule, Candy would anticipate that under state 4 her gains would be exceeded by Uncle Sam’s gains, and would therefore prefer current common law rule to the proposed rule. However, if the proposed rule were adopted, and assuming that Uncle Sam sues to enforce his own understanding of the agreement, Candy would be better off asserting her claim to enforcement on her own understanding, since this would provide a reduction in her net losses. In state 5, both parties would be indifferent to enforcement under the current common law rule and also under the proposed rule, since the forward agreement provides for the enforcement of the realized market outcomes. In state 6, the outcomes are such that neither party would want to exercise his or her own understanding of the agreement vis-à-vis the other, but would welcome enforcement on the other party’s understanding. In state 6, there would be no enforcement and both Candy and Uncle Sam would welcome the result.

VI. Conclusion

Curiously, though perhaps not surprisingly given the attractive features of the legal solution I propose to cases of mutual misunderstanding, this proposed approach has much in common with the recent movement in contract law toward protection of reasonable reliance on promises made with the reasonable expectation that they would be relied upon.72 In Canada, Australia, and the UK the doctrine regarding subsequent reliance is in a state of flux and can be

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72 See Waddams, supra note 9 at ¶ 215, where Waddams explains that, “Lip service continues to be paid to the bargain theory, but by a variety of devices the law does not, and has always, enforced promises by reason of subsequent reliance. This does not, however, mean that the state of the law is satisfactory. The suppression of the true principle underlying cases of reliance leads, as so often, to uncertainty and injustice… The solution seems to lie in an open recognition of reliance as a reason for enforcement, with, however, a proviso that enforcement need not always be to the full extent of the value promised. Sometimes full enforcement will be appropriate, but on occasion it will be sufficient to protect the promisee’s reliance. It would seem that the courts are already moving in this direction and, with the example of section 90 of the Second Restatement to guide them, there is every prospect of rational development in the future.”
expected to continue to develop in a more flexible direction. In the United States there has been considerably more development of the doctrine of subsequent reliance and it is generally used to enforce promises rather than simply to protect the reliance of promisees. This is convenient, since good ideas without a possibility of being adopted as public policy are in no shortage. The proposed solution to agreements founded on a mutual misunderstanding may already have a ready legal basis to find its footing on.

One of the central indicators of the development of the common law of contracts is the flexibility and broad nature of the power to enforce promises and protect reliance on promises is § 90 of the *Restatement of the Law of Contracts (Second)*. The provision provides, in part, that:

(1) A promise which the promisor should reasonably expect to induce action or forbearance on the part of the promisee or a third person and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise. The remedy granted for breach may be limited as justice requires.

Some commentators have contended that the practice of the American courts in applying § 90 has been primarily to enforce the expectation interest of the promisee, rather than merely to protect the reliance interest. The fact is that § 90 of the *Restatement of the Law of Contracts (Second)* may well be found to provide a legal basis upon which the rule proposed in this article might be adopted and operationalized. One question, if this is indeed the case, is how other provisions of the *Restatement of the Law of Contracts (Second)*, most especially § 20 “Effect of Misunderstanding,” can be reconciled with the legal rule I propose. I believe that it can still be given effect in that the basis of the obligation will not be a bargain but instead will be based on detrimental reliance. Because recovery under § 90 of the *Restatement of the Law of Contracts (Second)* does not appear to require mutual assent, the absence of an enforceable bargain under § 20 should not necessarily be dispositive of whether the promises of the parties can be enforced as the *promisee* in each case understood them.

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73 See, for example, the discussion of the British Columbia Court of Appeal in *N.M. v. A.T.A.*, [2003] B.C.J. No. 1139, 2003 BCCA 297, in which the court refused to extend the Canadian law of promissory estoppel to include cases that would arguably merit recovery under §90 of the *Restatement of the Law of Contracts (Second)*.

74 See Edward Yorio and Steve Thel, “The Promissory Basis of Section 90” (1991) 101 *Yale L.J.* 111 at 111: “This Article shows that the prominence of reliance in the text of Section 90 and in the commentary on the section does not correspond to what courts do in fact. Judges actually enforce promises rather than protect reliance in Section 90 cases.” At 112 the authors state, “Rather than using Section 90 to compensate promisees for losses suffered in reliance, judges use it to hold people to their promises by granting specific performance or by awarding expectation damages.”

75 *Id.*
It bears mentioning here that at least one other writer has considered the *Raffles v. Wichelhaus* case to be unsatisfactory and explored a rule that would apparently be an improvement on it. In a 2004 article, Omri Ben-Shahar\(^{76}\) suggests that one might well impose contractual obligations even in the absence of mutual assent by giving each party the option to enforce against the other a “no-retraction” obligation whereby parties’ obligations will emerge gradually as negotiations unfold. Under Ben-Shahar’s approach, the *Raffles v. Wichelhaus* case would be dealt with by the buyer being able to enforce on the seller’s terms, and the seller being able to enforce on the buyer’s terms.\(^{77}\) This approach is quite different from the one I propose, though it is motivated by the same dissatisfaction with the *Raffles v. Wichelhaus* result. It should be noted that Ben-Shahar’s approach would, in at least some circumstances, coincide with results which neither party would have desired.\(^{78}\)

At least since the *Raffles v. Wichelhaus* case, it has been regarded as entirely natural throughout the common law that apparent agreements based on mutual misunderstandings are not legally enforceable. There has been debate, however, surrounding whether the basis for this rule is subjectivist or objectivist. If one accepts that the rationale must be objectivist, it does not necessarily follow that unenforcement is the appropriate legal result. Indeed, there are a number of undesirable consequences associated with setting aside all agreements that are based on a mutual misunderstanding. First, parties will on the margin tend to overinvest in contract specificity *ex ante*. Second, parties will have an incentive *ex post* to strategically avoid agreements that have turned out poorly for them, regardless of whether there was originally a genuine mutual misunderstanding. Third, allowing mutual misunderstanding to interfere with the reasonable expectations of the parties reduces the efficacy of contract law generally at enforcing welfare-improving transactions.

The legal rule that I propose is (arguably) consistent with § 90 of the *Restatement of the Law of Contracts (Second)*. It would allow each party to enforce his or her reasonable understanding of the agreement vis-à-vis the other party. In the *Raffles v. Wichelhaus* case, the legal rule would allow the plaintiff seller to recover from the defendant buyer on the basis that

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\(^{77}\) Id. at 1834.

\(^{78}\) This can be seen from the litigation incentives faced by Candy and Uncle Sam in state 6. Each party would like to have enforcement on the other’s reasonable understanding, and would want to resist enforcement on his or her own understanding. This suggests that each party would be reluctant to reveal his or her own understanding of the agreement for fear that it would be used against them by the other party.
seller reasonably took the buyer to be agreeing to buy cotton from the Peerless II. It would also allow the buyer to recover against the seller for the seller’s failure to deliver cotton on the Peerless I, but the buyer would not bring this suit since on the buyer’s reasonable understanding he would incur losses from the seller’s performance in accordance with the buyer’s disappointed expectations. In the other cases discussed, the proposed legal rule avoids all the undesirable results and retains all the acceptable results of the current common law rule.

Ultimately, the current common law rule surrounding mutual misunderstanding reflects the strong and unfortunate early influence of a subjective account of contract formation—an account now widely thought to be lacking—along with a subsequent failure of legal imagination to consider where the adoption of an explicitly objectivist account of contract formation naturally leads. Indeed, it is a strong signal of the strength, robustness, and desirability of the objectivist account of contract formation that, properly applied, it yields unexpected dividends in the context of securing sensible outcomes in the context of mutual misunderstanding.