FREEDOM OF CHOICE AND PATERNALISM IN CONTRACT LAW: PROSPECTS AND LIMITS OF AN ECONOMIC APPROACH

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Preface

After attending the Erasmus Program in Law and Economics in the academic year 2003/04 at the University of Hamburg, I returned to the Hanseatic City for almost three more years. From 2005 I had the privilege to be a member of the Doctoral Program of the Institute for Law and Economics (Graduiertenkolleg Recht und Ökonomik) and have Professor Hans-Bernd Schäfer as my thesis supervisor. I am grateful to him, other professors and fellow graduates, in and around the Graduiertenkolleg, for many inspiring interactions, both academic and non-academic, during my Hamburg years.

The generosity of the program made it possible for me to discuss my research ideas with scholars at other universities. Between 2005 and 2007 I presented the draft of several portions of this thesis at conferences and workshops in Hamburg, Turin, Siena, Saarbrücken, Haifa, Rome, Kassel, Berlin, Krakow, Copenhagen and Milan. I also benefited much from the research semester I spent in New York City as a visiting fellow at the Law School of Columbia University in spring 2007.

I am happy to express my gratitude here to my family, colleagues and friends who contributed in many ways, knowingly or not, to the formation of this work. For the imperfections of which I, of course, bear sole responsibility.

Budapest, January 2008

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1. Introduction: motives and methods

1.1. Motivation

In recent years, contract regulation and legal paternalism have raised interest within both American legal academia and European private law scholarship. There are several reasons for this: the practical ones are related to the revision of the consumer *aquis* and the ongoing discussion regarding the pros and cons of the harmonization of contract law in the European Union. Understandably, this subject induces, eager interest, both academic and practical. This interest is nurtured by theoretical considerations as well. First, contract regulation and paternalism draw attention to the philosophical and methodological difficulties involved in the justification of the limitations on freedom of contract. Second, they demonstrate that empirical findings on human behavior may lead, in many cases, to conclusions, especially policy recommendations that are significantly different from the outcomes of traditional economic arguments.

More specifically, in the law and economics literature, the question has been raised as to whether the traditional anti-paternalist view of mainstream economics based on "consumer sovereignty" remains valid if (at least) one contracting party is imperfectly rational or not fully informed. Furthermore, as some of these imperfections of judgment and choice behavior characterize humans generally, legislators and regulators with the task of setting a legal framework for contracting, or judges and juries involved in individual contract disputes, are not necessarily immune from these biases either. Thus the question should be raised whether the traditional anti-paternalistic stance of law and economics has to be modified, or even replaced, by anti-antipaternalism: a limited and critical version of paternalism.[1]

1.2. Illustrating the problem

In order to give a flavor of the complexity of the problems concerning paternalism in contract law, I will briefly describe an example here.

[1] "[B]ounded rationality pushes toward a sort of anti-antipaternalism – a skepticism about antipaternalism, but not an affirmative defense of paternalism." Jolls – Sunstein – Thaler 2000: 46. See also Trout 2005.

Usury laws have a very long history, and not only in the Christian world.[2] Laws limiting the interest rate for credits have been in force in many legal systems; they are not uncommon in today's Europe either. For instance, in France the maximum interest rate is regulated in the *Code de la consommation* in a detailed manner.[3] In England, usury has been traditionally prohibited by both statutes and judicial decisions. In Germany, judges regulate usury with reference to §138 I of the BGB (*Bürgerliches Gesetzbuch*, the civil code of Germany).[4]

By prohibiting usurious contracts, the law does not allow people to grant and take on credits on very harsh or unbalanced terms. To be sure, financial contracts are also heavily regulated in other ways. For instance, the purpose of modern consumer credit regulation is to provide consumers with all the information necessary to allow for a rational decision.

With regard to this kind of regulation one could ask the following question: if consumers are aware of the conditions of the credit contract and the relevant market is workably competitive, how can any substantive limit such as a cap on the interest rates be justified? In other words, if usury laws are unnecessary for controlling the circumstances surrounding the contracting situation (this job is done by rules on fraud, duress, and information disclosure) they do not ever seem necessary. Eventually, such laws could be defended by paternalism, redistributive arguments, substantive fairness, or with reference to widely shared moral principles; but how compatible are they with another widely held principle, freedom of contract?

A related issue is that usury laws can be counter-productive. By prohibiting credit contracts with interest rates above a given limit, the law makes it impossible for certain consumers to legally access credit, as their default risk, and thus the interest rate, is so high that in a competitive credit market there is no (private) bank prepared to lend to them below the legally fixed maximum rate. Consequently, some potentially mutually beneficial transactions do not take place, and those whom the law wanted to protect are

[2] Cf. Baldwin 1959. For instance, according to an ancient Hindu rule called *damdupat*, interest in excess of the principal cannot be recovered. A similar rule was also codified in the *Usurious Loans Act, 1918* in India, see http://punjabrevenue.nic.in/usurios_loan_act.htm.

[3] For the English text of the relevant regulation see http://195.83.177.9/code/liste.phtml?lang=uk&c=30&r=1503.

[4] For a historical and comparative overview see Menyhárd 2004: 33-47.

possibly made worse off. Usury laws make "it more difficult for poor people to borrow, thus harming them ex ante though benefiting some of them ex post."[5]

Another question that arises, concerns the way usury laws actually work in practice. In a recent article, Hynes and Posner give an overview of usury laws in force in the different states of the U.S.[6] Some state laws are very restrictive, others more lenient. As the authors also demonstrate, there are many ways to make these restrictions ineffective through contractual arrangements. At least in the United States, strict usury laws are hardly relevant in practice.

It is interesting to note that some legal systems seem to have found ways to deal with the problem of poor debtors mentioned above. In South Africa, the Supreme Court "has decided that micro-lenders operate under exemptions to the Usury Act which give them the freedom to charge unrestricted interest on loans under R10000 (EUR 1400). The interest rates for such credits are often higher than 50 per cent per year and sometimes even higher."[7] This South-African example seems to reflect the court's understanding that there is a group of, probably low income, people who need a special regime. In this market segment, credit is only viable at a relatively high interest rate, because of the high average default risk of the borrowers as a group. Thus this ruling of the Supreme Court is probably efficient, i.e. mutually beneficial from an ex ante perspective. It makes it possible for borrowers of smaller amounts to take credit legally. *Given their current set of opportunities* it serves the interest of the low-income group as well.

Not surprisingly, when consumer credit is more easily available, there is more credit outstanding, and more cases of overindebtedness. As psychological studies confirm, people are not rational in taking on credit: they fall prey to cognitive and emotional biases which make their decisions erroneous, even measured on the scale of their own interest. Currently there is intensive discussion about the possible causes of, and policy responses to, consumer overindebtedness throughout the world.[8] The potential policy responses can be preventive ones working *ex ante*, including the

[5] R. Posner 1998: 129.
[6] For a recent critical summary of the economic arguments and the legal rules of the US, see Hynes – Posner 2002.
[7] Personal communication from Prof. Hans-Bernd Schäfer (Hamburg). For a detailed analysis see Meagher 2005.
[8] See, e.g. http://www.responsible-credit.net/.

provision of adequate information, cooling-off periods and other procedural limits. Meanwhile, other measures may help to get out of indebtedness *ex post*. There are many promising initiatives which give assistance to consumers not only financially but by providing information about rational management of personal finances. For instance, NGOs work on designing and distributing easily accessible information, like brochures with simple rules of thumb and vivid illustrations about how to notice the threat, and then fight the danger of overindebtedness. As we will see later, this is an instance of what is called "debiasing through law", a research idea suggested in behavioral law and economics.[9]

As a sort of indirect paternalism, another way of intervening is to regulate the behavior of the lenders. The many "Fairness in Lending Acts" in the U.S, have, starting from the 1970s, basically mandated that the true costs of credit should be communicated to the consumer. As I will argue below, these information provision rules are not unnecessary. Unfortunately, such rules seem insufficient. Typically, they do not help when consumers take credits knowingly but irresponsibly. One of the current regulative ideas which is supposed to address this problem, parallel to helping borrowers, is promoted under the label of "responsive lending". The term refers to voluntarily assumed norms of ethical and responsive business. Indeed it resonates with some jurisprudential arguments which seek to include the principle of "transactional care"[10] into contract law in order to counteract exploitation.

"Responsive lending" and "transactional care" are terms with strong moral undertones. What could be the theoretical and normative background of these ideas? Why am I my brother's keeper? Such ideas can have different philosophical roots and justifications. Arguments in favor of paternalism by a better informed (endowed) fellow citizen, or transactional partner (and not the state) are in part based on the idea that not only legal norms matter: rather, social norms do, and should, regulate which business practices are considered fair and socially acceptable.

As the 2007 subprime mortgage financial crisis indicates, irresponsible lending (in a wider sense) may have also serious macroeconomic effects. Even a non-paternalistic state may have reasons for intervention in certain circumstances. These widespread

[9] See section 2.4.3, below.
[10] Bigwood 2004.

economic consequences also indicate that the impact of credit contracts definitely goes beyond the competencies and capacities of contract law and the judicial system.

In sum, the example of the regulation of credit contracts between formally equal but economically powerful and weak parties suggests four general ideas.

(1) Throughout history, policymakers have regulated such transactions using various justifications.

(2) In modern legal systems, a wide variety of legal instruments are used for paternalistic purposes, these can be compared with regards to their effectiveness.

(3) Economic theory can illuminate these issues.

(4) As these contracts are embedded in a social context, understanding this contextual richness requires going beyond the standard economic approach.

To be sure, these ideas are not completely new. What I suggest to do in the following thesis is to look at the different ways in which the law of contracts confronts such problems. At the same time, the analysis of such problems will confront us with challenges of another kind. These are linked to methodological and theoretical aspects of conducting economic analysis. My research builds on the results in various fields of study: the philosophical literature on paternalism, contract theory, the economic analysis of contract law, and mainstream and behavioral law and economics literature on contract regulation. I will be raising questions about the justifiability of paternalistic contract law rules in different legal systems in light of an extended law and economics approach. This raises the question: What are the methodological premises of this approach? This will be explored in the following sections of the Introduction.

1.3. Methodology

In my view, in order to assess the problems of paternalism in contract law properly, an empirically based policy-oriented view is both fruitful and necessary. More generally, legal scholarship should take into account not only practical philosophy, but insights from both economic theory and empirical research as well.

1.3.1. Economists learning from law?

Specifically and succinctly, lawyers can, and should, learn from both economics and psychology. Or is it the other way around? Interestingly, Robert Cooter and Thomas Ulen, two eminent law and economics scholars suggest that this learning should *also* work the other way around. Economists should learn from law, most notably contract law. In the introductory chapter of what is probably the most popular textbook on the subject, they write: "*Economists frequently extol the virtues of voluntary exchange, but economics does not have a detailed account of what it means for an exchange to be voluntary. [...][C]ontract law has a complex well-articulated theory of volition. If economists will listen to what the law has to teach them, they will find their models being drawn closer to reality*."[11]

Although these sentences have been reprinted in the book several times since 1988, they seem to have elicited little formal comment. Nevertheless, their claim is far from trivial. In this statement Cooter and Ulen argue here for a kind of import; if not from jurisprudence, at least from the law. In my view, even if this gesture of two economists towards lawyers is to be appreciated, it cannot be taken at face value. The "theory of volition" of contract law, well-articulated as it may be, is not well-founded theoretically.[12] In the law, this generally seems to be the case. Legal rules and doctrines doubtlessly often reflect practical rationality and offer at the level of folk psychology an intuitively appealing shortcut to endless philosophical debates. For instance, in many legal systems there is a close-to-ordinary-language or doctrinal-technical legal meaning to concepts like voluntariness, intent, or causation – the former interpretation typically characterizes the Common law, the latter Continental legal rules. These legal concepts usually half-knowingly reflect philosophical or scientific standpoints of earlier ages[13] or just express some folk-psychological notions. For the everyday working of law as a practical enterprise these naive or common sense theories are fully satisfactory, at least

[11] Cooter – Ulen 2004: 11.
[12] Another problem is that, important overlaps notwithstanding, there are as many "theories of volition" as national (as well as infra- and supranational) contract laws.
[13] "[T]he metaphysics of the Stone Age" (Hart – Honoré 1985: 2). These authors do not share the critique implied by the term.

in the so called 'easy cases'. But what the law says about voluntariness, causation etc. can be called a "theory" only in this "practical" sense.[14]

A further difficulty is that this "legal world view" is not of much help in policy design. It is impossible, for instance, to answer from a purely legal perspective how the legally required degree of voluntariness of contract formation, or the criteria for the judicial control of standard form contracts *should* be reasonably regulated. If we want to understand and/or criticize the rationale behind legal rules, then what law regulates in this or that way has to be analyzed and evaluated from an outside perspective, i.e. from a not strictly *legal* point of view.

1.3.2. Interdisciplinarity

Regarding the proper methods and scope of such a non-doctrinal analysis of legal issues, many methodological questions can be raised. Here, mention will only be made of a couple of points which help elucidate the methodological stance taken in this work.[15]

The reason why legal policy should be informed by empirical and theoretical research on human decision making and judgment is mainly instrumental. This information makes it possible to systematically predict the consequences of legal rules, and their alteration. Here, both economic and psychological insights are highly relevant.[16]

In modern societies law is often conceived of as a means to various policy ends. On the other hand, it is also understood as a system of institutional actions performed in the name of 'the law'. To the extent that legal discourse is formally rational, it has some autonomy that does not allow for the direct codification or application of any normative philosophy or the results of empirical research *in* law or *as* law.[17] In this sense, 'the law'

[14] For a classical analysis of causation from an "ordinary language philosophy" perspective see Hart – Honoré 1985. The rather innocent quote by Cooter and Ulen raises important jurisprudential and philosophical questions. The relations between folk psychology, legal epistemology and scientific knowledge are a fascinating research topic but it is beyond the scope of this work.

[15] These questions are discussed extensively in the German-speaking law and economics literature. See e.g. Behrens 1986, Eidenmüller 1995, Aaken 2003.

[16] This does not imply that law should have a "psychologically adequate" view of man. I cannot elaborate on this here but there are reasons why the law should deviate from such a view. See section 2.4.2, below.

[17] On legal formalism see Kennedy 1973, 1976. Theorists like Luhmann and Teubner represent some version of this idea.

is a specialized practical activity rather than a political or academic, i.e. scientific, or philosophical discussion.[18]

An important implication of this is that 'the law' as a practice cannot be suspended until the best theoretical solutions are found. Since time constraints are strict, resources, including expertise, are limited, and experimentation is exceptional, pragmatism and simple rules are used and needed.[19] In legislation and, to an even larger extent in adjudication, the use of external knowledge is limited by both systemic and practical considerations.

As to the incorporation of interdisciplinary knowledge in the theoretical understanding or analysis of law, these practical limits are irrelevant. On the other hand, whether the findings of (behavioral) economics are as relevant for jurisprudence proper, as for legal policy, is not straightforward. Much depends on the self-understanding (definition, purpose, methods) of legal scholarship itself.[20]

In this respect, I can only note a few points here. Economic, psychological, sociological etc. analyses *of* law are legitimate theoretical approaches. They provide insights to law from an external point of view. While such analyses do not *replace* doctrinal argumentation which has important separate functions to fulfill in a complex modern legal system, they interact with it in a number of ways. For the purposes of this thesis one of these ways is especially relevant: economics, psychology, philosophy help scholars who criticize and improve legal rules and doctrines through policy recommendations.[21]

As I have argued, various factors place limits upon the *direct* usefulness of philosophy, economics and psychology in the development of legal policy and in jurisprudence. It is important to note however, that the proper role of economic and other non-legal insights in adjudication, or legal decision-making in general, cannot be determined generally: rather, it depends on a number of characteristics of legal decision-making (linked to various issues like discretion, expertise and legitimacy). Particular legal cultures (Continental, common law, and non-Western), national legal systems, or

[18] I will come back to this idea in the Conclusion.
[19] There are various normative legal theories arguing for "simple rules", see e.g. Epstein 2006b.
[20] As Peter Behrens convincingly argues, the methodological self-understanding of "legal science" (*Rechtswissenschaft*) and economics has a crucial impact on the possible ways of their cooperation and the perspectives of interdisciplinary research on law and the economy (Behrens 1986: 6–30).
[21] Roughly, this is the way Hans Albert conceives jurisprudence. See e.g. Albert 1972, 1986, 1992, 1993.

even legal areas (private law, administrative law, and criminal law) differ crucially along these dimensions.

An important question in this context concerns the role of consequentialist reasoning, especially that of economic analysis in legal decision making.[22] Here I refer to only a single aspect of this question. In a recent book Stephen Smith argues that a theory of contract should be transparent.[23] By this he means that the language of contract theory should either support the express legal reasoning judges offer or demonstrate "how legal officials could sincerely, even if erroneously, believe the law is transparent."[24] Transparency implies a close link between the theoretical perspective on contract law and the language judges use in deciding cases. For Smith, this requirement provides a meta-theoretical criticism of law and economics. Law and economics falls short of the transparency criterion as it does not use the moral language of corrective justice, which allegedly judges do use in deciding contract cases, at least in common law countries. Under this view, the challenge for the economic analysis of law is to account for the behavior of judges and for the moral language of law.

In contrast to Smith, I think that the two languages are, at least in part, continuous.[25] Even if they are not, the lack of transparency is not a decisive argument against law and economics. Indeed, as Jody Kraus argues

"*efficiency theories can account for the divergence between the non-consequentialist, moral nature of judicial opinions and the consequentialist nature of economic analysis by offering an evolutionary theory of how the terms of judicial opinions acquire their meaning. …[W]hile contract and tort law might have first evolved with the aspiration to apply common deontic moral concepts to resolve disputes, the common law's focus on hard cases, in which the moral answer is unclear, forced judges to turn to consequentialist reasoning. Since no clear moral answer resolved the disputes before them, judges naturally used adjudication as an opportunity to set a sensible precedent for regulating future conduct. As the common law evolved, judges came to use deontic moral argument to express essentially consequentialist reasoning. The difference between the plain meaning of express judicial reasoning and the best (economic) theory of the outcome of judicial decisions using that reasoning is therefore only superficial. According to economic analysis, the real meaning of express judicial reasoning in hard cases is given by economic, not deontic moral, theory.*"[26]

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[22] On the role of consequentialist arguments in adjudication see e.g. Wälde 1979, Deckert 1995, Cane 2000. For two opposing views on the role of efficiency arguments in (German) law see Eidenmüller 1995: part IV, Kötz – Schäfer 2003: vi–viii.

[23] Smith 2004.

[24] Smith 2004: 25-

[25] See Oman 2005.

[26] Kraus 2006: 14. For a more detailed argument see Kraus 2007.

If this argument is sound, it explains the working of contract and tort law under the common law. However, there is a more general question: what is (and should be) the role of theory and policy in contract adjudication? In various legal systems and in different legal areas, this role is considered to be different. As noted above, law as a practical institution needs, and has, some autonomy. One should avoid "the jurisprudential naïveté about the ultimate connection, if any, between […] economic analysis and the sort of argument that might be acceptable to courts."[27] This statement suggests that irrespective of the soundness of Kraus' evolutionary explanation, the direct impact of economic analysis on adjudication depends on the canon of arguments considered legitimate or acceptable within a particular legal system or legal area.[28] This reasoning applies to contracts and torts in common law as well. As Richard Craswell had argued, "it is appropriate to regard each economic analysis as being limited by the preface" which makes clear that the particular efficiency arguments of the analysis should be considered by judges *to the extent prudential arguments are relevant*.[29] In brief, economic analysis is relevant in adjudication if and when prudential arguments in general are relevant.

To be sure, policy arguments are not necessarily addressed to judges. In other, non-judicial arenas other "canons of acceptable arguments" operate. As I argue in section 1.3.3., for this work, the arena of legal policy is of primary relevance. Concerning the role of economic analysis in legal policy, it may be said it is both *vindicated* and *limited* by the following meta-criterion. "[E]conomic analysis can claim that its reasons justify outcomes because of the role the principle of efficiency plays in the overall set of institutions sanctioned by the normative political theory justifying political authority."[30]

To sum it up, while interdisciplinarity does not imply that lawyers should become economists, psychologists or philosophers, they should nevertheless rely both on a transparent normative theory about the goals to be achieved through law, and on empirical research about, and a theory of, human behavior facilitated and regulated by law. In the complex interrelations of empirical research, theoretical models and

[27] Craswell 1993a: 293.
[28] On the "canon of acceptable arguments" see Honoré 1973: 64–66.
[29] Craswell 1993a: 292–293.
[30] Kraus 2006: 15.

philosophical questions, multilateral translation and learning seem not only fruitful but necessary. In the following work, the need for "multilateral translation" will be obvious for a more simple reason. Paternalism is a *philosophical* concept which will be used in the analysis of *legal* problems with the tools of *economics*.

1.3.3. The policy perspective

Roughly speaking, one can distinguish three different discourses in which arguments from law and economics can be relevant. It can be conceived as a (consequentialist) normative legal philosophy; as an explanatory theory of law (rational choice theory applied to law); and as a set of propositions for legal reform (legal policy).

In the first branch, what I mean by law and economics as legal philosophy is a normative analysis dealing mainly with questions regarding the justifiability of adopting efficiency as the main guiding principle of law.[31] In the second, explanatory branch, law and economics seeks either to explain how law influences human behavior by changing incentives (law as *explanans*), or to analyze legal, and possibly non-legal, rules as the outcome of interactions between rational individuals (law as *explanandum*). The emergence and change of legal rules and doctrines are the subject matter of "positive political economy" or public choice theory. Finally, by law and economics as legal policy it is meant: a more or less coherent system of proposals for reforming legal rules in order to fulfill certain given or hypothetical normative criteria, among which efficiency has primary importance.

As with categorizations usually, this one is useful if it helps systematize our arguments. Thus the main research questions addressed by the thesis can be grouped into three categories which correspond to the three levels of economic analysis.

[31] For book-length arguments for efficiency in this respect see Posner 1981, Kaplow – Shavell 2002. For discussion and criticism see the still informative collection of articles in Symposium 1980, especially Kornhauser 1980. Even Richard Posner, a leading advocate of wealth-maximization as a normative criterion of legal rules draws attention to its potentially morally abhorrent implications: "[T]here is more to justice than a concern with efficiency. It is not obviously inefficient to allow suicide pacts; to allow private discrimination on racial, religious, or sexual grounds; to permit killing and eating the weakest passenger in the lifeboat in circumstances of genuine desperation; to force people to give self-incriminating testimony; to flog prisoners; to allow babies to be sold for adoption; to legalize blackmail; or to give convicted felons a choice between imprisonment and participation in dangerous medical experiments. Yet all these things offend the sense of justice of modern Americans, and all are to a greater or lesser (usually greater) extent illegal. An effort will be made in this book to explain some of these prohibitions in economic terms; but most cannot be; there is more to justice than economics." (R. Posner 1998: 30–31.) On inviolable rights as limits to efficiency see Schäfer – Ott 2004: 13–14.

(1) Conceptual and normative questions. What does paternalism mean? Is it justified to limit someone's freedom in order to promote his interests? If so, in which cases, to what extent and, by whom? Why and to what extent do we need freedom of contract? What are legitimate reasons for interfering with contracts?

(2) Empirical questions. Do people generally, and in given contexts, choose rationally? Do they evaluate risks correctly? How do they process the information available to them? How do individuals (consumers) and legal entities (firms) react to different regulations? What are the side-effects and possible non-intended consequences of contract regulation?

(3) Policy questions. Assuming sub-optimal contracts may occur, should the law interfere with contractual agreements in which one party was not fully informed, or not fully rational? If so, which instruments would be most applicable to achieve this? What are the legal, political and other institutions or mechanisms most suitable in any given case?

Obviously, the questions raised on each of these levels are linked to each other. Most importantly, the third level of analysis relies on both the first and the second levels. As legal policy refers to a more or less coherent system of proposals for reforming or interpreting legal rules, the basic idea behind such proposals is that the law should fulfill certain, either hypothetically or tacitly accepted, normative criteria. In the law and economics literature, Pareto or, more often, Kaldor–Hicks, efficiency is the most important of these criteria.[32] In this work, the analysis is based on arguments regarding the justification of certain instances of paternalism, and some empirical facts or hypotheses concerning the effects of freedom of choice and legal intervention. These are combined in order to contribute to a legal policy discourse regarding the possible legal means for achieving certain normative goals in an effective way.

[32] A social arrangement (the allocation of resources) is Pareto-efficient if reallocation can make nobody better off without making somebody worse off than in the status quo. When it is possible to make at least one person better off without making anybody worse off, we speak about a Pareto improvement. In contrast, a change is called potential Pareto improvement if the winners' gains from the change are higher than the losses of the losers, so that the former are capable to compensate the latter. Such changes are also called Kaldor–Hicks improvement. For technically precise definitions and refinements see Zerbe 2001.

1.3.4. Extending standard methods

In the quote above[33] Cooter and Ulen also suggest, rightly, that sometimes legal problems draw attention to highly important questions, to which standard economic analysis does not offer any well-developed answer. Arguably, the meaning and value of freedom of choice and the arguments for or against paternalism are such questions. This observation raises the methodological question, whether and how the traditional economic arguments against paternalism and for freedom of contract should be reassessed in light of recent empirical and theoretical studies. If Cooter and Ulen are right, then law and economics scholars should be open to insights coming from elsewhere. In the spirit of their observation, while the methodological starting point of the following work is rational choice theory, as applied in the law and economics literature[34] I will also discuss several limitations, corrections and extensions to this approach.

Standard law and economics literature usually rejects paternalism as a bad reason for limiting freedom of contract. This view is not, however, strongly nor coherently argued. First, it largely fails to take into account relevant empirical facts about contracting behavior. Second, it generally uses a strange mixture of liberal and utilitarian (welfarist) arguments without reflecting about their relationship. As I will argue, the tools recently developed within two branches of economic theory can contribute to an approach to paternalism which is simultaneously more coherent and richer in nuances than the traditional law and economics perspective. By reconsidering standard economic arguments and confronting them with psychological, philosophical and jurisprudential considerations, I suggest enriching and modifying the traditional law and economics arguments about paternalism in two main ways. The first way is to incorporate the empirical findings of behavioral decision theory which offer a more realistic view of the situations susceptible for paternalistic intervention. The second is to take into account insights from the analysis of freedom of choice in social choice theory concerning the possibility to include the non-welfarist dimension of the subject in economic analysis.

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[33] See quote in section 1.3.1. at note 13.

[34] On rational choice theory in law and economics see Ulen 2000.

Instead of discussing the benefits and methodological difficulties of incorporating these ideas, methods and results in law and economics *in abstracto*, these questions will be dealt with throughout the thesis, along with the discussion of specific issues. Here I should merely note that these methodological extensions have consequences for all three levels or types of discourses. On the level of normative political and legal philosophy the problem of autonomy makes economic theories on freedom of choice and a non-instrumental analysis of opportunities relevant. On the level of explanatory social science the empirical results and theoretical constructs of psychology come into play. Finally, the level of legal policy should rely both on the two other levels and, in order to avoid *naïveté* or the accusation of being dictatorial, it has to take into account the politico-institutional framework within which the legal policymaking of a modern democracy operates.[35]

1.4. The plan

The thesis commences with a discussion of the basic conceptual and normative problems of paternalism (ch. 2) and various theories of contract law (ch. 3). I then focus on legal policy questions in contract law (ch. 4). Rather than directly applying philosophical insights to either justify or criticize contract law rules, I take an empirically based policy-oriented approach. In light of these various theoretical findings and using this partly modified methodological apparatus of law and economics, I will analyze and criticize in detail some contract law rules and doctrines that at first glance look paternalist. The main body of this work is dedicated to such analysis.

First, however, we have to face some conceptual and normative questions. Freedom of contract and paternalism are eminently important concepts in political and legal theory. Chapter 2 is on paternalism. Here I discuss the concept and the possible justifications and limits of paternalism, focusing on philosophical, economic and

[35] Cf. how James Gordley concludes his paper on paternalism in contract law: "This Essay may have disappointed the reader because it does not attempt to prove which particular voluntary agreements the state should prohibit, require, encourage, discourage, or fund. If those issues were subject to proof, academics should rule the world. In our society, such decisions must be left to the prudence of the citizens, to that of leaders whom one hopes are prudently elected, and subject to constitutional constraints that one hopes are prudently imposed. That is one might expect in a representative democracy." (Gordley 2007: 1772) I do not fundamentally disagree with this. Only, at the beginning of my career I allow myself to be somewhat more trustful in academics and the role of proofs. But I will not discuss questions of political economy in the thesis.

psychological approaches. I also discuss the normative consequences of the difference between private (individual) and legal (institutional) paternalism. In chapter 3 I turn to contract theory and a discussion of the meaning and theoretical underpinnings of freedom of contract. I also connect the issue of contractual freedom and its limits to the discussion on different methodological approaches to contract theory.

Chapter 4 provides a comparative law and economics analysis of selected contract doctrines and techniques, which may be used for paternalistic purposes. Although in this chapter contract law rules drawn from a number of legal systems, including Germany, England, France, Italy and the United States are analyzed, this is not a work in comparative law, in the traditional doctrinal sense. Instead I am concerned with particular rules and doctrines in contract law (formation defenses, incapacity, formalities, unconscionability, among others) and some paternalistic uses of contract interpretation. Along the analysis of these doctrines, the focus remains on the following question: Which methods and techniques of paternalistic regulations used in modern contract law regimes serve legitimate paternalistic purposes.

In the concluding chapter 5 I draw these lines of thought together and discuss some heuristic rules about the desirable degree and ways of paternalistic intervention in contracting.

2. Paternalism

Should a physician be responsible for the harm suffered by her patient if he refuses a certain treatment because he did not want to hear, accept or believe the information given to him by the doctor? To what degree is the doctor obliged, or allowed, to convince, persuade, press and coerce the patient into having or not having a certain therapy? We face similar questions about the interference of family, friends, strangers, and public officials in our life almost daily. Both instances of personal paternalism (between parent and child, doctor and patient), and cases of legal paternalism abound. The latter ranges from medical law through drug prohibition, occupational safety and health regulation, to the mandatory waiting time before marriage, and the irrelevance of the victim's consent to mutilation and homicide in criminal law. Nevertheless, among the many ways modern law regulates our life, paternalism is a relatively specific phenomenon. We should beware of the indiscriminate use of the term for any interference with freedom of choice.

2.1. Concept and types of paternalism

2.1.1. Concept

Although intuitively we can identify a large number of regulations which seem paternalistic, the term itself hardly ever figures in legal texts or commentaries. In contrast, philosophers have spent much time, paper and ink on defining the concept and evaluating the moral or legal permissibility (desirability) of paternalism.[36] Even a cursory overview of this literature shows that in philosophy and social theory there is no consensus surrounding the conceptual boundaries of paternalism. The reason for this is probably that paternalism is closely linked to the concept of freedom, a notoriously and 'essentially contested concept'.[37] This means that it is difficult for one to identify in the literature the conceptual features around which there is a reasonable degree of

[36] The modern philosophical literature on paternalism is extensive. Some important contributions are Sartorius 1983, Kleinig 1984, Feinberg 1986, VanDeVeer 1986, Dworkin 2005b. A two-part review article of the English-speaking literature, with an extensive bibliography is Garren 2006–07.
[37] Gallie 1956, cf. Smith 2002.

consensus. Without going into the terminological controversies,[38] I give here a rough definition, simply indicating how I use the term in the following.

There are three conditions for an act to be paternalistic. The paternalist

(1) interferes with the subject's liberty,

(2) acts primarily out of benevolence toward the subject (i.e., his goal is to protect or promote the interests, good or welfare of the subject),

(3) acts without the consent of the subject.

What these three conditions more precisely mean should become clear in the discussion following in the remainder of this chapter. Here I simply indicate a few consequences of this definition. Paternalism is not necessarily coercive. It does not necessarily restrict liberty of action either: one can be paternalistic, for instance, by withholding bad news from a dying mother about her daughter's fate (paternalistic deception; *fraus pia*). What the paternalist does out of benevolence can be twofold: either conferring benefit or preventing harm to the subject. The increase or reduction in the interests of the subject can be compared to at least three different standards. First, it can refer to the status quo *ante*, i.e. the state of the world before the intervention. Second, the standard can be a counterfactual one, referring to what would have happened without intervention. Third, a normative standard determines what should have happened to the interest of the subject.

Later, I will make clear what distinguishes paternalism from similar and related phenomena (see section 2.2.5. below). However, substantive problems cannot be solved by definition. If we follow the given definition, paternalism has both justifiable and unjustifiable cases (forms). As for its justification, paternalism is not an essentially condemnable thing like murder. Instead, in a *logical* sense it is rather like killing which has both justified and unjustified cases.[39] These cases differ not on the level of definition, but with regards to their justifiability, legitimacy, or reasonableness, etc. More precisely, they can be classified in distinct categories only if we introduce some further specifications as to different kinds of paternalism.

[38] For such discussions see the references cited in note 36, above.
[39] Kleinig 1984.

2.1.2. Hard and soft paternalism

From the numerous distinctions in the philosophical literature, between pure and impure paternalism,[40] direct and indirect paternalism[41] etc., probably the most important is the one between hard and soft paternalism. It is related to a conceptual problem concerning the first part of the definition above, namely, the freedom of the subject.

What free will or voluntary consent means in a specific context is not easy to tell, as there is no self-evident reference point or threshold. More precisely, there are a number of criteria that should be fulfilled for an action to count as fully autonomous. In practice, this is an unattainable ideal; autonomy is always somewhat limited. This observation of course does not in itself justify paternalistic intervention, but leads to a useful distinction, suggested in the literature by Joel Feinberg.[42]

Feinberg makes a distinction between hard (strong) and soft (weak) paternalism. The distinguishing feature is whether the subject's conduct which is susceptible for intervention is 'substantially voluntary'. A lack of substantial voluntariness negates the value of autonomy with regard to that conduct. While both forms involve restricting individual liberty, soft paternalism applies to actions which are not fully autonomous. In contrast, hard paternalism restricts a substantially voluntary self-harming action.

Although Feinberg's theory is more elaborate on this point, one can roughly distinguish three conditions of substantial voluntariness:

(1) A capability of making choices (even if the decisions are foolish, unwise, reckless, they are still decisions of an autarchic subject),

(2) Substantial freedom from controlling external influences such as coercion, threat, or manipulation,

[40] In case of pure paternalism, the reason behind the action, rule etc. is paternalistic only. Paternalism is impure when it is mixed with other reasons.

[41] We speak of direct paternalism when one's freedom is limited in his interest. An action is indirectly paternalistic when A's freedom is restricted in order to paternalistically promote B's good. This distinction is especially relevant for contract law. By regulating contracts, not only the freedom of choice of the self-harming individual (the subject of direct paternalism) but that of the other party is limited. Indirect paternalism can occur with or without simultaneous direct paternalism. An example for the latter is when one is punished for assistance to a suicide. For further distinctions see Dworkin 2005b.

[42] Feinberg 1986: 11–12.

(3) Substantial freedom from epistemic defects, such as ignorance of the nature of one's conduct or its foreseeable consequences.[43]

For Feinberg, the soft vs. hard distinction has clear consequences for the justifiability of paternalism. From the perspective of autonomy, soft paternalism is not especially controversial and thus more easily justified. In contrast, the justification of hard paternalism raises more serious problems. In fact, the distinction between both types is of crucial importance for Feinberg's theory. In his view, soft paternalism is not paternalism in any interesting sense because it is not based on a liberty-limiting principle independent of the harm principle. By soft paternalism the intervention is defended, and according to Feinberg, justified, as protection from harm caused to the individual by conditions beyond his control.[44] Also, a temporary intervention is permissible as long as the degree of voluntariness of the action in question (the autonomy of the subject) is unknown or uncertain and needs to be established. In certain cases when consent is statistically rare, involuntariness is presumed[45] and even an upright prohibition can be justified by the costs of administering an exception for verified voluntariness.[46] As the distinction between soft vs. hard paternalism indicate, there are strong connections between analytical and normative problems.[47]

[43] See Pope 2004: 711–713 and the references there. At first glance, the three conditions may remind one different contract law doctrines. The rules of incapacity are supposed to regulate that only people being capable of making choices (in the above said sense) can conclude a valid contract. The contract law rules of fraud, duress and undue influence serve to guarantee the lack of certain substantial external controlling influences. Substantial freedom from epistemic defects is taken care of with rules on mistake or disclosure duties. I come back to this in section 4.2.

[44] "Soft paternalism would permit us to protect him from 'nonvoluntary choices,' which, being the genuine choices of no one at all, are no less foreign to him." (Feinberg 1986: 12) For a critique of the soft/hard distinction see Arneson 2005.

[45] This is Feinberg's main argument against voluntary self-enslavement. The lack of rationality does not justify interference but if the likely consequences are serious, this importance justifies a presumption against voluntariness, which should in principle be refutable.

[46] This is how Feinberg attempts to justify usury laws (1986: 9, 174–5).

[47] A related question is whether voluntariness is a continuous variable or a threshold-like feature of human action. In the latter case, if the voluntariness of the conduct is settled in the subject's favor, the wisdom or otherwise of her conduct becomes irrelevant for the justifiability of the interference. On the other hand, if the degree of voluntariness is a continuous variable, one becomes a potential subject of paternalism more easily.

2.1.3. Paternalism and modernity

Historically, both the concept and the problem of justifying paternalism were linked to the rise of liberalism and the value of individuality in Western culture. When speaking about the same phenomenon in earlier ages or different cultures, we are inclined to use another term, patriarchalism.[48] Patriarchalism was a social order in which the patriarch's concern in securing his own and his subjects' individual good was subsumed under a conception of the general good. Every individual good contributes to, and is defined by the general good. For example, the social and cultural setting of medieval Europe was characterized by generally shared views on the relational nature of the self who is embedded in his roles. Patriarchalism was backed by generally accepted values within a particular community.

By contrast, in the case of paternalism as a typically modern concept, even if one considers a particular instance of it as justified, the good of the individual is conceived as sufficiently independent from the good of others or some social whole, to come into the focus of attention in its own right. Relatedly, paternalism has become the *bête noir* of the liberal age.[49] Kant referred to 'imperium paternale' as the most serious despotism imaginable.[50] John Stuart Mill's ideas about the limits of state power and the harm principle as the only justification for the use of coercion against competent individuals, exposed in *On Liberty* a few decades later have proved even more influential.[51] Since the Kantian and Millian ideas have become widespread, paternalism has been a central problem of legal and political theory.

The impact of modern individualism can be evidenced by the fact that for most Western people nowadays the term 'paternalism' itself has a negative and oppressive

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[48] At least, according to the standard narrative in the history of political thought which attaches much importance to John Locke as a liberal political thinker and his critique of Sir Robert Filmer's work, *Patriarcha* (Filmer 1991) in the *Two Treatises of Government* (Locke1690).

[49] Kleinig 1984: 3–4.

[50] In his essay 'Über den Gemeinspruch: Das mag in der Theorie richtig sein, taugt aber nicht für die Praxis' Kant wrote (1793: A 236): "*Eine Regierung, die auf dem Prinzip des Wohlwollens gegen das Volk als eines Vaters gegen seine Kinder errichtet wäre, d. i. eine väterliche Regierung (imperium paternale), wo also die Untertanen als unmündige Kinder, die nicht unterscheiden können, was ihnen wahrhaftig nützlich oder schädlich ist, sich bloß passiv zu verhalten genötigt sind, um, wie sie glücklich sein sollen, bloß von dem Urteile des Staatsoberhaupts, und, daß dieser es auch wolle, bloß von seiner Gütigkeit zu erwarten: ist der größte denkbare Despotismus.*"

[51] See Mill 2004 [1859]. There has been an enormous body of secondary literature on Mill's *On Liberty.* As one of the most thoroughgoing 19th century critique see Stephen 1992. For some current interpretations see Dworkin 1997.

connotation. In the theoretical literature on paternalism, almost every longer contribution starts by discussing the possibility of a non-pejorative and gender-neutral use of the word. Eventually scholars indeed switch to neologisms like 'parentalism'.[52] In the following I will retain the word 'paternalism' because of its familiarity. I will use it in a descriptive (classificatory) sense, dealing with the question of evaluation (justification) separately and leaving out possible gender issues entirely.

2.2. Justificatory questions

Despite the general acceptance of the importance of liberty as a social and political value in the Western world, there is much disagreement about why it should be valued, and how to compromise it with other values. Accordingly, in the contemporary philosophical literature there is no consensus on the justifiability of paternalism. However, looking at the end-result we can roughly distinguish three standpoints:

(1) hard anti-paternalists consider paternalism unjustifiable, even in its soft version;

(2) soft anti-paternalists distinguish hard and soft paternalism and condemn only the former;

(3) finally there are those who argue that even hard paternalism can be justified in certain contexts.

In contrast to law and legal policy, in philosophy the argumentation used is more important (and interesting) than the end-result. In fact, paternalism can be supported or attacked with very different arguments.

2.2.1. Freedom and benevolence

In defining and evaluating paternalism, we should not confound meanings. There might be other values competing with freedom (autonomy), and not everything valuable is a sort of freedom. Therefore, if we want to limit freedom of choice in certain situations, it is better to say that in a given case there are good reasons for preferring some other value (e.g., welfare, security, etc.) to freedom, instead of arguing that it is 'real' or

[52] See e.g. Kultgen 1995.

'positive' etc. freedom that is promoted by paternalism.[53] The dubiousness of this reference to freedom can be seen in the "real will" argument which wants to justify paternalism (or worse) with reference to freedom: "Even though a person manifestly wants to do A, it may be claimed that what he or she *really* wants is B. Because priority is given to the latter, interferences with the former are not considered to be a violation of freedom."[54] Such argument from real will are used in legal settings as well. An example could be when in order to curb their spending habits, the relatives of elderly people (successfully) initiate guardianship proceedings.

According to the definition above, paternalism implies doing something against the freedom of the subject without his consent. Under any theory which attaches value to freedom of choice, this lack of concern for consent needs justification. Actually paternalism provides such a *reason*: it refers to the protection or promotion of the interests (welfare or good) of the subject. What distinguishes an action as paternalistic is not what is done but why it is done. In political philosophy, one usually distinguishes four main liberty-limiting principles: (1) the harm principle, (2) the offense principle, (3) paternalism, and (4) moralism. Paternalism is thus one such principle: it is a (good or bad) way to justify the restriction of liberty.[55]

Paternalism is problematic from the liberal point of view as it implies promoting the good of a person against his (free) will; violating individual autonomy for the sake of the individual's welfare. The freedom-diminishing character of paternalism raises a moral question. A standard way to interpret this question is to say that the moral interest of paternalism comes from the juxtaposition of two values: freedom and benevolence.[56] To be sure, this question not only concerns liberals. The conflict of freedom of choice and welfare is also relevant to other political and philosophical perspectives.

Freedom of choice can be valuable for different reasons. But why would objectively wrong choices be valuable? Some theories deny the intrinsic value of the freedom to choose to harm oneself (to decrease one's welfare). They deny the value of welfare-reducing choices. This position can be based either on a narrow act-utilitarian

[53] Still, this seems to be the view of Burrows, one of the few law and economics scholars arguing in favor of paternalism. On Burrows' theory of paternalism see section 2.3.1.
[54] Kleinig 1984: 58.
[55] For a more elaborate categorization of liberty-limiting principles see Feinberg 1986: xvi–xviii.
[56] Kleinig 1984: ch. 1.

theory, or justified by a theory of positive freedom. The main problem with such views is that they do not attach any content-independent value to freedom of choice. Under a liberty-based view, freedom of choice is valuable because of the value of autonomy. Under a consequentialist view, freedom of choice is the instrument through which preferences are fulfilled. In some perfectionist views, making choices is part of being human. If pressed, even economic theory can account for this intrinsic value of freedom of choice.

On the other hand, most plausible theories of liberty admit that there are reasons for limiting freedom of choice other than protecting the same freedom of third parties.[57] In the following part I briefly compare stylized versions of the deontological (autonomy-based), the consequentialist (welfarist), and the perfectionist (Aristotelian) perspectives. Later we will see whether, and to what extent these conceptions overlap. Namely, it is possible that the practical conclusions drawn from different philosophical arguments are quite similar.

2.2.2. Philosophical positions

Deontology and autonomy

Paternalism implies some loss of freedom in at least two ways. First, it involves the oppression of individuality. Second, it inhibits the making of voluntary choices, including occasionally wrong ones. In this way it curbs the development of the capacity for competent choice by individuals.

Non-instrumental theories take freedom as an intrinsic and primarily important value. Deontological antipaternalism is based on the value of personal autonomy. According to Joseph Raz, autonomy is the ability to make one's own life. This raises the question: is this always incompatible with paternalism? Raz argues that it is only necessarily so when paternalism is coercive.[58]

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[57] Sartorius 1983: xi.

[58] Raz 1986. In chapter 15 of his *The Morality of Freedom*, Raz discusses how autonomy can justify political liberty (negative freedom). "Autonomy is a constituent element of the good life. A person's life is autonomous if it is to a considerable extent his own creation." In his view, "the principle of autonomy, the principle requiring people to secure the conditions of autonomy for all people, yields duties which go far beyond the negative duties of non-interference, which are the only ones recognized by some [other] defenders of autonomy." (p. 408) "Since our concern for autonomy is a concern to enable people to have

Other theorists who defend autonomy on a non-perfectionist ground argue that people should have the right to choose self-harming actions because there is an intrinsic value to freedom of choice. Nonetheless, they usually soften this anti-paternalist standpoint by justifying intervention in certain cases. As we have seen, Feinberg attaches a nearly absolute value to the autonomy realized through voluntary choices, irrespective of what is chosen. However, by setting the threshold of voluntariness high and making it somewhat flexible, various interventions can be justified as soft paternalism. Donald VanDeVeer, another autonomy theorist arrives at a similar conclusion in a different way. He starts from an absolute value of the right to autonomy. Only he denies this right to moral incompetents. The membership in this latter group is then defined so as to account for the same problems as Feinberg's soft paternalism does.[59]

Another "softening" strategy is to concede that one should not be absolutistic about freedom; not every such loss is equally serious in a moral sense.[60] As commentators have noted, "One must take into consideration the importance of the preferences that are being frustrated."[61] Very few people would attach moral value to the freedom not to wear a safety belt or helmet under dangerous circumstances. On the other hand, people are permitted to assume risks in dangerous sports, even more serious ones than found in motorized traffic. The reason for this difference is probably related to the significance of these sports in the set of personal values for certain people; the centrality of these sports in their life plans.

In both of these theoretical strategies, autonomy theories require some kind of balancing. As Dan Brock has convincingly argued: "Paternalism is not, contrary to the common view, an issue that forces a choice between rights-based and consequentialist

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a good life it furnishes us with reason to secure that autonomy which could be valuable. Providing, preserving or protecting bad options does not enable one to enjoy valuable autonomy. This may sound very rigoristic and paternalistic." But it is not necessarily so. As to legal paternalism, "the fact that the state *considers* anything to be valuable or valueless is no reason for anything. Only its being valuable or valueless is a reason." (p. 412) The "pursuit of the morally repugnant cannot be defended from coercive interference on the ground that being an autonomous choice endows it with any value. It does not (except in special circumstances where it is therapeutic or educational). And yet the harm principle is defensible in the light of the principle of autonomy for one simple reason. The means used, coercive interference, violates the autonomy of its victim." (p. 418)

[59] VanDeVeer 1986.

[60] Greenawalt 1996: 481–482, Marneffe 2006.

[61] Van Wyk 1996: 77.

theories. […] [C]ontrary to appearances, [even autonomy theories like] Feinberg's and VanDeVeer's […] in fact require a balancing of respecting an individual's autonomy against protecting his good in the way commonsense morality supposes."[62]

Consequentialism and welfare

From a consequentialist perspective, what matters are the consequences of any action or rule.[63] In its welfarist version, characteristic of standard law and economics and certain varieties of utilitarianism, the relevant consequences are the effects in terms of welfare.[64]

Welfarism, in this rudimentary form, has no fundamental objection against paternalism.[65] To bring the theory into greater accord with common moral intuitions, and render it more workable as a policy guide, commentators supplement it with empirical claims about the working of different institutional mechanisms to promote welfare or satisfy preferences. An additional, empirically based presumption of such theories is that freedom of choice promotes well-being. Still, this presumption can be refuted in any particular instance. More weight can be given to the value of freedom itself by acknowledging that the freedom to make one's own choices is a component of this well-being. Consequentialism is even more flexible: theoretically, autonomy can even hold a central place amongst the goods constituting welfare. Nevertheless, as long as there are other components of welfare, it cannot always be decisive: trade-offs might be necessary.

In many cases soft paternalism can be most plausibly interpreted within a consequentialist framework. For instance, in the case of judgment biases or weakness of will (*akrasia*), the interference with personal *revealed* preferences can be justified by the goal of satisfying the individual's *deeper* preferences.

The principle of freedom-maximization is a related case of sophisticated consequentialism. It refers to the normative idea that the freedom of choice of an

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[62] Brock 1988: 565.

[63] To be sure, most deontological theories care about consequences as well. "All ethical theories worth of attention take consequences into account in judging rightness." Rawls 1999: 26.

[64] Welfare (good, well-being) can be understood in an objective sense or subjectively, as the person concerned conceives it. Cf. Kornhauser 1998, 2003a.

[65] See Burrows 1993, 1995; Zamir 1998; Zamir – Medina 2007

individual may, or even should, be restricted in the present if this increases his future freedom to a larger extent. Future freedom of choice is a component of the welfare of persons.[66] Of course, to make this idea any more than intuitive, the paternalist should be able to compare present and future freedom, *a fortiori*, to measure freedom. However, it is even conceptually unclear what such measurement would mean.[67] In order to work as a guiding principle of legal policy, the maximization of freedom should be more operational than the purely theoretical argument that justifiable paternalism should (paradoxically) increase or promote autonomy.[68]

The idea of maximizing freedom implies that the welfare of the individual is not only defined according to the actual wants and preferences (desire theory of preferences). Rather, one also takes into account other objective elements of human well-being and eventually comes close to a kind of perfectionism (ideal theory of preferences). Indeed, when welfare is understood so generally as to include *ideal preferences* (i.e. preferences which one *should* have in light of some moral theory), this view is hardly distinguished from perfectionism.

Perfectionism and virtue

If one's philosophical starting point is neither libertarian (deontological) anti-paternalism, nor a potentially paternalistic welfarist (consequentialist) view but perfectionism (or communitarianism), the arguments which will be made usually refer to concepts such as prudence, the ultimate end of humans, connectedness and the community as the context of human flourishing. At first sight, these concepts are at odds with modern individualism (cf. section 2.1.3 above). Perfectionism also seems to be very far from the amalgam of autonomy and welfare which implicitly characterizes the standard law and economics approach to paternalism.[69] On closer look, this impression is somewhat misleading.

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[66] Enderlein 1996: 13.

[67] On the possible "metrics of opportunity" in the social choice literature see Sugden 1998. If the normative idea should guide (individual or collective) action, the theoretical difficulties are accompanied with practical ones concerning observability and measurement.

[68] Eidenmüller 1995.

[69] For an exception see Buckley: 2005a, 2005b.

In its most abstract form, perfectionism is a moral theory which views the human good (flourishing, excellence) as resting on human nature. Perfectionism has an ideal for each human, namely that she develops her nature. It accepts self-regarding moral duties, thus it is concerned with what one should choose for herself. In contrast to other moralities which hold that the good is subjective and thus exclude any claims about what humans ought to desire, perfectionism has an objective theory of the good. Nevertheless, for our purposes perfectionism is less relevant as a personal morality. As far as political philosophy, i.e. normative ideas about the aims of a political community, eventually formulated in legal rules, is concerned, on the most general level perfectionism holds that "the best government most promotes the perfection of all its citizens."[70]

To be sure, perfectionism is a catch-all phrase for many different approaches. To name but a few examples, John Kleinig holds personal integrity as a primary value,[71] while James Gordley subscribes to a Neo-Aristotelian theory,[72] and Joseph Raz is a liberal perfectionist.[73] When Amartya Sen stresses the distinction between what one desires (the fulfillment of actual preferences) and what one has reason to value (in terms of a philosophical or moral view of the good), his views could also be characterized as a perfectionist version of consequentialism.[74]

Generally, perfectionist moral theories either hold that one should strive for a good which is supra-individual (the overall utility, happiness, etc. of a community) or compare one's actual actions and decisions with a morally or otherwise superior preference or value system. This might sound overly rationalistic. However, in the Aristotelian view, to find the right choice in a given situation is not a matter of demonstration, deductive logic or scientific knowledge. Choosing rightly is a matter of prudence, or practical rationality. Still, the view that there are wrong, e.g. self-harming

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[70] Hurka 1993: 5.

[71] John Kleinig's justification of paternalism is based on "the argument from personal integrity". The core of the argument is the following. "Not only do we have a diversity of aims, preferences, wants, and so on, but they vary in the status we accord them so far as our core identity and life-plans are concerned. We can differentiate passing and settled desires, major and minor projects, central and peripheral concerns, valued and disvalued habits and dispositions. (…) [W]here a course of conduct would, in response to some peripheral or lowly ranked tendency, threaten disproportionate disruption to highly ranked concerns, paternalistic grounds for intervention have a legitimate place." Kleinig 1984: 70–71.

[72] Gordley 2001: 280–285, 2007.

[73] Raz 1986. See n.49 above.

[74] Sen 2002, cf. Deneulin 2002.

or immoral choices that should not be supported but rather discouraged by law is part of most perfectionist theories.

Paternalism is justified under this approach if there is an objective good, i.e., there is a difference between a right and a wrong action, and an individual's good can be promoted by the actions of another person. Contrary to general views, this does not imply or justify paternalism across the board. It is possible to argue that in many cases the individual is the best judge of how to attain the good or end-state. Also, in many cases a third party, especially the state is unable to promote this good better than the individual. There are limits to paternalism from a perfectionist perspective, for at least five reasons.[75]

(1) Making one's own choices is part of being human. Otherwise a person would be only "a figure on a chessboard" moved by a paternalist.

(2) Sometimes it is better to let people make mistakes and learn from them to some extent, in order to make better choices in the future. Still there are fatal mistakes that should not be allowed for this "therapeutic or pedagogical" reason.

(3) Sometimes the answer to what the right choice is depends on facts which are best known by the choosing person and cannot be practically known by the paternalist. The latter may be able to sort out choices which are definitely wrong but there are several right ones amongst which the individual herself should choose.

(4) Sometimes the actions are such that by their nature they cannot be forced. For instance, persons cannot be forced to honestly believe in certain religious doctrines or to be genuinely interested in high culture (except, perhaps with severe psychological manipulation).

(5) There are practical limits to paternalism by the government, especially if it is a democratic one. In a democracy, there is no presumption that the political elite is morally superior. Also there is no *general* presumption that the government "knows better."[76]

From the point of view of virtue ethics, freedom of choice is valuable as a means to facilitate, or promote the goal of humans to lead a happy and worthwhile life. Within the limits just mentioned, perfectionism provides an argument for restricting individual

[75] Gordley 2001: 280–285, 2007.
[76] Cf. n.28 above.

choice in order to vindicate a theory of the good by impeaching immoral or ignoble choices.

2.2.3. Paternalism and consent

One way to look at the moral problem surrounding paternalism is to conceptualize it as a conflict between freedom and benevolence. From the perspective of its subject, the imposition on her behavior is limiting her autonomy in order to promote her welfare. Still there are alternative views that redefine paternalism in such a way that it either looks normatively more acceptable or it seems easier to analyze its justifiability.[77] These justificatory redefinitions focus on "self-paternalism", i.e. the protection of the autonomy of one's inner or future self by a second-order decision of the individual, and ask whether paternalism can be justified by some kind of consent.

According to the definition of paternalism stipulated above (section 2.1.1.), the consent of the subject makes the intervention non-paternalistic. But what kind of consent is necessary? Is the lack of actual consent fatal for justifiability? There have been several attempts to redefine paternalism on the basis of some kind of consent other than actual. These are discussed below in turn.

Prior consent

An example of prior consent could be the following. B signs an agreement with a clinic for a certain medical treatment. For a given period of time patients who agreed to the treatment, cannot leave the program. The reason for such an agreement is that during the treatment, patients usually prefer to leave which makes their treatment less effective or ineffective. Is the clinic allowed to deny B discharge? If so, under what circumstances? One of the problems with prior consent is that in some cases it is hard to know whether the change in the subject's wants is permanent or episodic.

Another example is the paradigmatic case of Ulysses, often discussed in social sciences, including rational choice theory.[78] As Homer tells us, before navigating close to the island of the attractive but fatally dangerous sirens, Ulysses commanded (and by

[77] Enderlein 1996: 22–35.
[78] Cf. Elster 1984, 2000.

this gave his prior consent to) his crew to tie him to the mast and by making his men unable to hear his subsequent orders, he ascertained that they disobey his commands to the contrary. In this sense, the crew was *not* acting paternalistically. Ulysses' men were not paternalists as their action was authorized by prior consent (or even commanded).

Homer is silent however, as to whether the timing and conditions for unbinding after the danger has past were regulated in the prior agreement. If not, then the entire story can also be interpreted differently. The crew's action can also be said to be justified because it respected Ulysses' settled values over his current disturbed wishes. The sailors did not act out of obedience to his authority but rather, because they knew what was better for him. Under this view, the crew acted paternalistically. Under this second interpretation the stress is not on form, i.e. Ulysses' consent but on substance, i.e. Ulysses' interests. As we will see, this distinction between form and substance is crucial for the connection of paternalism and consent. At any rate, we can say that when prior consent has been given, *within the consented domain* limitations of freedom are not paternalistic.

Anticipated consent

Sometimes circumstances arise in which those in need of care have not had the opportunity to consent to intervention. A classic example of this is J. S. Mill's man crossing a river on an unsafe bridge.[79] When there is no way to warn him, forcing the man to stop is considered justified on the assumption that he almost surely did not want to fall into the river. In the legal context, a similar case might be the medical treatment of an unconscious victim of an accident. Here even the doctor's claim for compensation is based (in traditional common law terminology) on an "implied contract".

These examples are both instances of soft paternalism. To the extent they are justified, it is not because of an anticipated consent of the subject to paternalism (moreover, to speak about a contract here is a fiction), but because intervention, as a

[79] Mill 2004 [1859] ch. 5: "If either a public officer or any one else saw a person attempting to cross a bridge which had been ascertained to be unsafe, and there were no time to warn him of his danger, they might seize him and turn him back without any real infringement of his liberty; for liberty consists in doing what one desires, and he does not desire to fall into the river."

rule, has better overall consequences than non-intervention, in terms of the interests of the subject. [80] Here again, what matters is substance rather than form.

Collective self-paternalism and democratic legitimacy

Consent is also often invoked with regard to paternalistic government actions as well. One form of this justification is based on the general argument that the democratic legitimacy of government, if present, justifies paternalism. Another is to use a collective analogue of the Ulysses parable and refer to certain restrictive or protective laws as "collective self-paternalism." But do majoritarian decisions or the popular support of legislative actions make them non-paternalistic and *for this reason* justified? The answer is clearly negative.

To be sure, in a metaphoric sense one can speak of self-paternalism. This would be a third interpretation of the Ulysses story. If somebody is aware of his own weakness-of-will or irrational first-order preferences, he may have a second-order preference against fulfilling the first-order ones. One can impose different measures to protect one's "higher self" from "base desires" or "dangerous temptations". If a group of people is in such a situation they can even use collective mechanisms and impose institutions in order to protect themselves. This could be called "community self-paternalism".

However, genuine community self-paternalism requires unanimity. Unless the support is by universal, conscious, informed and expressed acts of consent, the collective decision and the government action based on it cannot be properly dubbed collectively self-paternalistic. It has been noted that "So long as there is even a single dissenter, the real issue must be this: may the majority [interfere] with actions [of the minority] on account of a second-order preference to not acquire or retain a first-order preference to elect certain actions?"[81] This is instead a case of the majority's self-paternalism and the imposition of harm or costs on the minority. Whether such legal interference is justified will depend on a number of factors. There are, for instance, good reasons against using criminal law in such a manner. For less coercive rules the balance may be different.

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[80] For an efficiency-based justification of the law on "implied contracts" in this example see R. Posner 1998: 151–152.

[81] Schonsheck 1991: 36.

A further point is that in a representative democracy a legal rule which expresses the second-order preferences of the majority is enacted and enforced by a representative, namely the government. Strictly speaking, this is not self-paternalism but governmental paternalism. A special case of this setting, "asymmetric paternalism" will be analyzed below (see section 2.4.3.). In that case, the desirability of the intervention is based on the positive balance of the benefits for those protected and the costs, i.e. the losses for those who do not need protection, plus the costs of implementation. This balance can be calculated for any particular governmental action or policy. Indeed, this calculation can even be made by an enlightened dictator. Legal protection of the majority from self-inflicted harm is not intrinsically or necessarily democratic.

The general justification for legislative actions in a representative democracy on the basis of consent is a different matter altogether. It is among the most discussed problems of political philosophy. In a democracy, one can speak of a general consent to the actions of the legitimate government, in a weak sense. This justificatory consent is weak because it has to be prior and generic (referring to an unknown set of future state actions) and it does not have strong implications for the reasonableness of any particular action. On the other hand, democratic legitimacy is not directly based on the substantive reasonableness, self-paternalistic or otherwise of its singular actions or policies. Authority is content-independent.

Hypothetical consent

Finally, it is sometimes said that the justification of paternalism can be based on some sort of hypothetical consent.[82] As I will argue, this view of paternalism is problematic. The reason for this goes deeper than the problem of paternalism, as in my view the entire construction of hypothetical consent is debatable as a justificatory argument. Its terminology misleadingly hides what really happens. When in formulating the justification of a rule (action, policy, etc.) one refers to the hypothetical consent of those subject to it, or concerned by it, the reference to consent has only a heuristic role.[83] As has been widely discussed in the literature on "social contract" theories and

[82] See, e.g. Kerber – Vanberg 2001.
[83] See e.g. Kleinig 1984: 64–66, Suchanek 2004, Pope 2004. On the redundancy of arguments from hypothetical consent in the economic analysis of contract law see Craswell 1992.

contractarianism, the essence of the problem is that hypothetical consent is not actual consent: it does not live up to justify a rule on its own, i.e. in a content-independent way. On a closer look, hypothetical consent is not a content-independent justification, referring to the procedure of deciding over a rule. Rather, it refers to the substantive arguments which should be raised in its favor. More precisely, it is a metaphor which refers to the public nature of arguments that rational individuals have reason to accept as the justification for a rule. In some loose sense, hypothetical consent is linked to normative individualism. What is decisive for the justification of the rule is the substance of such normative individualist arguments. These arguments should refer to the impact of the rule on the rights or interests of the individuals concerned.

In sum, from a moral point of view, only prior and actual consent directly matter. They only count *qua consent* for the justification of preventing self-inflicted harm or promoting the interest of others. "*Post facto* (subsequent) consent, disposition to consent, hypothetical consent, the imaginary consent of a rational subject all cannot waive the subject's actual right to autonomy."[84] One can see this clearly when there is actual dissent, i.e. the voice or vote of someone is against the imposed rule. However, this negative result only means that these instances of intervention are not justified *by consent*. Although consent is a morally strong justification, it is neither necessary nor sufficient in every case.

2.2.4. Problems of legal paternalism

Up to now, the discussion has focused on the subject of paternalism and mostly abstracted away from the personage of the paternalist. But the identity of the paternalist is clearly relevant to the justifiability of paternalism. For instance, it matters whether the intervention is exercised by an individual, a group or by the state. Within legal paternalism, it is not irrelevant whether private law, taxation, criminal law or other instruments are used. In chapter 4 the focus will be on legal paternalism via contract law rules. We will be concerned with paternalistic interventions by the state, either through legislation or by judicial control,[85] with relatively non-coercive means, e.g. the non-

[84] Kultgen 1995: 122. Of course, there can be other, weightier argument than this right.
[85] On this distinction see 4.6.1. below.

enforcement or voidness of a contract or compensation for damages. These specifics have a great impact on the justifiability of a given legal intervention.

Reason and legislative intent

The simple question: "What is paternalism?" becomes more complicated in legal contexts.[86] As discussed above, an action is not paternalism by virtue of its effect, although consequences do matter to the justification; rather, paternalism is a reason or motivation for action. But if this is so, how can then a law be paternalistic? Isn't it a category mistake to speak about the reason or motivation of a law? Does the actual motivation of legislators matter?

By browsing the relevant jurisprudential literature, one can easily see that the difficulties with the concept of "legislative intent" are manifold. Whether the term has a role in statutory and constitutional interpretation or not does not concern us here. Instead, what matters for the justifiability of a law are not the, unobservable and contradictory subjective intentions of the lawmakers but the possible justifications for a legal rule.[87] We can thus attribute a paternalistic purpose to the regulation even if historically (as a matter of psychology) paternalistic motivations were not necessarily present. In essence, this is a teleological interpretation.[88]

Rules and reasons: the theoretical over-determination of rules

It seems that there is no real hope for identifying "the reason" for a law. This implies that if one condemns paternalism, one is only entitled to say: a law is unjustified in so far as it exists for paternalistic reasons. In case of mixed motives, paternalism does not have to be the only or main reason. Nevertheless, it has to be relevant to the justification in order to call a law paternalistic.[89] A purist would even say that it is only correct to call a law paternalistic when paternalism is the "most plausible reason" or "the best rationale" for it. But how can this "most plausible reason" be identified?

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[86] Husak 2003.
[87] Cf. Marneffe 2006.
[88] To be sure, motivations are not irrelevant. The legitimacy and authority of law largely depends on whether its rules are enacted and enforced for the *right reasons*. Hidden motivations and insincere justifications, if uncovered, may undermine legitimacy.
[89] Enderlein 1996: 14

An elementary insight from comparative legal research is that in one or the other legal system the same function can be fulfilled by different rules, doctrines or institutions. Something similar works the other way around as well. Any given rule can be interpreted in light of several reasons. In other words, legal doctrines and rules are theoretically over-determined. There is no clear correspondence between rules on the one hand and their justificatory reasons or the functions they serve, on the other. As a consequence, we cannot neatly separate paternalistic and non-paternalistic contract regulation.

In law we can see the uneasy relationship between general principles and specific rules very clearly. If we analyze a given legal doctrine non-dogmatically, i.e. not by asking for its technicalities, wording, or its place in a larger body of rules but critically, looking for reasons justifying it, we often find that a given rule can be backed by several, often contradictory principles. Due to this over-determination we might not clearly determine whether a given rule results from paternalism, the self-interest of an influential group, a symbolic expression of a generally held value (moralism), or an instrumentally rational response to an externality problem.

As the possible overarching theoretical systems behind more specific reasons for intervention and also the possible justifications of a concrete rule are multiple, one can construct several more or less coherent explanations or justifications for any rule. They are not, of course, equally plausible or convincing.

Let me illustrate this problem of over-determination with an example. It is often argued that in order to justify the compulsory use of safety helmets or the ban on tobacco advertisements it is sufficient to refer to the social burdens caused by accidents and tobacco-related medical costs, respectively. In this way, the argument goes, ‘dubious’ and controversial issues about autonomy, coercion etc. can be avoided. In contemporary European countries with universal (i.e. nationwide and compulsory) social security systems, one can allegedly avoid referring to paternalism in order to justify the prohibition of certain self-harming behaviors. One can “simply” refer to the external effects, i.e. the financial burdens that a given action would cause – provided self-inflicted harms are not excluded from the coverage of social security systems right at the beginning.

There is a serious problem with this argument. Both empirical research and common sense suggest that in pure social expense terms these prohibitive rules are possibly counter-effective.[90] While serious accidents without safety helmet often cause death, helmets usually save "only" the life of a severely disabled person; in social expense terms his care tends to be burdensome. Without smoking people live longer on average, thus it might easily be that they consume more social funds, mainly in the form of pensions, than smokers who die relatively early, near to the end of their working carriers. Notwithstanding that if these effects are empirically confirmed, they are remarkable and even relevant from a policy perspective, they are not workable as 'public reasons' *against* tobacco bans or compulsory safety helmets in the Rawlsian sense.[91] If we do not want the arguments about public policy to run fully against our moral intuitions, we should take paternalism seriously.

This example illustrates that if a rule is impurely paternalistic, i.e. there are several reasons behind it[92] then we have to analyze each reason for its plausibility. As we will see below (in section 2.2.5), there are reasons, like fairness, redistribution or legal moralism that often concur with paternalism. In sum, as rules are over-determined by potential justificatory reasons, first, one has to assess them separately, and then one can see whether these reasons, taken together are weighty enough to justify the rule.

Over- and under-inclusiveness of rules

An additional problem posed by legal paternalism, already hinted at, is that it is general, rather than case-by-case paternalism. The law is general when it is applicable to an indeterminate number of different persons. Some are made better off, according to their own preferences or according to an objective metric, some made worse off. Persons have different motivations for wanting to engage in prohibited conduct. Some are informed, some not. Some have strange or dangerous preferences. Even if it might be justified to interfere in individual cases, a general rule would diminish the freedom of those who do not need to be assisted. The problem of the over-inclusiveness of rules vis-à-vis their background justification arises unavoidably when general rules are

[90] See Lee 1991: 72–73, Lee – Wagner 1991: 119.
[91] See Rawls 1993, Larmore 2003.
[92] On impure paternalism see note 40 above.

applied heterogeneous the cases or subjects.[93] The problem is not unknown in the law and economics literature either. In one sense, it is a special case of how to find the optimal mix of rules and standards in regulation, or the division of labor between legislation and the judiciary.

One of the arguments for rule-based decision-making is that finding an appropriate solution for individual cases would be extremely costly. For instance, in administrative law it is relatively rare that permission for dangerous, irreversible or otherwise important actions is granted on the basis of case-by-case investigation, e.g. individual licensing or individual hearing. In general, even when cases are heterogeneous, the law has to use rules, categorizations and classifications. As a consequence, these categories will be either over- or under-inclusive, or both. Therefore, despite the uncertainty regarding the distribution of competence, well-informedness etc. amongst individuals in a given community, the lawmaker is bound to formulate general rules regulating their conduct.

In the decentralized enforcement of contract law, judges evaluate the merit of individual cases. When they decide not to enforce, or enforce on different terms, contracts falling into certain predetermined categories, they are not entirely bound by rules. If we put the decision's force as precedence aside, over-inclusiveness matters less in adjudication than in legislation and administration.[94]

2.2.5. Non-paternalistic reasons for protective regulation

As mentioned before, besides paternalism there are competing justifications for limiting freedom of contract. These reasons are not always easily distinguishable from each other, or from paternalism.

A rule can protect against an irrational self-harming contractual choice with mandatory law, provide for the correction of negative externalities, counteract an informational asymmetry and compensate for losses all at the same time. Other rules prohibit transactions against the public interest, against public policy or some basic

[93] The jurisprudential classic on the topic is Schauer 1991. See also Schauer 2003.

[94] In contrast, over-determination is present in adjudication as well. As I will discuss in chapter 4, judges can refer to doctrines like coercion, fraud, or unconscionability for different reasons. Such rules, especially the general clauses are, in this sense, only potentially or partially paternalistic.

moral principles formulated as "the value system of the constitution". We can distinguish other-regarding constraints (externalities), agent-regarding ones (paternalism and autonomy-protection) and non-individualistic ones (which are based on legal moralism). Paternalism should be also distinguished from redistribution.

Third-party effects

In the contractual context, externalities involve the imposition of costs or benefits from a particular exchange transaction on third parties not involved in the transaction. Positive externalities pose incentive problems, leading to a suboptimal quantity of the good or transaction in question. Negative externalities are arguably more important with respect to freedom of contract.[95] The crucial conceptual problem here is that third-party effects, known as negative externalities in economics and harm in autonomy theories, are pervasive. If all these effects should be taken into account when prohibiting the exchange process or in justifying constraints upon it, freedom of contract would be largely at an end.[96] Once one goes beyond tangible harms to third parties, many activities might be viewed as generating some externality, e.g. by imposing costs on dependents, the social welfare system or the public health care system. It is questionable however whether such externalities provide a sufficient reason, for example, to regulate inadequate dietary or exercise regimens, excessively stressful work habits or risky leisure activities.[97]

In a thoughtful article, Eric Posner has suggested that many protective laws function to redress imbalances created by social security and welfare laws.[98] By truncating the downside of financial and other risks through a social safety net, the welfare state and its laws have the effect of encouraging irresponsible spending, risky borrowing and over-indebtedness. Many limitations on freedom of contract may be justified with the argument that contracting parties take on too much risk in reliance of the welfare state. In Posner's view, what first looks like a protective rule in contract law is in fact, in whole or in part, protecting the public budget. This argument is very similar

[95] Autonomy-based theories formulate the same negative effect under the name 'harm' (or, within another category of Joel Feinberg's scheme: 'offense').
[96] Trebilcock 1993: 58.
[97] Trebilcock 1993: 75.
[98] E. Posner 1995.

to the social burden argument in support of mandatory safety belts. As we have seen, economists are still willing to refer to externalities, in this case burdens for the social security system, in order to justify laws which on their face are paternalistic, such as safety measures.

Other limitations on contractual freedom can be more plausibly justified by third-party effects. A trivial example is that an agreement to commit a bank robbery is illegal. Also, "antitrust authorities may frown upon contracts that have potentially harmful effects on competition (most favored nation clauses, contracts that induce predatory or collusive behavior, etc.) Contracts between a firm and a creditor may exert externalities on other creditors, either directly through priority rules in the case of bankruptcy or indirectly through the induced change in managerial incentives. The Internal Revenue Service warily investigates employment contracts that might dissimulate real income."[99] These cases are clearly distinct from paternalism.

Some protective laws can be understood as both paternalistic and solving collective action problems. For instance, John Stuart Mill justified the statutory limitation of working hours by arguing that it helps employees to fulfill their preferences which would otherwise be frustrated because of a prisoners' dilemma-like situation. Mill discussed approvingly such contract regulations not in *On Liberty* but in his *Principles of Political Economy*, referring to "cases in which public intervention may be necessary to give effect to the wishes of the persons interested, because they being unable to give effect to it except by concert, which concert again cannot be effectual unless it receives validity and sanction from the law."[100] On a closer look, such interventions are similar to collective self-paternalism (see above section 2.2.3.). Since workers do not only face a common action problem, but they are also competitors on the labor market, the game-theoretical analysis of the problem would be somewhat more complex.

Under one interpretation, the *public policy* doctrine in contract law is a special case of avoiding negative externalities. The contract may have negative effects on public purposes that justify its regulation or non-enforcement. Many contract codes

[99] Tirole 1992: 109.
[100] Mill 1997: 956. The entire chapter XI of Mill's *Principles* ("Of the Grounds and Limits of the *Laisser-Faire* or Non-Interference Principle", pp. 936–971) is still worth reading.

refer to such limitations, combining in the wording public policy or public interest with illegality or immorality.[101] For instance, the French Code civil (art. 6) provides that "One cannot by private agreements derogate from laws involving public policy and good morals."[102] According to the art. 7 of the General Principles of Civil Law of the People's Republic of China (1986), "Civil activities shall have respect for social ethics and shall not harm the public interest, undermine state economic plans or disrupt social economic order."[103]

These general clauses are put to a large range of uses in their judicial application. Some of these purposes are paternalistic, others are linked to externalities. Additionally, public policy is sometimes referred to when the externality is "moral" in nature. This term refers to cases when neither the contracting parties nor any third party, individuals or the public, suffers any tangible harm. This suggests that the public policy doctrine can be an instance of legal moralism as well.

Legal moralism

Paternalism is sometimes not easily distinguished from legal moralism. As already has been mentioned, this latter principle justifies an intervention by appealing to abstract moral values, instead of the interests of individuals or their groups. The line between moralistic and paternalistic reasons is somewhat blurred, at least in law. When "exploitative" contracts are prohibited, one party is considered "victim", although, at least *ex ante*, he might have consented fully voluntarily.[104] Even his interests might have been promoted by the contract, compared to his outside opportunities. When the "victim" is granted relief *ex post*, it is often done in the name of abstract values imbued in social morality.

In the philosophical literature, the line of demarcation between legal paternalism and legal moralism is neater. Gerald Dworkin distinguishes "moralistic paternalism" from legal moralism. Whereas, when a law restricts the individual's choices for his

[101] Zweigert – Kötz 1998: 380–387, Scott – Kraus 2003: 517–553.
[102] The translation of the governmental website Legifrance (http://195.83.177.9/code/liste.phtml?lang=uk&c=22&r=209) is this: "Statutes relating to public policy and morals may not be derogated from by private agreements."
[103] http://www.law-bridge.net/english/LAW/20065/1322572053247.html
[104] On exploitation in contracts see Bigwood 2004, in general Wertheimer 2005.

moral good, it represents "moral paternalism."[105] When it wants to restrict the individual's choices for enforcing social morality, it is a form of legal moralism. Only the first is a case of paternalism. When discussing liberty-restricting principles, Joel Feinberg contrasts paternalism as "harm to self" with moralism as "harmless wrongdoing."[106] It should be also noted that some supporters of legal moralism do not consider the wrongdoing "harmless"; they argue that the survival or flourishing of any particular society needs moral uniformity. Under this view, immorality does not simply violate an abstract moral principle or code; it causes harm to society by weakening its moral ties.[107] This brings us back to the problem of externalities. Indeed, some law and economics scholars tend to speak of moral externalities.[108] In either case, these reasons are not paternalistic.

The typical instruments of legal moralism are contract doctrines like immorality and illegality, or legal techniques like inalienability, which restrict the transferability of rights or resources.[109] We will come back to these instruments as substantive limits on freedom of contract in section 4.4.2.

Fear of commodification

Inalienability can also be motivated by a special version of legal moralism which could be called fear of commodification. The roots of these concerns can be found deep in history.

Even in societies committed to political and economic liberalism, there is room for debate about the scope of the market. Critics of the market paradigm sometimes use historical arguments to show that markets are not "naturally given" but the product of historical development and depend on legal constructions.[110] More relevant from a policy perspective, the role of markets is also the subject of direct normative

[105] Dworkin 2005a.
[106] Feinberg 1986.
[107] Devlin 1965. For a thoughtful critique see Hart 1963, 1983.
[108] See e.g. Hatzis 2006b. This use of words is unfortunate, as it implies the false claim that moral views can be reduced to preferences (Kornhauser 2003b, Zamir – Medina 2007).
[109] For a law and economics analysis of inalienability see Calabresi – Melamed 1972, Rose-Ackerman 1985, 1998.
[110] For the first see e.g. Polányi 1944, for the second e.g. Hale 1952 (cf. also Fuller 1954) and Atiyah 1979.

controversies. These controversies focus on heavily discussed issues such as whether "permitting the sale of votes or public offices, the sale of blood or body organs, commercial surrogacy contracts, prostitution contracts or pornography undermine values of human self-fulfillment or human flourishing."[111] These questions are, of course, not only raised by critics or the enemies of markets. As the Nobel-laureate economist, Kenneth Arrow once noted, "a private property—private exchange system depends, for its stability, on the system's being non-universal."[112] What he meant by this is that if political, legal and bureaucratic offices were auctioned off, their holders freely bribed or votes freely bought and sold, the private sphere would be massively destabilized.

In the American legal academia, one of the main proponents of this anti-commodification view is Margaret J. Radin.[113] In her theory about commodification and inalienability Radin argues that these problems are difficult to solve because of two opposite effects: the double bind effect and the domino effect. The *double bind effect* refers to the problem that in many contexts prohibiting exchanges may actually worsen the plight of the individual whose welfare is central to the issue. For example, banning prostitution may eliminate an income-earning option of poor women. The *domino effect* refers to the effect counterbalancing the former, that "market rhetoric and manifestations [...] may change and pervert the terms of discourse in which members of the community engage with one another".[114]

While Radin is skeptical about the relevance of economic analysis to this subject, Michael Trebilcock proposes to reinterpret commodification with the tools of law and economics, and in accord with common moral intuitions about the cited problems. The problems can be interpreted as contracting failures or types of market failures (e.g. externalities, coercion, and information failures). In conclusion, Trebilcock argues for a significant role for private ordering; for a careful design of default rules and procedural limits of freedom of contract; and for autonomy-enhancing public policies that broaden the access to market of historically oppressed groups.[115]

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[111] Trebilcock 1993: 19.
[112] Cited in Trebilcock 1993: 23.
[113] Radin 1996, for its critique see Arrow 1997.
[114] Trebilcock 1993: 25–26.
[115] Trebilcock 1993: ch. 2 (p. 23–57).

2.2.6. Pragmatic antipaternalism

If we consider economics as purely welfarist, then there is no theoretical limit to paternalism. Within this framework, antipaternalist limits can be added, in a contingent way, with reference to empirical facts about the functioning of the legal system. These empirically based arguments, together with other arguments against paternalism *not* based on autonomy could be called pragmatic antipaternalism. These arguments are not only interesting for the antipaternalist. The adjective 'pragmatic' in this catch-all phrase indicates that supporters of paternalism should also take these limitations into account when they move from the ideal (pure) to real world theory or from theory to policy.

The most important pragmatic arguments refer to the over-inclusiveness of rules and the ensuing redistributive effects. Others warn about the lack of information and lack of motivation of the regulator.[116] Here I only mention these arguments *in abstracto*.

Over-inclusiveness has been discussed above in section 2.2.4. Its main consequence is that a paternalistic rule allocates burdens on those who are subject to the general rule but do not benefit from it as they would not need assistance. In another sense, this points to the (possibly unintended) redistributive consequences of paternalism.[117] Namely, the costs of paternalistic rules are borne by rational and informed individuals. Such individuals are actually impeded by paternalistic limitations from carrying out their actions as they want.

As economic analysis has long since established, when individuals on one side of the market have heterogeneous preferences or differ in other dimensions, protective regulation usually leads to redistribution *between* them, i.e. within one side of the market. In contrast, so long as contract price or other contractual terms are not regulated, contract law is largely ineffective at redistributing between the two sides of the transaction. The contract price is changed accordingly so as to reflect and pass-on changes in costs. This implies that the non-enforcement of certain odious terms does not lead to redistribution from the contracting partners to the class of paternalised

[116] Kleinig (1984: 31) mentions further arguments: "the law will be brought into disrepute, the corrupting tendencies of power will be accentuated, valuable resources will be diverted from more worthwhile ends, and effective enforcement will cause disruption to unconnected activities." In my view, these are too general to be relevant for the present analysis.

[117] See Mitchell 2005.

individuals. To be sure, limits to freedom of contract can have redistributive consequences between the two sides of the contract. However, this effect is not an instance of paternalism.[118]

There is a further instrumentalist argument against all sorts of paternalism. Following the Hayekian line of argument about the dispersed nature of knowledge in society, serious doubts can be raised about the superior knowledge of the *pater*. To put it simply, the argument is that even if the paternalist legislator is benevolent, he is possibly ignorant about what promotes the good (well-being, happiness etc.) of the paternalised individuals. The information the regulator has about the "genuine interests" of the subjects of paternalism is not only seriously limited but potentially biased, because of the potential capture of legislatures and regulators by interest groups. Information problems are even more serious for judges and jurors. Additionally, as empirical research has established, official persons are also subject to cognitive and emotional biases which need a careful separate assessment.[119]

In sum, pragmatic anti-paternalist arguments draw attention to the side-effects and non-intended, counter-intentional, consequences of paternalistic interventions. The intervention may be more costly or harmful than beneficial, either (1) for the paternalised subject (e.g. due to the double bind effect), (2) for third parties (e.g. due to the over-inclusiveness of the legal rule), (3) or for the general public (e.g. due to implementation costs). In regards to the unintended consequences, overly protective regulation always runs the danger that certain transactions become unprofitable and lead to the collapse of the market, or the segment which was the object protection. To put it in another way, paternalism may be problematic in these cases not only because it is costly for others, but also because it might backfire, i.e. make worse off the very group of persons it intended to protect.[120]

2.3. Paternalism in economic theory

As mentioned, the traditional economic approach to freedom of contract and paternalism is a non-reflexive mixture of liberalism and utilitarianism. As such, it is ill-

[118] On the passing on of costs see Craswell 1991.
[119] On the one of biases in judging see Rachlinski 2000.
[120] On 'legal backfire' see Hillman 2002.

equipped to handle the problems which arise when these two principles collide. The potential conflict between welfare-maximization and autonomy draws attention to the non-welfarist dimension of the problem of paternalism. When this dimension is not taken into account, the whole problem of paternalism is reducible to a more or less sophisticated exercise in welfare-maximization. Within a strictly welfarist perspective, if the regulator knows better, he should decide in every case in the agent's place. In terms of the preceding section, the constraints to paternalism can only be pragmatic. In contrast, autonomy provides a principled constraint. As we will see, economists also take this constraint into account, at least implicitly.

In another dimension, contemporary economics is often criticized on the basis that it accepts existing preferences as given. As the critique goes, economic theory does not offer "ethical criteria for disqualifying morally offensive, self-destructive, or irrational preferences as unworthy of recognition." If, to the contrary, it acknowledges some exceptions, as it usually does (e.g. in case of minors or mentally incompetent persons) then "some theory of paternalism is required, the contours of which are not readily suggested by the private ordering paradigm itself."[121] Being reluctant to criticize or "launder" preferences or rethink their model of individual choice as a combination of information (beliefs) and preferences, economists use an "eliminative redefinition" strategy in order to fit paternalism in the neoclassical models. In this part I examine how this strategy works.

2.3.1. Redefinitions of paternalism in economic theory

The economic literature on paternalism[122] strives to justify instances of reasonable, seemingly paternalistic regulations in several ways. For the sake of simplicity, they can be put into four categories: market failures, merit goods, non-standard preferences and non-welfarist objectives.

[121] Trebilcock 1993: 21. On the private ordering paradigm see section 3.2.2. above.
[122] E.g. Burrows 1993, 1995, 1998; Saint-Paul 2004; Zamir 1998.

Market failures

The first approach sticks with consumer sovereignty and revealed preferences. As we have seen above, in most cases paternalism is redefined or "explained away" by showing that the policy in question serves to prevent externalities or other market failures. These ways do not question consumer sovereignty. This eliminative redefinition of paternalism is arguably the natural way to treat the substantive problem in economics. Indeed, at first glance it is relatively easy to incorporate paternalism in mainstream economic analysis: we just have to identify specific transaction costs and/or informational imperfections and asymmetries which lead to a market failure.

Limits of freedom of contract, like the judicial control of standard form contracts, labor law or consumer protection can be analyzed in terms of these (now) standard economic concepts. These limits are economically justified to the extent that they remedy market failures. In this way not only the case *for* freedom of contract, but many of its limits can be explained in relatively narrow economic terms, by neither relaxing the rationality assumptions nor recurring to fairness arguments.[123] In fact, the biggest "advantage" of this approach is that the conflict between welfare and autonomy does not come to surface.

Merit goods

The second approach clearly and almost openly faces this conflict and solves it in favor of welfare. In the 1950s Richard Musgrave introduced two new concepts in the theory of public finance: merit wants and merit goods.[124] These concepts serve to formalize the welfarist idea of paternalism with regard to certain publicly provided or publicly subsidized goods. In the case of merit wants or goods, the welfare function that the policymaker has to maximize on behalf of the individuals is modeled formally differently from the way the individuals themselves (are modeled to) perceive and reveal their preferences. In this way, "consumer sovereignty" is openly questioned and abandoned in favor of a supra-individual assessment as to how much one should receive and consume of certain "merit goods".

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[123] Mitchell 2002, cf. Hermalin – Katz – Craswell 2006: §2.

[124] For a useful introduction see the still very illuminating summary article by Head 1966. Cf. also Andel 1969, 1984, Brennan – Lomasky 1983, Müller –Tietzel 2002.

Although merit goods often have public good characteristics and their provision can also be driven by redistributive concerns or justified by asymmetric information, Musgrave has insisted that there can be a separate reason, independent of all these standard economic ones for overriding individual preferences. In the case of merit goods, individual choice is overridden in the name of what a particular (political) community considers worthwhile for individuals to do (consume).[125]

"Irrational" preferences

The third category of redefinitions comprises those more or less sophisticated models of preference-formation and decision-making which introduce specific *ad hoc* assumptions about the preference structure of individuals. Examples include choice models based on path-dependent preferences, dynamic inconsistency or the multiple self. The methodological goal here is to analyze certain conflicts between autonomy and welfare with a minimal deviation from mainstream economic theory (rational choice theory).

When economists analyze market behavior, they not only implicitly rely on a standard of voluntariness but also explicitly on a standard of rationality. According to rational choice theory, weakness of will, "sour grapes" mechanisms etc. are irrational behavioral patterns. This view implies that the preferences of real-world individuals should be measured on a normative scale. The actual or revealed preference structure of individuals is compared to an ideal or rational preference structure of an abstract model construct, the rational decision-maker. Irrationality in this sense may justify intervention.

To some extent, rationality is treated in these models like autonomy in freedom-maximization 'models' (see section 2.2.2.). One's preferences are to be respected if they truly and consistently reflect one's desires. But this is not always the case. The rational self can be in conflict with other features of the very same person or in other terms with different selves. These models re-conceptualize paternalism as a multiple-self problem or even as an 'intra-personal externality' or 'internality' problem.

Paul Burrows was amongst the first law and economics scholars to analyze legal

[125] Musgrave 1987.

paternalism in this manner.[126] In his work he proposed a welfare-based justificatory theory of paternalism. "If a paternalistic legal intervention is capable of creating benefits for people whose freedom of choice it restricts, then there is a *prima facie* case for intervention on *efficiency* grounds."[127] The pragmatic limits of intervention are related to the capability of the legal system to identify *ex ante* the contexts within which such benefits are attainable. The normative benchmark is provided by individual preferences, as defined in his model of preference formation and modification. The model is clearly *ad hoc* and not based on empirical psychological research; it rather adds intuitive, more or less realistic modifications and complications to the standard economic assumptions about preference formation and modification. As he argues, "conventional economic theory is rather stymied in its ability to analyze paternalistic law by its adherence to the assumption that people have complete and fixed preferences. Legal paternalism, on the contrary, tends to derive from the incompleteness, the variability through time and other problematic aspects, of people's preferences."[128]

One characteristic feature of Burrow's analysis of paternalism is that in his view a judgment about the value of any paternalistic intervention "should be based upon the benefits to the constrained individuals as they perceive them *ex post*."[129] These benefits are threefold: "the enhancement of a person's physical wellbeing, the stimulation of the creative development of a person's preferences, and the moderation of impulsive, self-damaging decisions."[130]

Interestingly, on the level of normative philosophy, Burrows has defended his welfare-based theory against autonomy-based criticisms with arguments of a slightly perfectionist flavor. His first counter-objection is that autonomy-based theories "seriously oversimplif[y] the consequences of legal paternalism for people's freedom" as they consider only negative freedom, i.e. the right to make free choices to the exclusion of positive freedom, i.e. the right to have access to an enhanced set of options, the right to develop and fulfill one's potential. Second, he seems to claim that values

[126] Burrows 1993, 1995, 1998. For another model see Zamir 1998.
[127] Burrows 1998: 541.
[128] Burrows 1998: 540.
[129] Burrows 1998: 541.
[130] Burrows 1998: 541.

held in current societies are much less influenced by the value and the theories of autonomy than its supporters claim.[131]

In sum, in certain cases soft paternalism is justified by the following argument: limiting freedom of choice is instrumental to the defense of the true self of the subject against one's weakness of will or judgment errors. Eventually, these limitations many even increase the subject's rationality and/or autonomy.

Beyond welfarism

Finally, there are such heterodox economic approaches that criticize mainstream economic theory for the reduction of every normative instance to preferences over outcomes and suggest this simplistic view be remedied. As we have seen above (section 2.2.2), by stressing the difference between what one desires and what one has reason to value Amartya Sen belongs within this category. This distinction would move economics in a perfectionist direction.

Other economists (or the same ones in other writings) highlight the need for including freedom of choice in economic models.[132] These lines of research can be extremely helpful for an economic analysis of the non-welfarist dimension of paternalism. Here I only briefly and superficially characterize this "freedom of choice" literature.

Originating from Amartya Sen's seminal article on the impossibility of a Paretian liberal,[133] there is now an emerging branch of literature in social choice theory which searches methods and modeling techniques for the incorporation of the dimension of freedom of choice into formal economic (social choice) models. The intuition behind this line of research is that the extent of opportunities, i.e. the number and diversity of alternatives open to an individual might be valuable in and of itself. The freedom to choose among alternatives might have some value independent of the intrinsic value of these alternatives.

[131] "It asserts a degree of dominance of freedom of choice that society does not generally try to implement." Burrows 1998: 542.
[132] See, e.g. Sugden 1998, Van Hees 2002, Sen 2002.
[133] Sen 1970.

This idea is hardly new in political and moral philosophy. Still the philosophical literature on autonomy, liberty or paternalism usually lacks the conceptual rigor, or the degree of formalization, that would make such arguments directly amenable to economic analysis. Conversely, economists find it difficult to incorporate relevant and important philosophical ideas into their analysis while ever they cannot translate them to their own formalized language. Hence the relevance of the economic analysis of freedom of choice, and the use of social choice theory to formalize, measure and evaluate freedom of choice.[134] Authors active in the freedom of choice literature, besides searching for formal methods to measure the extent of freedom, usually argue for the importance and normative superiority of a non-welfarist metric of well-being.

In regards to paternalism however, this line of research has no clear and direct policy implications. Whatever normative position one holds, the insights of the economics of freedom of choice are crucial in analyzing the autonomy-related dimension of paternalism in a conceptually clear and rigorous way.

2.3.2. The need for empirical foundations

From the discussion in the preceding sections it has become clear that the mainstream economic approach has to face two problems. First, it remains controversial from a normative point of view whether the function of law can be reduced to the maximization of individual preferences. Second, there remains a methodological difficulty: the growing amount of evidence on biases and other irrational behavior calling the scientific fruitfulness of *ad hoc* modeling of bounded rationality into question. To put it differently: in cases where people systematically make suboptimal choices, paternalistic intervention may be justified. To determine the appropriate scope and technique of intervention, systematic empirical research on bounded rationality is necessary. However, the justification of interventions cannot be based simply on revealed individual preferences as the ultimate normative benchmark, because the concept of preference has also become questionable.

As Robert Sugden has argued with regard to political philosophy on the one hand and economics on the other, albeit in a slightly different context:

[134] Cf. Van Hees, 2004, Sugden 1998.

"Neither approach is grounded in empirical hypotheses about human psychology or human nature. Political philosophy is concerned with good reasons: the question of how, as a matter of psychological fact, good reasons motivate people to act is left unanswered. But …economic theory … does not concern itself with the psychology of motivation either. It simply asserts the a priori postulate that, for each individual, there is a well-defined set of self-interested preferences, on which that individual invariably acts. When pressed, economists usually defend this assumption on the grounds that it corresponds with the requirements of rational behavior. In other words, they appeal to a notion of good (prudential) reasons and do not concern themselves with the question of how such reasons motivate. […] However, an empirical social science has to rest on empirical foundations.

Consider the fact that many people choose to consume substances such as alcohol and heroin in amounts that endanger their health, social lives, and careers. Is this self-interest? From a conventional economic perspective it is: the consumers have preferences for these substances, and they are willing to pay to have those preferences satisfied. This is all that economics ever expects of self-interested consumption. Psychologically speaking, the consumers are motivated by desires for the sensations that are triggered by the substances they consume. Biologically speaking, those sensations are by-products of a neural system that is well adapted to the world in which homo sapiens evolved, but they are dysfunctional (that is, they do not serve the "purpose" of survival and reproduction) in a world in which manufactured drugs are readily available." [135]

I consider Sugden's critique regarding philosophy and economics mainly justified. Empirical research is crucial in order to answer questions about the best possible way to design legal rules, be they paternalistic or otherwise, and in the discussion of the reasons for paternalism.

2.4. Psychology alias behavioral law and economics

Whether legal policy needs empirical foundations is not a real question.[136] The main question is, instead: what will, and should, these foundations look like? In recent decades there has been a large volume of ongoing empirical research in this direction, both by psychologists and economists.[137] It has been shown in thorough and extensive empirical studies that human behavior systematically deviates from the precepts of expected utility theory and rational choice theory in general.

[135] Sugden 2004: 210.
[136] On empirical research in contract law scholarship see Korobkin 2002.
[137] For overview with further references see Sunstein 2000, Englerth 2004, Camerer et al. 2004, Korobkin – Ulen 2000.

2.4.1. Empirical findings

Human decision-making, choice and judgment reaching behavior are often characterized by loss aversion, the endowment effect and framing effects. Furthermore, people commit judgment errors when assessing probabilities. By using mental shortcuts called heuristics (availability, representativeness etc.) their judgments might become biased and vulnerable to manipulation – self-serving bias, hindsight bias, over-optimism, unstable risk-assessment being the most well-known examples.[138]

For instance, several hundreds of studies raised fundamental doubts about the assumptions regarding preferences in economic theory. The framing effect shows that in many situations the concept of preference itself is indeterminate. In a descriptive psychological sense, the assumption that preferences are autonomous and stable is false. Several other features and mechanisms of human judgment and choice have been also described which contradict the assumptions in neoclassical economics (rational choice theory). Cognitive limits and emotional biases are ubiquitous. These should be, and have been, theoretically explained and modeled within neuro-sciences and cognitive psychology. It is important to note that in terms of these sciences, the issue is not one of biases and anomalies but the understanding of the very way human minds work.

The question to be raised it: how should law and economics (being interested in how *law* works) react to these insights? Is it possible to build a competing (and possibly superior) version of legal theory based on the analysis of these psychological phenomena? There are many obvious difficulties impeding such an endeavor. The main criticisms against behavioral law and economics (and the counter-arguments) can be summarized in the following extremely simplified way.[139]

(1) *The phenomena described in this line of research are not real. The empirical results do not have internal validity.*

True, these mechanisms are context-dependent. Controversy in the literature remains about the magnitude and subsequent significance of these effects. Still, some of the effects have been studied in several hundreds of experiments and their significant presence has been confirmed in a wide range of contexts. The internal validity of the empirical research seems warranted.

[138] For details see references in note 138, above.
[139] The following is loosely based on Rachlinski 2006.

(2) The phenomena analyzed and the results presented in the empirical studies are not relevant to the real world. This line of research has no external validity.

With regard to the external validity of the empirical facts uncovered by behavioral decision theory, it has been empirically confirmed that people (consumers, managers, judges, etc.) "fall prey" to certain choice and judgment anomalies systematically and repeatedly. This happens not only in one-shot laboratory experiments but in real-world situations and despite the possibility of learning effects.

(3) The phenomena disappear when sufficient monetary incentives are provided. When stakes are high, people do calculate and choose as rational choice theory would predict.

To be sure, the responsiveness of biases to monetary incentives varies. In some cases, this incentive effect is observable. However, it is unclear through which psychological mechanism it is driven and how predictably it happens. Furthermore, "small-stake" situations may be also economically or socially relevant.

(4) There are private institutions that cope with biases.

This is, in fact the case. However, it is not an argument against a theory explaining how this debiasing works and when it is expected to be used. Rather it provides a reason why legal paternalism should be designed so as to take into account this institutional context and avoid crowding-out.[140]

(5) The errors compensate, even cancel out each other, thus on the macro (market) level their effect cannot be observed.

This might be the case for random errors in many cases. But the distribution of biases is typically not random – they do indeed follow some well-defined patterns. It is enough to refer to the literature in "behavioral finance" in this respect.[141]

(6) Finally, the last argument claims that there is no coherent theory to encompass all the empirical observations on human judgment and choice behavior.

[140] On private debiasing mechanisms and mandatory advice see section 4.3.3, below.
[141] See Thaler 2005.

In fact, behavioral law and economics does not rest on a single theory or definition of bounded rationality that would allow the observations on human behavior to be axiomatized. Despite prospect theory having been suggested by Kahneman and Tversky as the alternative to expected utility theory[142] (and still other candidates arising in the literature[143]), in this matter the research has remained inductive to a considerable extent. There are specific behavioral regularities which are highly relevant and can be modeled at a lower or middle level of abstraction. Nevertheless, the fact that behavioral law and economics cannot fully explain every main feature of human decision making and judgment in terms of a single general theory,[144] should not be seen as a failure or "a problem to be solved". It is rather the general condition of scientific research, its reason being in the nature of empirical knowledge.

In conclusion, the objections against behavioral law and economics are either false or not decisive in dismissing it as a line of research. Still, one further concern with psychological research should be mentioned.

As noted above with regard to the economic approach to human preferences (section 2.3.1.), the benchmark of what counts as an error is uncertain. The uncertainty of the benchmark raises problems when a theory of human decision-making is used in a normative context. It is especially relevant for the development of legal policy and the justification of paternalistic interventions. The problem is that it is not always easy to tell what is given and part of the autonomous (rational) self and what is potentially subject to paternalistic correction. It is not evident which features belong to the abstract person to be protected and what counts for an anomaly or judgment error that needs or justifies a cure.

For instance, it is not self-evident how to define (and measure) the value that an individual attaches to a certain entitlement. Due to the endowment effect there is often a considerable gap between an individual's willingness-to-accept and their willingness-to-

[142] On the genesis of Kahneman and Tversky's theory see Heukelom 2005.
[143] See, e.g. Gigerenzer 2002.
[144] Cf. Roundtable 2005, Parisi – Smith 2005.

pay. It is not self-evident, which of these sums should be accepted as the "real" valuation of the object, right etc. in question.[145]

Another example is the normative status of attitudes toward risk. In some contexts they are taken as given, in others as a policy variable. It is again not clear whether extreme risk aversion is to be corrected for, or an individual's risk attitude is just a *datum* which can not be the object of regulation, manipulation etc. as it belongs to the autonomous preference structure of the person making the decision. Experimental results show that risk attitudes are context-dependent, differ for gains and losses, and depend also on the quantum of value at stake and a number of other factors. Thus the cognitive background of risk perception is too complex to allow for an easy conclusion.[146] Still this is not a matter of empirical data only. One needs to make conceptual decisions and normative choices in defining "the self", "identity" and the like. In this respect, psychology and economics, as well as law, should rely on philosophy or at least be aware of the philosophical issues at stake.

2.4.2. Policy implications

As to the policy implications of psychological research, it is clear that empirical findings alone cannot justify legal intervention. True, in some cases it can be shown in an economic model that limiting the freedom of choice of boundedly rational individuals may increase, on average, their welfare. This is so even if the regulator does not know what is best for each person individually but only knows the distribution function of their cognitive errors.[147] In general, however, the welfare implications (and consequently, the normative conclusions) are not straightforward.

Psychological insights suggest that the justifiability of paternalism is an "uncertain case" – outright anti-paternalism should not be replaced by uncritical paternalism.[148] In short, there are strong arguments both for and against paternalism. The behavioral findings may lead, in certain circumstances, to normative conclusions (policy recommendations) that are significantly different from those arising from the

[145] Cf. Jolls – Sunstein 2006: pt.2.2.
[146] See e.g. Noll – Krier 2000.
[147] Saint-Paul 2004.
[148] Rachlinski 2003, Blumenthal 2007.

traditional anti-paternalism of mainstream economics. The consequences for normative analysis, however, are not simply the uncritical endorsement of paternalism. Some researchers speak about anti-anti-paternalism in this respect.[149]

The *prima facie* arguments for paternalism seem obvious: when law can promote the interests of humans by reducing their biases, increasing their autonomy, it should. But why should the law *not* always intervene despite systematic irrationality? The pragmatic antipaternalist arguments (section 2.2.6.) can of course be invoked. Interestingly, there are also specific psychological arguments which can complement traditional skepticism toward governmental regulation. The psychological arguments for not intervening in people's choice are numerous.

First, they refer to the fact that biases are highly context-dependent. We simply do not know enough about the biases to suggest a general remedy.

Second, what are called "biases" in the light (or shadow) of rational choice theory are in fact (in terms of psychology) components embedded in a complex decision-making mechanism. In this complex cognitive and emotional system, there are several interactions between these mechanisms. It is possible that one bias may temper another. When such interactions are neglected, debiasing might make the overall result worse than the initial situation.

Third, learning effects can be at work. In a dynamic perspective, regulation may lead to the inhibition of learning and negatively affect rational and autonomous choice in the future. This provides a dynamic or developmental argument against paternalism. "If adults are treated as children, they will in time come to be like children. Deprived of the right to choose for themselves, they will soon lose the power of rational judgment and decision. Even children, after a certain point, had better not be 'treated as children,' else they will never acquire the outlook and capability of responsive adults."[150]

This dynamic effect, already stressed by J. S. Mill, has been now convincingly demonstrated in empirical terms.[151] In my view, it provides a reason why the law should deliberately deviate from a "psychologically adequate" view of man. Arguably, if rational autonomous choice is accepted as a normative ideal, especially for contracts,

[149] See note 1.
[150] Feinberg 1986: 24.
[151] See Klick–Mitchell 2006.

then the law should counterfactually slightly "overshoot" with its assumptions concerning both of them. This should be done in order not to simply map and thus stabilize biases but to leave space for learning and development.[152]

Fourth, since biases are so varied and complex it is often the case that individuals themselves are in the best position to cope with their own irrational tendencies and deficiencies. In fact, this is what happens when people hire experts, use self-binding techniques etc. Law should encourage, or at least not crowd out these mechanisms.

2.4.3. New regulative ideas

In arguing for protective rules, legal commentators often refer to empirical data about the vulnerability of consumers to biases and manipulation. The psychological, pragmatic, economic and philosophical arguments, and counter-arguments, discussed in the previous sections should make supporters of legal paternalism cautious. An uncritical, across-the-board support of paternalism is unwarranted. Recently, a number of more or less sophisticated approaches have been suggested by law and economics scholars which take into account both the behavioral insights and some of the counter-arguments. I briefly recall here three regulatory ideas: asymmetric paternalism, libertarian paternalism, and debiasing through law.

"Asymmetric paternalism"

"A policy is asymmetrically paternalistic if it creates large benefits for those people who are boundedly rational while imposing little or no harm on those who are fully rational."[153] More concretely, it is argued that legal interference with private choices is justified (in a firm/consumers setting) if:

$$(p * B) – [(1-p) * C] – I + d\prod > 0,$$

where *B* denotes the net benefits to boundedly rational agents, *C* is the net costs to rational agents, *I* stands for the implementation costs, $d\prod$ denotes the change in firms'

[152] Eidenmüller 2005.
[153] Camerer et al. 2003: 1219.

profits, and *p* is the fraction of consumers who are boundedly rational (all other consumers are supposed to be fully rational).[154]

The economists and psychologists who argue for 'asymmetric' paternalism on a welfarist basis also compare real-world agents with the fully rational individual as assumed in orthodox economic models. They go on to say that bounded rationality is something which can be justifiably regulated in a similar way to externalities. Here one has, first, to suppose the existence of a true 'inner self', characterized by such desires and beliefs which are normatively undisputed, or accepted as rational. Second, one has to explain the behavior of real world individuals as cases where their inner self falls prey to certain anomalies. As I mentioned above, one of the problems with this approach, is that it is not clear which features of the empirical self should be respected and protected.

Asymmetric paternalism is a purely consequentialist argument. As such, it is open to criticisms for not taking autonomy seriously. Read in a different way, this formula only illustrates the structure of the problem of legal paternalism. It does not serve to measure and quantify these variables, but to highlight who are the beneficiaries, and who are the cost bearers of a paternalistic intervention. These costs and benefits can be more precisely assessed in specific contexts.

"Libertarian paternalism"

While "asymmetric paternalism" suggests policies that protect boundedly rational individuals while not (significantly) burdening others who do not need protection, "libertarian paternalism" draws attention to the different methods and techniques of this protection. More precisely, "libertarian paternalism" suggests policies that respect the autonomy of boundedly rational people to the extent possible, but nevertheless help them to avoid making bad choices.[155] It advocates paternalistic interventions mainly in the form of default rules and "menus." As we will see, contract law is the legal area *par excellence* where even non-mandatory rules can improve the welfare of the parties.

[154] Camerer et al. 2003: 1219.

[155] Thaler – Sunstein 2003, Sunstein – Thaler 2003. Mostly due to the provocative title of their article, there has been some controversy in the literature whether what Thaler and Sunstein suggest is indeed paternalism and whether it is truly libertarian (Klein 2004a, 2004b, Sunstein 2004, Mitchell 2005). For a restatement of their view see Sunstein – Thaler 2006.

"Debiasing through law"

Still another regulatory ideal, suggested by Christine Jolls and Cass Sunstein is more ambitious.[156] Instead of searching for legal rules which are adaptive to judgment and decision errors, it aims to reduce the occurrence of boundedly rational behavior at the first place. In addition, the novelty of this view is to suggest debiasing be achieved by exploiting (or at least relying on) bounded rationality itself. As already mentioned, psychologists have found several instances where biases interact, and more specifically, offset each other. In these cases, an intervention aimed at the reduction of only one of the biases can actually worsen the overall result. Now, the interaction between compensating biases may be deliberately designed and used by policymakers as well. Jolls and Sunstein illustrate, with examples from various legal areas, how legislators can make use of the presence of one psychological mechanism (e.g. the availability heuristic) in order to counteract the self-detrimental effects of another (e.g. over-optimism). One of their examples is consumer safety law.[157] I will discuss it in section 4.3.4.

2.5. Overlapping consensus in a limited domain

The ultimate justificatory question about paternalism belongs to normative (moral or political) philosophy. Some philosophers answer it with an absolutistic certainty and a claim to universal validity, without recurring to the specificities of particular societies or to empirical facts. To be sure, most of them think that these specificities matter; they (only) disagree, why and how.[158]

Looking at the extensive philosophical literature on the topic, it seems difficult to decide between the standpoints without discussing such far-reaching questions as the nature of the good, and the meaning of free will. Still, my aspirations in this thesis are more modest. When we want to see what law and economics has to say about

[156] Jolls – Sunstein 2006.
[157] Jolls – Sunstein 2006: 215.
[158] For instance, Mill (2004 [1859]) approves paternalism over "barbarians" in some cases, and grants the full extent of liberty to "civilized" peoples. In his analysis, Feinberg (1986) disregards situations when a society is in emergency ("garrison under attack").

paternalism in contract law, we are not necessarily concerned with these ultimate questions.

As discussed in this chapter, the justification of paternalism is a complicated case where autonomy and welfare concerns should be balanced. In some sense, the conflict between these two values is at the core of paternalism. The divergent implications of the two basic values eventually force the philosopher to choose. But, if Dan Brock is right, on the level of theories there can be convergence.[159] We are not forced to choose between different theories in discussing the justification of every case of paternalistic intervention.

One way to avoid taking sides in far-reaching metaphysical debates is suggested by John Rawls' ideas about 'public reason' and 'overlapping consensus.'[160] In this spirit, I will use arguments that can be, at a medium level of abstraction, acceptable, or at least reasonable from several comprehensive perspectives. Speaking about legal issues of more practical concern, the idea of searching for an overlapping consensus seems quite attractive and plausible. Even such a prominent figure of the law and economics movement as Richard Posner once argued for this idea as one possible basis for the general acceptance of the minimization of social costs as the objective of tort (accident) law.[161] In the next chapters we shall see whether a similar consensus is possible in the domain of paternalistic contract law rules.

[159] Brock 1988: 565, see text at note 63 above.
[160] See Rawls 1993. To be sure, in Rawls' view overlapping consensus is not simply a compromise reached by softening or mixing irreconcilable views.
[161] R. Posner 1995: 505.

3. Contract theory

3.1. The world of contracts vs. the world of contract law

From a non-doctrinal (economic or sociological) perspective, contract law is only one of the possible mechanisms for enforcing contracts and regulating transactions.[162] Standard law and economics has been sometimes criticized for what is called legal *centralism*, i.e. the neglect of the non-legal mechanisms in enforcing contracts.[163] Legal centralism is the view that law is the only relevant normative rule to be modeled in law and economics. In this view, enacted law is supposed to modify the behavior of the agents as changes in market prices do and law is supposed to be enforced in an anonymous way. Consequently, non-legal mechanisms of cooperation have been often neglected.[164]

In the last few decades this critique has lost much of its force. It did not ever apply to a large body of research, the economics of contracts. Now it does not apply to many economically minded legal scholars either. Nevertheless, there is still an open, and somewhat neglected, question for the economic analysis of contract law: how should the interaction of law and non-legal contract norms be assessed in legal policy.

First, a note of clarification. The economic analysis of *contracts* and the economic analysis of *contract law* are two somewhat different research areas. In regards to contract economics, it comprises three sub-areas: incentive theory, incomplete-contract-theory and transaction-costs theory.[165] From the 1970s, economists have introduced into the analysis of contracts, such now standard concepts as: asymmetric information; moral hazard; adverse selection; incentive compatibility; incomplete contract; principal–agent relationship; asset-specificity; holdup problem; and most prominently, transaction costs.[166]

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[162] "[T]he system of voluntary exchange would not break down completely without a law of contracts." R. Posner 1998: 102.
[163] Posner 2000: 4–6, Ellickson 1998: 541.
[164] "By exaggerating the reach of law, [law and economics scholars have] underrated two other major sources of order: internally enforced norms (socialization) and externally enforced [social] norms." Ellickson 1998: 539. To be sure, in a number of contexts the anonymity of agents and the lack of reputation effects is a realistic assumption. In others, like in village societies and communities it is clearly unconvincing (Andreozzi 2002: 407–8, Platteau 2000: 246).
[165] Brousseau – Glanchant 2002: 8.
[166] For a useful overview see Bolton – Dewatripont 2005.

The economics of contract law is somewhat more specific: it relates mainly to the legal framework in which contractual transactions take place. Even within this narrower scope, this latter research area is not merely a subfield of contract economics. Normatively, one objective of legal scholarship is to design *legal* rules in order to influence the contracting parties in a certain direction or at least to offer the framework in which they may operate. However, in designing and applying contract law, legal scholars and practitioners should be aware that the law interacts with a set of non-legal mechanisms of contract-enforcement as complements and/or substitutes.

Legally enforceable contracts are only one amongst the many mechanisms which serve to facilitate cooperation by making the cooperative commitment of one party credible to the other. "In addition to [legal remedies for breach of contract], the credible commitment problem might be addressed through (1) piece-work contracting, (2) reciprocal altruism, (3) internalized norms, (4) union strategies and (5) non-contractual bonding."[167] The real-world operation of contracts and transactions is embedded within a network of social norms of cooperation.[168] There are interactions between these mechanisms and normative systems; the most important are the following:

(1) Norms inspire law. Contract law can follow, imitate, and copy business norms, and eventually transform them into default rules. For instance, this is the path Karl Llewellyn claimed to have followed during the drafting of the Uniform Commercial Code of the United States.[169] On the other hand, law may also fulfill an expressive role in restating and reinforcing preexisting norms.[170]

(2) Contract law changes the normative context of transactions. Sometimes it deliberately counteracts widely shared norms, e.g. by making discrimination

[167] Buckley 2005a: 43. See also ibid., 43–49 ("Substitutes for contract law"). Following Dixit (2004), Fernando Gomez lists the following "mechanisms to achieve cooperation among humans": biological kin selection, selfish cooperation (assurance game), altruism and fairness, reciprocity, and external enforcement (Gomez 2007: 7–14).

[168] Patrick Atiyah claims that "an agreement is a social or moral or legal construct, and is therefore necessarily already imbued with our social or moral or legal ideals. Contract law is about a broad area of human interaction such as 'cooperative activity', characterized by consent, reciprocity of benefit, and reliance." (Atiyah 1990: 10)

[169] The historical question, whether Llewellyn actually codified business practice is often linked with a normative one. The latter concerns whether codified contract law should rely on business practice or not. On both problems see Bernstein 1996, Scott 2002, Triantis 2002.

[170] See e.g. Cooter 1998. In game-theoretic terms, one of the expressive functions of law is to coordinate expectations around a focal point.

illegal.[171] On the other hand, the legalization, or juridization, of certain transactions may also contribute to the erosion of socially beneficial norms in an unintended way.[172] Relatedly, empirical research suggests that contracts are often deliberately left incomplete because extrinsic, formal control would crowd out intrinsically motivated behavior. This "hidden cost of control" means that the inclusion of control mechanisms in an interaction signals distrust, and thus reduces its benefits.[173]

(3) Social norms make law less relevant to real life. Thus, legislators and judges should be less concerned about the impact of their activity. On the other hand, one can argue that the fact that the law is rarely invoked does not make it irrelevant. As rational actors can predict the outcome of an eventual legal case, they bargain in the shadow of the law, taking into account what they expect the legal consequences of their actions to be.[174] From the viewpoint of these actors, the law is present in the background (in game theoretic terms, it provides a threat point in their bargain and subsequent actions). This mechanism relies on strong assumptions about the information the parties possess about the law. Empirically, a large segment of everyday transactions happen, not in the shadow, but in the ignorance of the law, i.e. without the parties realizing that their transaction has a legal significance or aspect. Contract law is an enabling set of rules consisting mainly of default rules. Its formal apparatus rarely comes into play even through default rules because parties often follow non-legal norms in designing their contracts.

[171] On the role of contract law with respect to discrimination, from an economic perspective see Trebilcock 1993: ch. 9 (p. 188–240).

[172] With regard to contracts, this suggests the following risk. "An exclusive focus on the legal dimensions might induce a design of rules and legal instruments that interfere with non-legal mechanisms promoting desirable cooperative outcomes, with the undesired result that some substantive Contract Law rules may actually end up reducing, rather than increasing, the level of cooperation in economic exchange." Gomez 2007:14.

[173] Falk – Kosfeld 2006. As the authors argue, if a contract specifies control rights for one party, it might increase or decrease the surplus from cooperation. The net result is the sum of positive and negative effects of control. On the positive side are the direct effect of control and the expressive role of the rule. On the negative, there is the crowding out of voluntary compliance. The interpretation of the experimental results is somewhat unclear, concerning the psychological mechanisms that drive the results (gratitude for trust, guilt, and/or the reciprocation of an insult might be at play).

[174] For the classical article see Mnookin – Kornhauser 1979.

For some social scientists and philosophers these cursorily mentioned aspects regarding the everyday world of contracts might be remarkable or even fascinating subjects in their own right. This world of contracts is seen as a normatively saturated area, one of the last fields of "socially embedded subjectivity" in the ocean of objectively standardized behavior in our modern universe. Their research strives to understand this human experience better.[175]

What is the relevance of the world of contracts for an analysis of paternalism in contract law from a policy perspective? For our purposes, this knowledge serves to make law better. The policy question is: what is the impact of contract law, with its often "sticky" default rules, on contracting behavior?[176] What should courts do if parties do not take contract law or standard form contracts as guidance influencing their behavior? Should regulators care at all?

The answer is that as long as relational contracts are governed by non-legal norms, they are, and should be, out of sight of contract law. Provided there are no significant external effects or other market failures, the main purpose of contract law is facilitative. However, the world of informal enforcement mechanisms and relational contracts is not completely lawless. Sometimes, written contracts are concluded because parties take into account the possible end game, i.e. the eventuality that their relationship might collapse and come to litigation. Also, putting certain terms into writing can be beneficial for the parties by reducing misunderstandings in coordination problems during the relationship.

Normative embeddedness is widespread in many areas, even beyond the world of relational, long-term contracts. However the content of these norms is often uncertain. If contract law's task is to determine a reasonable (majoritarian) default rule, it can be difficult, and sometimes similar to flipping coins: it cannot choose the best result. Still, there are situations when mandatory rules are needed to replace these norms. As will be argued below, there is some room for paternalistic intervention as well.

There are two further links between our subject and social norms. In almost every Western legal system, a contract can be voided when a judge finds it violates certain fundamental norms of social morality, even when the transaction does not violate the

[175] See, e.g. Yovel 2000.
[176] On the stickiness of default rules see section 4.1.2. below.

law. This doctrine of immorality reinforces social morality. In the discussion below, whether the doctrine is justifiable, economically or otherwise, concerns us to the extent that it represents an instance of paternalism, as widely understood.[177]

Second, the larger social context of a contract may also matter in deciding whether the transaction has a legally acceptable rationale or not. This consideration has implications for the application of the unconscionability doctrine, as will be discussed below in section 4.4.1.

3.2. Accounting for contract law

In the previous section we have seen that from the varied and normatively plural world of contracts, or cooperative transactions, only a small segment is relevant to contract law. In this section, we go further in analyzing what contract law should do. We can ask the question again: why is contract law needed at all. Or more precisely, why should the law provide for anything beyond freedom of contract?

3.2.1. Will theory: the doctrinal view

Freedom of contract is an ideologically charged notion which attracts strongly-held political beliefs, but which for the most part, eludes the interest of the lawyer in his everyday work. On the other hand, the question of freedom of choice and its limits are of crucial importance in contract law. For instance, the validity of a contract, liability and remedies are often conditional on the (in)voluntariness of the actions of the parties. As Cooter and Ulen have already reminded us, the law has elaborate rules for checking the voluntariness of contractual agreements. Modern Western laws attach a high value to freedom of contract but at the same time have set several limits to it.

Why are economic or moral arguments relevant in the analysis of contract law? Why is it not possible to "find" a contract theory within law, leaving philosophy, economics etc. aside? Historically, there have been several attempts in this direction. This is especially true for the contract doctrines expressed in most European Civil Codes. These codes are inspired by nineteenth century contract theories. The century

[177] The relation of paternalism and moralism has been discussed above in section 2.2.5.

before-last was an era during which legal scholars deliberately worked out their doctrinal constructions, both in civil law and common law countries, as markedly *legal* doctrines, i.e. independently of philosophical theories.[178]

The so-called "classical theory of contract" or "will theory" was based on the fundamental premise that a contract is an expression of the free will of two consenting individuals. Its binding force derives from the mutual assent of the parties, i.e. "the meeting of their minds". The will theory of contracts, dominant in the nineteenth and still influential well into the twentieth century, holds that, as far as contracts are concerned, the ultimate measure of the good is the will of the parties of a legal transaction (*Rechtsgeschäft*). As for freedom of contract and its limits, this theory focuses mainly on the voluntariness of consent. It can account for what could be called the "constitutive" limits of freedom of contract, like mistake, fraud and duress. These limits can be explained in the following way. When a contract is unenforceable for one of these reasons, then either the content of the contract is not considered to derive from the actual free will of the parties (mistake); or some additional premise is introduced, claiming that it is wrong or at least illegal to lie (fraud) viz. to use coercion (duress) in order to influence the free will of the other party.[179]

Despite these efforts, even the most liberal 19th century contract *rules* cannot be accounted for fully under the will *theory*. Any procedural and substantial contract regulation beyond the "constitutive limits" remains theoretically problematic under this view, and has to be explained (away) in an *ad hoc* manner. The classical theory's paradigmatic contract is: (1) a discrete, (2) two-party, (3) commercial, (4) executory (5) exchange. Many contracts which are more, or less, unlike this paradigmatic case, are dealt with under special rules.

[178] On the historical origins and main representatives of the will theory see Gordley 1991, Atiyah 1990. As Gordley argues, Aristotelian and Thomistic philosophical theories were used by the late Scholastics and natural lawyers like Grotius or Pufendorf to give a coherent theoretical structure to contract law (and other areas of private law as well) in the 16th and 17th century. Paradoxically, at the same time, the Aristotelian philosophical background went to disrepute and oblivion. As there has not been any overarching alternative philosophical theory which legal theorists could or would have used to replace it, what remained were the fragmentary and heterogeneous 'legal' doctrines of the last two centuries, most prominently the will theory of contracts. These doctrines still bear the marks of their philosophical origins though.

[179] On these constitutive limits see section 4.2. below.

Although the categories of the classical theory are reflected in the provisions of many civil codes, and deeply rooted in the mindset of doctrinal contract lawyers, this theory was not been long-lived among theoreticians. Today, most agree that the theory is part of a legal epistemology (ideology), the external validity of which is rather dubious. Regardless, as mentioned in the Introduction, this does not imply that will theory is useless.

As Patrick Atiyah once argued, the view that bare promises are (to be) enforced because they are promises is untenable, both descriptively and normatively. However, there are still

"great advantages which ensue from treating bare promises as binding legal obligations, without looking behind them (to see why they are made) or after them (to see whether they have been relied upon). Still there must always remain some circumstances in which we do need to ask why a promise was made or what has been done in consequence of its having been made, before we can sensibly say that it created an obligation. In these circumstances, much weight is going to be placed on these other considerations, and the promise itself may then turn out not to be capable of generating an obligation of its own force."[180]

While I will not discuss Atiyah's ideas about these "other considerations", his line of thought points at fundamental questions in contract theory. Why is there then such an institution as a legally enforceable contract? Why are contracts binding? These and related questions will be discussed in the remaining sections of this chapter.

3.2.2. Freedom of contract and the private ordering paradigm

Behind the law of contracts, a central subject area in private law lies a broad set of economic, social and political values that define the role of markets in modern developed societies. However, markets are not the sole mode of social organization. As Heilbroner argues, societies basically organize production and distribution through three types of institutions: tradition (social conventions and status), command (centralized information gathering and processing and coercion) and market (decentralized decisions).[181] While historically most societies have combined all these organizational modes to some extent, the allocation of resources in a developed Western society is mainly focused on market-type mechanisms.

[180] Atiyah 1990: 4.
[181] Robert Heilbroner *The Making of Economic Society* (1975), cited in Trebilcock 1993: 271. n.2.

At the same time, within a market-based society mechanisms need to be developed to cope with the backdrops of the market economy, relative to the other two modes of social organization. Vagrancies within the market economy include the potential for dramatic shifts in consumption and production, the destabilization of personal, social and communal relationships, and a significant degree of inequality. Intertwined within these backdrops, there are many troubling and controversial normative debates about the extent to which markets and freedom of contract are desirable. Still, in general there is a relatively wide consensus in favor of economic liberalism and the market economy in these societies.

Michael Trebilcock calls this consensus, together with its theoretical underpinnings the *private ordering paradigm*. What are these theoretical underpinnings of freedom of contract? In neoclassical economics the "predilection for private ordering over collective decision-making is based on a simple (perhaps simple-minded) premise: if two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel the exchange is likely to make them better off, otherwise they would not have entered into it."[182] To rebut this presumption, the economist must refer to either contracting failures or market failures. As we will see, these constitute, from an economic perspective, the reasons for limiting freedom of contract. Or, as Milton Friedman has put it: "The possibility of coordination through voluntary cooperation rests on the elementary – yet frequently denied – proposition that both parties to an economic transaction benefit from it, provided the transaction is bilaterally voluntary and informed."[183]

Besides the consequentialist arguments used in economics, there are also non-economic justifications for the primacy of private ordering and the rejection of paternalism, which are based on individual autonomy or negative liberty as a paramount social value. Autonomy theories see the law of contracts as a guarantee of individual autonomy. These theories are content-independent. If, for instance, one accepts a radically autonomy-based (content-independent) conception of contract, exploitation can only be *procedurally* unjust or *procedurally* unfair.

[182] Trebilcock 1993: 7.
[183] Friedman 1962: 13.

Other stances in political philosophy are more ambivalent towards freedom of contract. Theories based on the positive, or affirmative, concept of liberty are concerned with the fairness of distribution of welfare, and equality, in society. Communitarian theories, on the other hand, emphasize the essentially social nature of the individual.

These four theories about freedom of contract partly cohere and converge, but also partly contradict each other. If we explore the congruencies and conflicts between current moral and political philosophies and their normative implications regarding the fine details of the law of contracts and in addition, contrast them with common moral intuitions and legal rules in force, we will probably come to the following conclusion. Neither autonomy-based theories nor different sorts of utilitarianism, nor communitarianism alone can offer a coherent theory about freedom of contract.

Nevertheless, there is a large area where what Trebilcock calls the "convergence thesis" applies. This thesis says that market ordering and freedom of contract simultaneously promote individual autonomy and social welfare. To the extent that the convergence thesis is true, one does not have to choose between autonomy and welfare theories. When different modes of analysis converge on the same conclusion, our confidence in that conclusion increases.[184]

The question then becomes whether there is a reasonably large range of overlapping consensus between different theories. That freedom of contract is valuable seems to be within this consensus.[185] As for contract theory in general, commentators have pointed towards numerous exceptions to the convergence thesis.[186] For our present purposes, it is important to recognize that the convergence thesis is not sufficiently robust; "the convergence between autonomy and welfare values is much more tenuous than proponents of the private ordering paradigm have conventionally been prepared to acknowledge."[187]

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[184] "In this way, depending on how the term is used, either competing modes of analysis are not truly "redundant", or redundant modes of analysis are valuable." Barnett 1992: 94. See also Barnett 1989.

[185] Barnett (1992: 93–94) joins the private ordering paradigm by providing a functional analysis of freedom of contract, in part based on Hayekian arguments about markets as decentralized systems for aggregating knowledge.

[186] See Trebilcock 1993, *passim*, esp. 241–248, Hadfield 1995, Trebilcock 1995: 369–373.

[187] Trebilcock 1993: 242. From this, Trebilcock mainly draws the conclusion that autonomy and welfare should be treated as separate values and pursued simultaneously, in an institutional division of labor, rather than chosen between.

To be able to construct a normative contract theory and deduce arguments from it, for or against certain limits of freedom of contract, the complex relationship "between autonomy values and welfare (end-state) values (efficiency, utility, equality, community)" should be cleared.[188] This project seems rather ambitious. In view of so many competing contract theories,[189] one tends to agree with the skeptical position: "There is no such thing as a correct theory of contract."[190] Be that as it may, the ultimate victory between rival philosophical theories of contract will not be decided upon in this thesis. This does not mean I am fully agnostic. Theoretical pluralism, i.e. the plurality of theories does not imply the end of reasoned arguments. One possibility to go further is to search for meta-theoretical ways to make theories compatible and/or delineate their competencies.[191] In the next section I discuss some of these attempts.

3.2.3. Autonomy *and* welfare: towards a unified contract theory?

In the English-speaking literature, there has been suggested at least four different ways to integrate different contract theories within a single meta-theoretical framework.

Buckley

In an insightful book on contract theory, F.H. Buckley argues that a theory of contract must fulfill three tasks: account for the institution of promising; justify why this institution is desirable; and explain the majority of contract law rules. Different contract theories give different answers. Buckley also claims that among rival contract theories only law and economics is able to meet this triple challenge.[192] Looking at the answers he provides to the three questions, however, in final analysis his is not a pure economic

[188] Trebilcock 1993: 21.
[189] For overviews see e.g. Benson 1996, Hillman 1997, Benson 2001, Kraus 2002c.
[190] Patterson 1991: 1436. To be sure, Patterson's claim is not merely based on the pedestrian argument about the plurality of theories; his is rather a philosophical one, related to his skepticism about "what philosophy can provide by way of justification of our legal practices." Instead of asking for a correct theory of contract, he claims, "it is better to think of contract law not as a thing but more akin to an ongoing, self-transforming cultural activity." Patterson 1991: 1432; 1436.
[191] Trebilcock (1993: 248) argues for an "institutional division of labor" but acknowledges the possibility of a meta-theory.
[192] "To persuade, a theory of contracts must do three things: it must recognize that promising is an institution; it must account for the promisor's fidelity duties; and it must explain the basic rules of contract law. Only one theory meets this challenge, the consequentialist explanation of contract law provided by law-and-economics." Buckley 2005a: 22.

theory: he constructs a hybrid theory. Whether he does this unknowingly or simply without acknowledging it should not concern us here. What matters is that his arguments go beyond standard law and economics.

Buckley argues that one can justify the institution of legally enforceable contracts with the desirable consequences it produces in terms of welfare and preference-satisfaction. This makes the institution of promise-enforcement not only instrumentally beneficial, but also just. Carrying his thoughts further consequently, Buckley proceeds to ask the moral question: why one should be obliged to support such a "just" institution, or in other words, to play according to its rules. In his solution, he then relies on the "natural duty to support just institutions".[193]

Whether such a natural duty exists or not, in my view, Buckley's claim locates him outside the law and economics camp, at least as far as the justification for the binding force of contracts is concerned. Although he explicitly distinguishes his theory from the natural law tradition, the ultimate foundation of this natural duty is based on neither consequentialist, nor consensual arguments; in fact, it is supposed to be natural. The less speculative, or dare I say more mundane, part of his theory is based on the empirical claim that contract-enforcement contributes significantly to economic welfare. In connection with this claim there is considerable scope in his theory for the incorporation of typical questions in the economic analysis of contract law. One of these questions, central also for Buckley, is: how to design contract law rules in order to contribute most to welfare.

Gordley

We come to a somewhat similar conclusion with respect to another non-economic theory of contract. Based on a methodologically self-reflective (Neo-)Aristotelian approach, James Gordley argues that as a mechanism for allocating resources contracts are valuable "to the extent people exercise the virtues of prudence and distributive justice."[194] Contract law contributes to achieving the ultimate end of human beings (a

[193] Buckley 2005a: 58.

[194] Gordley 2001: 268, 333. See also Gordley 2007: 1735: "For some modern thinkers, the choices a person makes matter because he will choose what he most prefers. The satisfaction of his preferences is deemed to be desirable, whatever they may be. Other modern thinkers believe that choices matter because

happy and meaningful life) if, and when, it is so designed, that people can spend their money to acquire the resources they should, and each person has the purchasing power he should have to acquire resources. The point or *telos* of 'contract law' as a human institution is to help people to achieve what is good for them. There is a presumption that what they choose is actually good for them, and that this is true in most cases.[195]

While on the foundational level Gordley clearly distinguishes Aristotelian theory from both autonomy-based and welfare-based contract theories, on the practical level he leaves some scope for both autonomy, and welfare as subordinate values.[196]

One way, though perhaps not a literally Aristotelian one, towards integrating these theories could be the following reasoning. Ultimately what constitutes a good life is an objective matter and society should promote it. On the second level, autonomy is an important component of the good life, both intrinsically and instrumentally. Given human nature and the characteristics of representative democracy as they are, pragmatic considerations set limits on the direct pursuit of some values constituting the good. Under these circumstances, on the third level, private ordering is the best means of resource allocation to promote these instrumental and intrinsic goods. The proper functioning of markets requires rules that make market transactions (contracts) efficient.[197]

Craswell

Richard Craswell is one of the few law and economics scholars who take non-economic contract theories seriously. He argues that while these theories are concerned with the

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they are the expression of individual freedom which no one has the right to override. In contrast, in the Aristotelian tradition, choices matter because of the contribution they make to a good life, a life that realizes, so far as possible, one's potential as a human being. Leading such a life constitutes human happiness. It is the end which all actions should serve either instrumentally or as constituent parts of such a life. Living such a life is the ultimate end of an individual. Enabling its citizens to live such a life is the end of government."

[195] When this is not the case, then there is some legitimate space for paternalism. On the Aristotelian view of paternalism see section 2.2.2. above.

[196] Gordley 2001: 272–280. There are a lot of incompatibilities between an Aristotelian theory and the law and economics approach. But when Gordley identifies the economic approach with a theory of preference-satisfaction, this is a somewhat narrow view. Economic theory itself is not logically committed to any particular conception of welfare; welfare could mean what Aristotelians mean by it. As we have seen in section 2.5., with respect to paternalism the convergence is surprisingly close.

[197] This is a purely hypothetical argument. In my view, any perfectionist theory has to face serious objections, especially when translated into legal policy.

philosophical justification of the morally binding force of contracts (promises), they have "little or no relevance to those parts of contract law that govern the proper remedies for breach, the conditions under which the promisor is excused from her duty to perform, or the additional obligations (such as implied warranties) imputed to the promisor as an implicit part of her promise."[198] In short, he claims that pure autonomy-based theories are under-determined as to how contract law's background rules should look like.[199] This leaves room, on the level of background rules for the incorporation of welfare-based theories.

A full-fledged contract theory should answer two questions. First, it should tell us what the basis of enforcing contracts is. Second, it also has implications as to what contract law should look like, in other words, how contracts should be interpreted, supplemented and regulated. I am uncertain what Craswell would think about the possibility of a hybrid theory, but at least his views leave this possibility open.

Kraus

A sophisticated way of integrating insights of different contract theories has been suggested by Jody Kraus in a number of his writings.[200] More specifically, his purpose has been to combine autonomy-based and welfare-based theories "to produce an overall theory that takes advantage of the strengths and avoids the weaknesses of each kind of theory."[201] As the two theories have very different methodological commitments and answer different questions, one is not superior to the other, and neither is to be preferred to the other. The "apparently first-order conflicts between autonomy and economic contract theories in fact are implicit, second-order conflicts over legal methodology."[202] If the conflict is so fundamental, this has some important consequences. "Since their conceptions of what contract law is (express doctrinal statements versus outcomes), what contract theories should do (explain versus justify contract law, explain versus explain away the distinctness of contract law), and the object of adjudication (retrospective dispute resolution versus prospective regulation) are so different, these

[198] Craswell 1989: 489.
[199] Craswell 1989: 516. For a restatement of the argument see Craswell 2006.
[200] Kraus 2001, 2002a, 2002b, 2002c, 2006.
[201] Kraus 2002c: 689.
[202] Kraus 2002c: 689.

theories cannot be meaningfully compared."[203] In this situation, one way is to continue the debate at the level of these methodological commitments.

Alternatively, in light of these methodological differences, one can attempt to "vertically integrate"[204] autonomy and welfare theories, by delineating their competencies. The vertical integration strategy deals with the conflict between consequentialist and rights-based theories by combining them as logically distinct components of a unified theory. Such united theories can take different forms. Still in my view this strategy promises the best hope for arriving at a coherent theory of contract, both in a normative and an explanatory sense.[205]

3.3. The economics of contract law

What is the role of contract law from an economic perspective?[206] Richard Posner distinguishes "five economic functions: (1) to prevent opportunism, (2) to interpolate efficient terms, (3) to prevent avoidable mistakes in the contracting process, (4) to allocate risk to the superior risk bearer, and (5) to reduce the costs of resolving contract disputes."[207] Briefly, it either enables or regulates contracts.

3.3.1. Enabling and regulation

In its enabling function, contract law should facilitate the voluntary (and well-informed) exchange of well-defined property rights. From a regulatory perspective, contract law addresses contracting failures and market failures. This includes four main tasks. First, contract law is a "check on opportunism in non-simultaneous exchanges by ensuring that the first mover, in terms of performance, does not run the risk of defection, rather than co-operation, by the second mover."[208] Second, it reduces transaction costs. Third, as a part of this, it provides a set of default rules which apply when the terms of a

[203] Kraus 2006: 13.
[204] Kraus 2001.
[205] For two further integration strategies see Farber 2000, Oman 2005. For critiques: Gargarella 2002, Morris 2002.
[206] The economic literature on contract law is extensive. For two recent overviews of the standard law and economics view of contract law see Shavell 2004: pt. 3, Hermalin – Katz – Craswell 2006.
[207] R. Posner 1998: 108.
[208] Trebilcock 1993: 16.

contract are incomplete. Fourth, it distinguishes welfare-enhancing and welfare-reducing exchanges. Amongst these four tasks of contract law, it is mainly the last one that can be linked to paternalism.

Interest in contract regulation has been reinvigorated by the debates regarding the harmonization/unification of contract law in the European Union.[209] Law and economics has traditionally conceived contract law as a set of facilitative or enabling rules which are necessary for the working of markets and transactional planning. It is a relatively recent insight that contract law is also a part of the economic regulation 'toolkit'.[210] In a general sense, any system of rules which fulfills the functions of standard-setting, monitoring and enforcement towards its subjects can be called regulation.[211] To be sure, traditional distinctions between contract law and administrative regulation remain; these can be seen as alternative regulatory techniques with different institutional competencies. The former is private, decentralized, and operates *ex post*, the latter is public, centralized, and operates *ex ante*.[212]

3.3.2. Regulation: ex ante and ex post

Paternalism towards contracting parties can be observed in two different forms. First, it may be found in regulation by legislative or administrative rules, formulated in general terms and applicable to every individual case uniformly (*ex ante* paternalism). Although these rules restrict the power of individuals to conclude enforceable contracts, they often lie either structurally or doctrinally, outside the body of traditional contract law, e.g. in labor law or administrative law.

Second, on the other hand, there are several "genuine" contract law doctrines which can be interpreted paternalistically. These are usually formulated as vague standards, leaving the judiciary a relatively wide discretionary scope. For instance, it is for the judge to determine in individual cases whether a certain contract (provision) is

[209] Cf. Kerber – Grundmann 2006 and the references cited there.
[210] For different economic perspectives on contract regulation see Werin – Wijkander 1992, Collins 1999, Schwartz – Scott 2003, Rubin 2005.
[211] Collins 1999: 7–8, Cafaggi – Golywoda 2007.
[212] Ogus 1994. On the choice between contracts and public regulation see section 4.6.1. below.

"unconscionable", "immoral" or "grossly unfair". These are typical examples of *ex post* paternalism.[213]

As mentioned above (section 2.2.4.), here we face the usual trade-off implied by standards. If the question of the legality or enforceability of a contract term is left to *ex post* case-by-case determination, then the over- and under-inclusiveness of a general rule is avoided at the price of more *ex post* regulation by judges.

For judges solving contract disputes, their policing role in regards to labor, consumer and other standard-form contracts has become increasingly apparent since the late 19th and early 20th century,. Since then, there have been several types of cases where modern legal regimes have set limits upon the general principle of freedom of contract. Many contract law rules do not aim at enforcing the parties' intentions, be they actual or hypothetical. Illegality, public policy and numerous other doctrines, mandatory rules of labor law, tenancy and consumer protection set such limits, for the right or wrong reasons. These doctrines are argued for in the literature in a number of different ways: third-party effects (externalities), redistribution, fairness, moralism, and paternalism are amongst the reasons.

3.3.3. Regulatory doctrines of contract law

Following Cooter and Ulen,[214] in this section I give an overview of some regulatory doctrines of contract law. The main purpose here is to identify the links between the reasons for setting limits to contractual freedom, and the typical rules that serve these reasons.

Legal doctrine	**Fact triggering legal doctrine (problem)**	**Incentive (solution)**	**Legal solution**
Incompetence	Incompetent person makes promise	Protect incompetents at least cost	Interpret contract in incompetent's best interest / No enforcement
Duress	Promisee threatens to destroy	Deter threats	No enforcement of coerced promises
Necessity	Promisee threatens not to rescue	Reward rescue	Beneficiary pays cost of rescue plus reward
Impossibility	Contingency prevents performance	Encourage precaution and risk-spreading	Liability for the least-cost risk-bearer
Frustration of purpose	Contingency destroys purpose of performance	Encourage precaution and risk-spreading	Liability for the least-cost risk-bearer
Mutual mistake	Buyer and seller make same	Encourage precaution and risk-	Liability for the least-cost risk-bearer

[213] For this distinction see Klick – Mitchell 2006.
[214] Cooter – Ulen 2004: 294 (Table 7.5).

about facts	mistake about facts	spreading	
Mutual mistake about identity	Buyer and seller have different object in mind	Prevent involuntary exchange	Unwind contract
Unilateral mistake	Buyer or seller mistaken about facts	Unite knowledge and control; encourage discovery	Enforce contract
Duty to disclose	Promisee harms by withholding information	Induce supply of true information	Liability for harm
Fraud	Promisee supplies false information knowingly	Deter supply of false information	No enforcement of contract and liability for harm
Adhesion contracts	Cartel uses standard forms to promote collusion	Destabilize cartels	Deny enforcement to contracts of cartels
Procedural unconscionability	Consumer ignorant of critical terms in retailer's contract	Create incentive to communicate meaning of contract terms	Deny enforcement unless bargaining process communicates crucial information

Although based on American law, the information in this table can also be generalized to other legal systems. The economic reasons for intervention are essentially twofold: contracting failures and market failures. Contracting failures or problems with individual rationality are either cases of bounded rationality which is addressed by the doctrine of incapacity or of constrained choice which is addressed as coercion, duress, necessity, or impossibility. Market failures can be explained by three types of transaction costs and addressed in contract law accordingly. First, they can be externalities which lead to the unenforceability of contracts which derogate public policy or violate a statutory duty. Second, failures deriving from imperfect information are addressed as fraud, failure to disclose, frustration of purpose, or mutual mistake. A third type is structural or situational monopoly which leads to the lack of competition, which is addressed by doctrines such as necessity, unconscionability, and lesion.[215]

How is this categorization relevant for our topic? Paternalism relates primarily to contracting failures. One can speak of paternalistic intervention mainly: (1) in the case of systematic cognitive failures or insufficient cognitive capacities; (2) when there is insufficient or asymmetric information; and (3) when there are insufficient outside opportunities, due to the circumstances of necessity or, situational or structural, monopoly. In the next chapter, I will discuss in greater detail whether, and to what extent, these problems are addressed appropriately in doctrines and rules of contemporary contract law.

[215] Based on Cooter – Ulen 2004: 267 (Table 7.3).

4. Paternalistic Doctrines in Contract law

4.1. Mandatory and default rules

4.1.1. The "default rule paradigm"

Freedom of contract implies that contract law is principally non-mandatory in nature. Parties are free to determine their mutual rights and obligations; the provisions of contract law only apply when explicitly referred to, or when there is a gap to be filled. Mandatory rules are the exception, if not in a quantitative, at least in a qualitative or structural sense.

We can see this in many legal systems. For example, in American law the Uniform Contract Code provides: "The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable."[216] Art. 19 (1) of the *Schweizerisches Obligationenrecht* (OR, Swiss Code of Obligations) provides that "within the limits of the law the contract may have such a content as the parties choose".[217]

In Western tribunals, a case for breach of contract is typically handled in the following manner. "The court must (1) determine whether contract formalities are satisfied; (2) if so, determine whether there was real consent (no fraud, duress, mistake), (3) if so, determine what the contract says; (4) if there is a gap (that is if the contract does not address the contingency that caused the dispute), apply a default rule; and (5) if an explicit or implied term was violated, award a remedy."[218]

Although analytically different, step 3 (contract interpretation) and step 4 (gap-filling) are closely linked in practice. In fact, in many cases it is not self-evident what a contractual gap means: it is often a matter of judicial interpretation whether the dispute

[216] UCC § 1-102 Sec. 3.
[217] Cf. Zweigert – Kötz 1998: 324–325.
[218] Posner 2006: 565.

is about interpreting a contract clause or supplementing a term in an incomplete contract.[219] When filling gaps in a contract, judges sometimes refer to "implied terms". Gap-filling can happen either by the implication of terms by law (statutory default rules), or by constructive interpretation (using general clauses and other legal principles). In Germany, Switzerland and Austria the judge supplements the contract by constructive interpretation. It is being said: "where the parties have omitted to say something the judge must discover and take into account what, in the light of the whole purpose of the contract, they would have said if they had regulated the point in question, acting pursuant to the requirements of good faith and sound business practice."[220] French courts decide in essentially the same way but they invoke the rule that the gap has been filled by the common intent of the parties.[221]

Some commentators even deny the usefulness of a theoretical distinction between contract interpretation and supplementation, i.e. gap-filling through default rules.[222] The two are closely linked to each other: not only is the conceptual limit between them blurred, but the reasons for choosing different rules to solve these problems follow essentially the same principles.

There are several reasons why a contract might be unclear or incomplete.[223] These different kinds of incompleteness justify different legal responses, and possibly argue for different methods of interpretation and supplementation. Contractual incompleteness may be unintended or strategic. Largely corresponding to this distinction,[224] gap-filling rules can be either majoritarian (market-mimicking) or information-forcing (penalty) defaults. Furthermore, "the approaches used to interpret contracts have much in common with the approaches used to select default rules. In many cases, for example,

[219] Zweigert – Kötz 1998: 407–408.
[220] *BGHZ* 16, 71, cited in Kötz – Flessner 1997: ch. 7. and Zweigert – Kötz 1998: 405.
[221] Kötz – Flessner 1997: ch. 7.
[222] While Americans typically refer to default rules, the French term is *règles suppletives*, Germans have *dispositives Recht*, and English lawyers refer to implied terms. Also, the English often speak about construction instead of interpretation. "English law has three principal techniques for ascertaining the meaning of the contract: interpretation of the express terms, filling the gaps by implication, and rectification of any documents which fail to record accurately the parties' intentions." McMeel 2005: 278 n. 75.
[223] Alan Schwartz (1992: 278–280) distinguishes five reasons: the inevitable limitations of language; party inadvertence; the costs of creating contract terms; asymmetric information; a preference for anonymity (pooling) by one party. On incomplete contracts see also Schwartz 1998.
[224] As we will see in section 4.5.3., information-forcing rules are not only used in case of strategic incompleteness, i.e. when one party opportunistically withdraws information but also in cases when this party is simply the 'cheaper drafter'.

vague or ambiguous language is interpreted so as to fit whatever the parties probably would have agreed to if they had discussed the matter, thus producing the same result as the majoritarian or market-mimicking default rules (...). In other cases, vague or ambiguous language is interpreted against the party who drafted it, just as in the case of a penalty or information-forcing default rule designed to induce more careful and explicit communication."[225]

One way to look at the problem of incompleteness is in analogy with tort law. From a consequentialist point of view, liability rules give incentives to people to take optimal precaution, i.e. to invest in the prevention of accidents up to the point when the last dollar spent on precaution reduces losses by one dollar. If contractual incompleteness is unavoidable and/or desirable due to transaction costs arising from limited resources, time, comprehension or foresight, courts should supply terms that would maximize the joint value of the contract, i.e. terms that the parties hypothetically would have intended. This majoritarian interpretative rule assumes that the court is the cheapest contract drafter. Indeed, for certain terms courts have a cost-advantage in providing efficient terms (either by using a statutory default or by referring to standard, pre-formulated meanings).[226]

As a practical matter, these cases may justify a contextualist approach to interpretation, where the court refers to the course of performance, course of dealing, trade usage, and other external standards. To be sure, if a court insures parties against incompleteness through flexible interpretations and implied terms, it creates a moral hazard problem: parties have a reduced incentive to write good contracts themselves. In every contractual regime various doctrines set limits upon the kinds or amount of extrinsic evidence a court can consider (e.g. the parol evidence rule in common law). Functionally, these limits can be seen as judicial instruments designed to create incentives for parties to reduce interpretive risks themselves. From an efficiency perspective, it makes sense to encourage parties to make such precautions to the extent that they are able to do so cost-effectively.

There are, however other cases where one of the parties is in the best position to clarify a term or identify what should happen in the event of some contingency. This is

[225] Craswell 2000: 15.
[226] Cf. Goetz – Scott 1985.

often the case with a repeat contractor, or one represented by legal counsel. Imposing liability on the "cheaper contract drafter" might make sense. Also, if this party has an informational advantage, gap-filling or interpretative rules can force him to reveal this information in future contracts. To be sure, there are a number of other factors that should be taken into account. The homogeneity or heterogeneity of the parties determines whether a single majoritarian default rule (e.g. one that determines the place of delivery in a sales contract) is desirable or not. Even more importantly, there is a risk of court error. These factors should be considered in searching for the optimal mix of express and implied contracting terms, and thus the optimal contractual completeness.

In a further class of cases the main reason for incompleteness is not transaction costs due to the imprecision of language, inadvertence of the parties etc., but rather asymmetric information between the parties. By filling a gap with the default rule unfavorable to the informed party (penalty default), law and economics suggests that contract law should force the informed to reveal private information either to the other party or to the court.[227]

In the last one or two decades, many law and economics scholars have argued that gap-filling rules can be either majoritarian (market-mimicking) or information-forcing (penalty) defaults. However, not long after only just finally gaining wide acceptance, several aspects of the "default rule paradigm" are now being criticized on different fronts.

In fact, the juxtaposition of the two types of default rule is somewhat misleading. As Ian Ayres has noted, "If we go far enough back behind the veil of ignorance, all information-forcing rules are majoritarian. From this perspective, the dichotomy between majoritarian and penalty defaults is false."[228] According to the "received view" in law and economics, contract default rules should be justified by the "hypothetical consent" of the parties concerned, hence Ayres' reference to the veil of ignorance. Here, hypothetical consent is a shortcut term for Pareto efficiency.[229] Thus, when contracting parties are homogeneous, both "regular" market mimicking rules, and information-forcing rules should be majoritarian in the sense that they should impute terms that the

[227] See e.g. Ayres – Gertner 1989, Bebchuk – Shavell 1991.
[228] Ayres 2006: 612.
[229] Craswell 1992.

two parties would have agreed upon. "A ruling that fails to interpolate the efficient term will not affect future conduct; it will be reversed by the parties in their subsequent dealings"[230] – provided the transaction costs of such deviation are not prohibitive. When this *ex ante* perspective is applied to both types of default rules, it relativizes their difference. Partly related to this has been the recent questioning of the concept of penalty default rules.[231] More generally, Robert Scott has suggested that the entire "default rule project" should be rethought. He provides several reasons to "question whether the state can create efficient default rules to supplement the relatively small number of simple, binary rule that have evolved through the common law process."[232] The economic analysis of contract incompleteness and default rules, both in its positive and its normative variants remains controversial.

4.1.2. Problems with the dichotomy

Blurred distinctions

In this section I discuss a few aspects of the controversy surrounding the dichotomy between mandatory rules and default rules in contract law. Law and economics has become somewhat ambivalent towards the mandatory/default rule distinction for several reasons, both analytically and empirically. First, on closer look the traditional distinction seems blurred in an analytical or conceptual sense:

> "*The term »default rule« refers to several different characteristics: (1) if the parties specify some contract term, the court will enforce that term; (2) if the parties fail to specify some contract term, the court will fill in the gap and supply one; and (3) if the parties fail to specify some contract term but do not want the court to fill in the gap, the court will honor that intent (that is, the gap-filling rule itself is a default). […] Default rules are usually contrasted with mandatory rules, which term can also refer to three characteristics. Mandatory rules can refer to situations in which the court knowingly: (1) imposes a term that contradicts a term the parties specified; (2) refuses to fill in a gap that the parties left when the parties wanted the court to fill the gap; and (3) fills in a gap that the parties did not want the court to fill in.*

[230] R. Posner 1998: 98.
[231] Posner 2006, Ayres 2006, Baffi 2006.
[232] Scott 2004: 90. Instead, he suggests a new policy, at least with regard to business contracts: "The project of the law should be to replicate those terms (and only those terms) that individual parties would choose not to bargain over if they knew that the state would provide them." Scott 2004: 94.

When economists refer to mandatory terms, they usually mean the first sense, that is the court rejecting a term the parties specified. An example would be a liquidated damage clause deemed to be a penalty, or a term deemed to be unconscionable. The usual critique of mandatory terms is that because they disregard the intentions of the parties, the parties who prefer these terms will be made worse off. […] This critique makes sense if contracts are assumed to be complete. But once we allow for the possibility of efficiently incomplete contracts and unclear intent, it becomes much more difficult to distinguish mandatory rules from default rules. Take, for example, the implied duty of good faith, or the duty of loyalty in fiduciary contracts. Are these defaults or mandatory rules? That depends on how well one thinks the duty of good faith tracks contractual intent. If one believes that parties may write incomplete contracts for which they expect courts to fill in the gaps, the duty of good faith or the duty of loyalty might easily be viewed as a default. If the parties want a particular obligation that conflicts with what courts ordinarily view as good faith or loyalty, and they specify that obligation, courts will generally enforce it.[…] On the other hand, if one believes that courts use the duty of good faith or the duty of loyalty to fill in gaps that the parties did not want to be filled, or to reject obligations the parties thought they had fully specified, then the duty of good faith looks more like a mandatory term."[233]

Mandatory rules from the bad man's view

The distinction between mandatory and default rules can be also deconstructed in a more radical (or in jurisprudential parlance, more realist) way.[234] The argument is based on a simple inference from a basic assumption of standard law and economics. Standard economic models usually follow O. W. Holmes in adopting a bad man's view of law.[235] Under this view, people (should) obey the law as long as they are deterred by sanctions:

"Managers do not have an ethical duty to obey economic regulatory law just because law exists. They must determine the importance of these laws. The penalties Congress names for disobedience are a measure of how much it wants firms to sacrifice in order to adhere to the rules; the idea of optimal sanctions is based on the supposition that managers not only may but also should violate the rules when it is profitable to do so."[236]

Whether the normative version of this view is acceptable or not, on the explanatory level, standard law and economics considers legal rules not as *obligations* but as *incentives*. It imputes to citizens only prudential reasons for compliance with the

[233] Cohen 2000: 84–85.
[234] Menyhárd – Mike – Szalai 2007.
[235] "If you want to know the law and nothing else, you must look at it as a bad man, who cares only for the material consequences which such knowledge enables him to predict, not as a good one, who finds his reasons for conduct, whether inside the law or outside of it, in the vaguer sanctions of conscience." O. W. Holmes 'The Path of the Law' (1897), cited in Cooter 2000: 375 n.12.
[236] Cited from Easterbrook and Fischel in Cooter 1984: 1523 n.2.

law. Sanctions are treated as prices. In the bad man's view, laws are price-like constraints; he considers them as constraints making certain actions more costly. This perspective, although not uncontroversial, has proved illuminating in the economic analysis of law in many ways.

With regard to the mandatory/default distinction, the bad man's view implies that "mandatoriness" only refers to a rule, the violation of which is more costly, than to deviate from the default rule. From the perspective of rationally calculating contracting parties, the distinction between mandatory and default rules is rather one of degree, and not of category. When the parties agree on a term violating a mandatory rule, it may govern their relationship to a large extent – only it cannot be enforced in (a law-abiding state) court. Parties follow mandatory contract law rules as long as, calculating their costs and benefits, they find it in their own interest not to deviate from it. As we will see, this insight has implications for policy in general, and paternalism in particular.

Sticky default rules

The distinction is less clear for a third, somewhat related reason as well. There is now growing evidence that defaults rules are sticky. For instance, in Spain, there are regional differences in matrimonial property regimes. The rule is different in Madrid and Barcelona. The rules are not mandatory, but in practice the typical solution follows the default rule. In fact, there are large regional differences in actual practice: in Madrid most couples agree on joint property, while in Barcelona divided property is typical. Arguably, this does not reflect a difference in preferences between the two cities but a difference in the statutory default rules. Similar stickiness has been observed in many other contexts and countries.[237]

This stickiness is somewhat puzzling when analyzed from an economic perspective. Parties often do not deviate from a default rule even when the rule is not efficient, i.e. it does not maximize the cooperative surplus of the parties. "Parties might

[237] See Trias 2000, on the different legal regimes in Spain cf. also http://www.spainlawyer.com/guialegal/guialegal.cfm?IDCAPITULO=01010000#01010400000000

choose not to opt out of a legal default even when a better provision can easily be identified and articulated at a negligible drafting cost."[238]

One reason for this stickiness might be the operation of network effects, but this only applies in specific contexts and cannot explain, for instance, the marital property case.[239] More probably, the explanation has to do with psychological mechanisms. Ben-Shahar and Pottow argue that default rules are sticky because unusual, non-standard terms *as such* might look suspicious to the other party. The very idea of deviating from the default may make the other party reluctant to accept such deviations. In consequence, parties are unwilling to propose opting out of the default in the first place. The possible negative signaling effects such proposal would have may be weightier than the merits (the Pareto-improvement) of a deviation.[240]

Others suggest different explanations. Whatever the reason for stickiness, it also has policy implications. When party preferences are heterogeneous, sticky default rules can correspond, at most, to the interests of the majority. One solution to remedy this is to offer a menu and force parties to choose one of the options. Of course, to be forced to make a choice is also costly for individuals. The menu provision only works when the transaction cost rationale for the default rule is not too strong and when it is otherwise technically possible. In general, stickiness implies that default rules matter even more than usually thought in economic analysis. On the other hand, as mentioned above (section 2.4.3.), default rules and menus provide a preferable instrument for "libertarian paternalism".

As to the role of mandatory rules, within the constraints mentioned above, these can also be used to pursue various policy purposes, including paternalism. The policymaker still has the choice between mandatory procedural rules (see section 4.3.) or substantive limitations, such as the non-enforcement or voiding of certain clauses or types of contract (see section 4.4.).

[238] Ben Shahar – Pottow 2006: 651.
[239] On network effects see section 4.5.3. below.
[240] Ben Shahar – Pottow 2006.

4.2. Voluntariness and the "constitutive limits" of contractual freedom

Before discussing procedural limits in the narrow sense, it is useful to distinguish yet another group of rules on freedom of contract. This category comprises those minimal limits which are necessary for the working of even a libertarian (unregulated) contract regime. These rules can be found among the basic contract provisions of practically every civil code and among the contract rules of the common law as well. From an economic perspective, they refer to the most obvious cases when a contract is presumably not welfare-enhancing and therefore should be void. From an autonomy perspective, these are the cases when the contract, for reasons related to its formation, does not typically reflects the autonomous choice of both parties. Both perspectives agree that in these cases the private ordering paradigm does not apply.

If we recall the conditions of substantial voluntariness,[241] at first glance the three conditions remind one different contract law doctrines. The rules of incapacity are supposed to regulate transactions in such a way that only agents being capable of making choices (in the abstract sense of being an autarchic subject) can conclude a valid contract. The contract law rules of duress, fraud, and misrepresentation serve to guarantee the lack of certain substantial external controlling influences. Whether this condition includes the absence of economic necessity, or that counts among the "legitimate inequalities of fortune",[242] is a matter of dispute and shall be discussed below. Finally, substantial freedom from epistemic defects is taken care of via rules on unilateral mistake, mandatory disclosure and other rules making consent more deliberate.

The specific content of these rules is not beyond critique. Especially with regard to the epistemic defects, there is much discussion as to whether these contract law rules, which, of course differ in their details within different legal systems, can be explained or justified with the tools of traditional or behavioral economic analysis. Also, as we shall see below in the discussion of unconscionability, when judges provide relief, or

[241] (1) The abstract capability of making choices, (2) substantial freedom from controlling external influences, (3) substantial freedom from epistemic defects. See section 2.1.2. above and Pope 2004: 711–713.

[242] Feinberg 1986: 196–197. This problem is related to what Feinberg calls "non-coercive exploitation" – on this see Feinberg 1983.

render a contractual clause unenforceable, their reasoning is often difficult to analyze within the framework of these categories. Stated in another way, when it comes to practical application, the function and domain of different legal doctrines is much less neatly separated than in theory.

4.2.1. Incapacity

Incapacity, or as it is sometimes termed, incompetence, as well as being one of the constitutive limits of contract law, may also be interpreted as a formal rule as well.[243] "The concept of »capacitas«, whose roots lie in Roman law, signifies a status conferred upon citizens for the purpose of enabling them to participate in the economic life of the polity. In modern legal systems, 'capacity' is the principal juridical mechanism by which individuals and entities are empowered to enter into legally binding agreements and, more generally, to arrange their affairs using the instruments of private law. Legal capacity is thereby the gateway to involvement in the operations of a market economy."[244] Therefore, legal rules on transactional capacity are of fundamental importance not only in a legal but also in an economic sense.

In modern legal systems, capacity is the default rule; only minors and insane persons (and in rare cases spendthrifts) have been considered legally incompetent.[245] Still, "all legal systems […] have to have rules which determine the conditions under which minors, incompetents and those mentally deranged are to be denied" contractual capacity.[246] It is also noteworthy that incompetence is a concept of more general application than just to contracts; one can also speak of delictual (no liability for torts) or criminal incompetence as well.

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[243] For a comparative overview of the legal rules of (contractual) capacity see Heldrich – Steiner 2001: 9–23, Scott – Kraus 2003: 481–517, Kötz – Flessner 1997: 148–161, Zweigert – Kötz 1998: 348–355. For philosophical and economic discussion see e.g. Feinberg 1986: ch. 26; Enderlein 1996: 173–231; Hesselink 2005; Deakin 2006.

[244] Deakin 2006: 318.

[245] As for spendthrifts, during the 19th and 20th centuries, a few jurisdictions, such as the U.S. state of Oregon, experimented with laws under which the family of such a person could have him legally declared a spendthrift by a court of law. In turn, such persons were considered to lack the legal capacity to enter into binding contracts. See ORS 126.335 (repealed Or. Stat. 1961, ch. 344, § 109), cf. http://en.wikipedia.org/wiki/Spendthrift

[246] Zweigert – Kötz 1998: 348.

This raises the question: which problems are addressed by the rules of incapacity? As noted above, in a formal legal sense, for a contract to be valid it should be concluded voluntarily. From an empirical point of view, there are significant individual differences; not every person is capable of making *substantially* voluntary actions in general. One of the conditions of substantial voluntariness is the capacity to make choices. In deciding upon the question of incapacity, what matters is something relatively limited: only the abstract capability of making choices, be they reasonable or not, is required. Thus, in the eyes of the law, even if the decisions are foolish, unwise, or reckless, these are still decisions of an autarchic subject. If there are paternalistic reasons for intervention because of the substantive irrationality of the choice, these come under another doctrinal rubric of contract law.

The rules of incapacity are supposed to regulate transactions in such a way that only people who are capable of making choices (in the above said abstract sense) can conclude a valid contract. A certain minimal intellectual capacity is a prerequisite of choice, in any meaningful sense, and hence of autonomy as well. These rules limit the contracting capacity of minors, mentally disabled persons and persons who are temporarily incapable, e.g. the intoxicated.

The precise incapacity rules in the different European legal systems are more or less complicated. For instance, Germany has strict and inflexible rules related to age; in Anglo–American law, statutory representation is unknown and thus the transactional opportunities for minors are larger.[247] Today, in most countries the age of majority is set at 18.[248] Minors themselves are often not treated uniformly. A few countries lay down an age under which children have no contractual capacity. This can vary from 7 in Germany (§ 105–106 BGB) and Austria (§ 865 ABGB), 10 in Greece (art. 128 Civil Code) to 14 in Hungary (§ 12–12A Civil Code). There is absolute incapacity under this age and some restrictions for older minors. In other countries, the limit between complete incapacity and limited capacity depends on the individual case. The majority of problems arise during this intervening period – here most legal systems distinguish between contracts which juveniles can validly conclude on their own, and other

[247] Zweigert – Kötz 1998: 351.
[248] In Switzerland it is 20 (art. 14 Civil Code) and in Austria 19 (§21 ABGB).

contracts which may be void or voidable, or subject to reduction in favor of the juvenile.[249]

From a policy perspective, there are two questions to be discussed. The first is about the strictness of the incapacity rule. Who should be incapacitated and until which age? The second concerns the flexibility of the limit. Is it better to draw a clear-cut line, or make the distinction more gradual by acknowledging exceptions or allowing discretion for *ex post* adjudication?

In regards to the first, minors often have an undeveloped conception of their own self-interests. Sometimes they have incomplete or hazy ideas about the obligations they are assuming. It is possible to determine a certain threshold in such a way that if the expected loss from different types of irrationality (problem of preferences), or lack of information, is sufficiently high the law should protect the individual against himself by making all his promises unenforceable.

The capacity rules for minors are more or less inflexible. The rules have to rely on easily observable criteria in order to reduce uncertainty for contracting parties with regard to the transactional capacity of their partners. Age is a convenient criterion.[250] Also, there is an identifiable and significant correlation between this particular natural fact and one's ability to comprehend the meaning of his or her acts and thus to act autonomously.

Once a certain age has been reached, people are vested with contractual capacity, regardless of their individual ability to look after their own affairs in a sensible way. It also happens that some adults lack the cognitive capacity or emotional balance necessary for a reasonable decision, but this occurs less frequently. Thus for administrative convenience and in order to enhance the reliability of promises generally, adults are denied the benefit of the incapacity defense, except in extreme cases like insanity.

While in most Continental legal systems, incapacity implies voidness, in common law countries, incompetence is a defense. "The rule [...] is that minors may make and enforce contracts but that their contracts may not be enforced against them."[251]

[249] Zweigert – Kötz 1998: 349.
[250] In earlier ages, e.g. in the rules of the *Sachsenspiegel*, capacity was linked to visible signs of puberty.
[251] Kronman – Posner 1979: 254.

On the other hand, practically all legal regimes recognize some exceptions from the voidness or unilateral non-enforcement of contracts by the incapacitated. Some are related to fraud by the minor. In other exceptional cases the protective aim of incapacity rules takes precedence over the needs of transactional certainty. This is the case in common law when the contract is for the sale of so called necessaries, i.e. goods and services that are judged to be in the "objective interest" of the buyer.[252]

This rule also involves a trade-off. There is some danger that minors will be overcharged for necessaries. However, the law considers it an even greater danger that, if they are not permitted to enter into binding contracts, they will be unable to obtain what society has judged to be essential for their welfare.

Incapacity rules are clearly (softly) paternalistic, as they protect people from themselves by completely disallowing them participating in certain potentially self-destructive actions. As long as the contracts concluded by minors or mentally incapacitated persons are void or voidable, the incapacity rules also defend these vulnerable persons from being exploited by others. The rules operate to have this effect indirectly, by changing the *ex ante* incentives of potential contractual partners. Briefly, a rational person is not (or much less) willing to make transactions with someone whose promises cannot be legally enforced. It increases the risks of contracting with minors, and therefore makes contracting more costly for minors themselves.

The rule has two opposite effects on the welfare of minors. The rule permits minors to withdraw without cost from contracts which they (or their parents) have later come to regard as ill-advised or unprofitable. This allows them to act opportunistically to some extent, while they are less likely to be opportunistically taken advantage of. This comes with the price that minors usually have difficulties in concluding contracts. This leads to the situation that "[t]hey often discover that their promises will be accepted only if they are backed by adult guarantors."[253]

Apart from contractual capacity, paternalism has a more active dimension with regard to incapacitated persons. The law has installed guardianship and statutory representation provisions as ways to take care of the interests of the incapacitated. This is, again, a clear instance of paternalism. More precisely, here law raises obligations for

[252] Zweigert – Kötz 1998: 351, Scott – Kraus 2003: 499.
[253] Kronman – Posner 1979: 255.

the parents, the guardian, etc. to take care of the interests of the incapacitated in an essentially paternalistic way. In this way, a principal–agent relationship is created which has some interesting peculiarities and which could be analyzed further.[254]

4.2.2. Formation defenses

From a doctrinal perspective, at least in modern laws, for a contract to be legally valid it has to be concluded voluntarily. A contract is founded on the agreement of the parties. Thus, in the context of contract formation, the law is concerned with the voluntariness of the agreement. In this way the law takes care of situations where individuals should be protected from their not fully voluntarily undertaken obligations. These "constitutive" limits of freedom of contract[255] are technically called formation defenses.[256]

Formation defenses include the doctrines on duress, fraud, and misrepresentation. French law distinguishes between three vitiating factors in contract creation: *erreur*, *violence*, and *dol* (art. 1109 Code civil). In doctrinal terms, the consent lacks validity because it was based on the party's mistake, or was obtained by pressure or fraud. English law admits similar vitiating factors: mutual fundamental mistake, misrepresentation (unilateral mistake caused by the defendant), duress (threat, pressure) and undue influence (abuse of a position of confidence).[257]

In contract law, formation defenses and incapacity represent the main category of soft paternalism.[258] As we have seen above, the normative justification for soft paternalism is relatively unproblematic; theoretically it is more interesting to ask whether there are instances of justifiable hard paternalism with regard to contract formation. That is, should the law void contracts for "economic duress" or "non-coercive exploitation"? This is a question which goes well beyond the scope of contract

[254] The active dimension of legal regulation of capacity-related issues is beyond the scope of contract law, thus it is not discussed further in this work. However, it is noteworthy that these legal rules on capacity come more into the focus of theoretical analysis when interpreted in light of such heterodox economic ideas as Amartya Sen's capability approach. On this perspective, see Deakin 2006.
[255] Kennedy 1982.
[256] For a comparative overview of the legal rules see Mehren 1992, Scott – Kraus 2003: 403–480, Zweigert – Kötz 1998: 410–430.
[257] Cartwright 2002: 154.
[258] On the distinction between hard and soft paternalism see Feinberg 1986:11–12 and section 2.1.2.

formation doctrines. Nevertheless, as it is related to formation defenses and relevant for paternalism, the following section is devoted to the problem of exploitation by contracts.

4.2.3. Coercion and exploitation

What voluntariness means in a given contract formation setting is not always easy to discern. Ultimately, the question of where to set the threshold is not a psychological one, but normative in nature. The seemingly simple question of what constitutes voluntary consent to a transaction involves a serious conceptual and normative problem. Suppose there is full information, no cognitive deficiencies and the contract is complete. The question is then, whether the *constrained choice* of a party renders his consent involuntary, nevertheless. In one sense, all contracts are "coerced" because of the scarcity of resources and opportunities. On the other hand, except for extreme cases, such as in the event of actual physical force, torture, or hypnotic trance, almost every exchange can be viewed as voluntary, or as the ancient Romans said, *coactus tamen volui*.[259]

Even when entered into contact under a your-money-or-your-life-type threat, it is not the actual consent which is lacking. Such a threat is illegal and the contract is void for duress in every legal system. It is illegal because of a normative judgment about the quality of the choices available. Conventional duress doctrine draws the moral baseline relatively low. A threat to the physical security of a contracting party is below this baseline. Lies (fraud) and abuse of a position of confidence (undue influence) are also considered to be below this line. On the other hand, it seems that the law should not be too lenient when allowing formation defenses. There are many pressures on a person entering into a contract, and the law must distinguish between them. Legal doctrines should restrict the circumstances in which a claimant can escape the contract. In my view, what these doctrines should provide is the protection of the conditions allowing for an autonomous choice.

Or should the range and quality of opportunities also matter? Should the threshold be set higher? One might think of different kinds and degrees of coercion and

[259] This problem has already been discussed in Aristotle's *Nicomachean Ethics* (2006: 1110a–b).

advantage-taking in this respect.[260] It is here that the divergence of an economic and an autonomy-based view can be observed. From the perspective of law and economics, the question is about Pareto efficiency: "Does this transaction render both parties to it better off, in terms of their subjective assessment of their own welfare, relative to how they would have perceived their welfare had they not encountered each other?"[261] Thus, regardless of the range of opportunities, when the contract has improved the situation of the person in necessity, the contract should be held valid. Other scholars would also account for the incentive effects and enforcement costs in their policy suggestions.[262]

Rights theorists define coercion by drawing a basic distinction between threats and offers. Threats reduce the possibilities open to the recipient of the proposal, whereas offers expand them.[263] The difficulties arise, however, in specifying the baseline, against which the offer is to be measured. The positioning of this baseline is not self-evident. It may be statistical (what the offeree might reasonably expect), phenomenological (what he in fact expects), or moral (what he is entitled to expect). Thus "the distinction between threats and offers depends on whether it is possible to fix a conception of what is right and what is wrong, and to determine what rights people

[260] Trebilcock (1993) construes seven cases and demonstrate the implications of the different theories. (1) The highwayman case (creation and exploitation of life-threatening risks: a highwayman or mugger holds up a passer-by confronting him with the proposition: 'Your money or your life' and the passer-by commits himself to hand over the money). (2) The tug and foundering ship case (exploitation but not creation of life-threatening risks: a third party encounters the highwayman and the passer-by before the transaction is consummated and offers to rescue the passer-by for all his money, less one dollar. Or imagine the same situation between a foundering ship on the stormy sea and a rescuing tug). (3) The dry wells case (exploitation but not creation of life-threatening risks with one supplier and many bidders: in a remote rural area all wells except from A's dry up in a drought and A auctions off drinking water to desperate inhabitants for large percentages of their wealth. Or, the same sea situation with several ships and one rescuer). (4) The Penny Black case (exploitation but not creation of non-life-threatening situations: A comes across a rare stamp in his aunt's attic and sells it either to B exploiting his idiosyncratic intense preferences or through a Sotheby's auction to the highest bidder). (5) The lecherous millionaire case (A agrees to pay for a costly medical treatment of B's child [or offers her an academic position or a promotion in the firm] in return for B's sexual favors). (6) The cartelized auto industry case (contrived monopolies: major automobile manufacturers form a cartel to curtail drastically consumers' rights of action with respect to personal injuries). (7) The single mother on welfare case (non-monopolized necessity: a person in necessity contracts with another who lacks monopoly but the terms are especially burdensome to the first, reflected in high risks and low return).

[261] Trebilcock 1993: 84.

[262] In a recent paper, Steven Shavell (2005) also analyzes similar problems. His normative starting point is that law should minimize social costs. He distinguishes two kinds of holdup situations. The first he calls "engineered holdup" where A creates an opportunity for himself to exploit B. In this case the contract should not be enforced. In the second type, "non-engineered" situations, A does not create but only uses the necessity of B. An example could be a rescue situation on high sea. Shavell claims that in non-engineered holdup situations efficiency dictates price control.

[263] See Nozick 1997.

have in contractual relations independent of whether their contracts should be enforced."[264] The main argument here is that the consequences of an exercise of autonomy will depend on the opportunities available to the individual. On this basis, many autonomy theorists argue that what is called economic duress, i.e. the lack of alternative ways to procure income, should be considered a case of coercion.

There are a couple of problems with this position. Those, who argue that individuals are entitled to some minimum level of economic well-being, and infer that the law of contracts should invalidate choices made when the scope of choice is limited by economic deprivation, forget at least two things. The first is that invalidation is not the only remedy available.[265] The other is the double bind effect, mentioned above (section 2.2.5). Even in a case of deprivation one can say that the choice does not reduce, but rather increase the individual's welfare, relative to the other options available.[266] On the other hand, "prohibition will almost never have the effect of enlarging the available choice set."[267] If this is the case then invalidating contracts for "economic duress" would be an unjustified case of hard paternalism.

4.3. Procedural limits of freedom of contract

In contrast to constitutive and substantive rules, procedural or formal rules do not constrain the parties when agreeing on the substantive terms they choose (accept or bargain for), but merely require certain actions to be taken (or not taken) before contracting, or during the contractual relationship. Formal requirements may relate to the manner of recording or authentication of the contract. They regulate the process or procedure according to which the making of a contract must be accomplished, or mandate the pre-contractual furnishing of information. In this section, I discuss the main

[264] Trebilcock 1993: 80.
[265] As Shavell's rescue example (n. 238 above) illustrates, price control is also an option. To be sure, this remedy has its drawbacks as well, see section 4.4.1.
[266] "It is, of course, entirely legitimate to decry the absence of a richer menu of non-demeaning and self-fulfilling life choices in many of these contexts and to advocate public policies that would enlarge the choice set. However, amongst these policies, the prohibition of the problematic activity, standing alone, seems unlikely to increase women's welfare, while clearly constraining their autonomy." Trebilcock 1995: 374.
[267] Trebilcock 1995: 374. In exceptional cases, this might be possible in the long run when such changes give political impetus to legal reforms enlarging the opportunities. Trebilcock argues that British laws against child labor and the subsequent development of public schooling in the 19th century provide such an example.

characteristics and the justifications of four types of procedural rules: contractual formalities (writing requirements, notarial form and others); withdrawal rights (cooling-off periods); mandatory independent advice seeking; and informational rules. Procedural aspects of unconscionability will be discussed in the next section, along with the substantive aspects.

There has been a long term historical tendency in the contract laws of both civilian Continental European, and common law systems, towards a diminished significance of contractual formalities.[268] Early legal systems were formalistic and "objectivist". This ancient formalism, linked to magical thinking, characterized, for instance, the early period of Roman law. In ancient law, forms were constitutive; the obligation arose from the precise use or performance of certain solemn actions or rituals which had magical or religious connotations. In modern times, the legal significance of formalities is quite different. As we have seen in section 3.2.1., the binding force of contracts is now justified differently, mainly based on consent. Consequently, the formal requirements are now to be explained and justified on instrumental grounds.[269]

Formalities have various historical origins and doctrinal explanations. Still, at first sight, the link between procedural rules and paternalism is relatively straightforward. As a policy instrument, their function is to make the conclusion of contracts more difficult, and in this way more deliberate (autonomous) and eventually more welfare-enhancing. In this section, I discuss to what extent the procedural requirements of contract validity may be interpreted as legal responses to bounded rationality and other contracting failures, and the limits of these functions. For each of the rules, a complete analysis would involve presenting its legal characteristics in different contract law regimes, its incentive and debiasing effects, and would also refer to empirical data. Here, due to space constraints I merely aim at a first approximation of these aspects.

4.3.1. Formal requirements

For a contract to be binding, voluntary consent is usually but not always enough. Besides the external constraints like duress, fraud, incapacity or public policy (*ordre*

[268] Zimmermann 1990: 86.
[269] Mehren 1998: 6–7.

public), in certain cases additional elements are required as proof that the parties "meant their words seriously". These formal requirements "concern the manner in which the conclusion of the contract must be marked or recorded."[270]

In Western contract laws, these formal requirements are evidence of a large diversity in historical origins and doctrinal explanations. Most legal regimes require formalities for the conclusion of certain categories of contract to be valid and enforceable.[271] The failure to satisfy the formal requirements either results in the denial of public enforcement or in voidness. The first type is called *forma ad probationem* or proof form, the second *forma ad solemnitatem* or solemn form.[272] In the following sections, first the laws of France, Germany, England and others will be briefly surveyed, then I draw attention to some commonalities in these national rules.

Comparative overview

France. In France, the regulation of contract formalities is relatively complicated. French contract law requires for any contract there be a *cause*, a legally acknowledged motivation of the transaction. This, in itself does not limit freedom of contract significantly, but certain substantive requirements are dogmatically linked to the *cause*.[273] In French contract law, writing has been required for noncommercial transactions, since as early as 1245. For contracts above a certain value, a written form is required as a "proof form". This means that when it comes to a judicial procedure concerning the contract, an oral testimony as to the content of the contract is not accepted as evidence. Art. 1341 of the Code Civil determines the amount above which a written form is necessary. The amount has been valorized from time to time, but when inflation made this amount trivially low, it influenced the courts to relax the requirement, almost to the point of meaninglessness. This non-acceptance of proof is

[270] Treitel 1999: 161.
[271] For a comparative legal overview of the formal requirements see Mehren 1998, Kötz – Flessner 1997: §4–5, Zweigert – Kötz 1998: 365–379, 388–399. For a law and economics discussion see Johnson 1998a, Hermalin – Katz – Craswell 2006: 42–46.
[272] On this classification of the formal requirements see Mehren 1998: 8.
[273] On substantive limits see section 4.4. below.

also relaxed through several exceptions (art. 1347–48). In practice, the writing requirements as "proof forms" are often left unenforced.[274]

In other cases, the "proof form" is enforced, e.g. for settlement agreements (art. 2044) or unilateral obligations to pay money or deliver a fungible object to another person (art. 1326). For promises to stand as a guarantor (art. 1326, 2015) the court strengthened the writing requirement from that of a proof form to a protective rule. Another formal requirement concerns the written disclosure of essential information (*mention informative*). This is an example of the larger tendency that formalities are considered instrumental in enforcing disclosure rules.[275]

In French law, to be valid, certain types of contract are required to be made as *actes authentiques.* This requires that they be drawn up and signed before a *notaire* who has both an authenticating role in respect of the transaction (certain aspects of which he must check), and also a compulsory advisory role in regards to all parties. An acute *authentic*, once created is extremely difficult to challenge before a court. It also has *force executors*, meaning that it can be executed without recourse to a prior court order.[276] A notarial form is required for a number of transactions, including donations (gift, art. 931–932), matrimonial contracts (art. 1394), and mortgages (art. 2127).

Germany. In Germany, formalities are always of the "solemn" type. The reason for this is the following. German legal scholarship holds that to use a proof formality would be incompatible with the principles of the judicial process, especially with the free evaluation of the evidence by the judge.[277] In contrast to Austria (§883 ABGB) or Switzerland (art. 11 OR), in Germany there is no explicit rule allowing parties to choose the form of their contract (this rule can be inferred from §125 BGB though). The German BGB regulates the written form (§126), with specific rules for text and electronic forms (§126b, §126a), the notarial form (§128), and public authentication (§129). German courts do not make individual exemptions from the writing requirements, but use a categorical method.

[274] Mehren 1998: 21. n. 96.
[275] On this function see Mankowski 2005. On disclosure rules see section 4.3.4. below.
[276] Whittaker 2002: 207.
[277] Mehren 1998:24.

In Germany, a simple written form is required for a number of contracts, e.g. for the lease of land or dwelling, or the termination of a labor contract. According to BGB §311b I and §925 a judicially or notarial authenticated contract is necessary for the transfer of real property. Such writing (*Beurkundung*) is required, among others, for contracts obligating a person to transfer all or part of his present assets (§ 311 b III), for a matrimonial contract (§1410), and for many transactions related to inheritance (e.g. §§ 311 b V 2, 2033, 2348, 2351, 2371, 2385).[278]

England. English law has both common law and statutory formalities. While consideration is a judge-made rule, the Statute of Frauds (1677) is of legislative origin.[279] Contract formation in common law requires "consideration".[280] Much has been written about the exact meaning and the purposes of this requirement.

As Simon Whittaker argues, it is

"*difficult to know where to place the doctrine of consideration in a discussion of English contractual formality. Its overall function is clearly substantive in that its rules give effect (even if in a complex and at times incoherent way) to a requirement of reciprocity, excluding from contract agreements which are deemed to be 'gratuitous'. On the other hand, certain aspects of the doctrine allow its practical impact to be viewed as formal rather than substantive, notably in the case of 'nominal' consideration, and its requirements may be avoided altogether by use by parties of a deed*."[281]

The historical origin of the Statute of Frauds is clearer. It was designed to discourage frivolous litigation based on false claims of the existence of a verbal contract. It originates from a time when procedural rules and the doctrines of duress and fraud were considered less workable then they are today. In the meantime, the Statute of Frauds has been changed and finally almost entirely abolished. From the seven types of contract originally subject to it, it is still applicable to guarantee agreements, in which case a document in writing is required from the would-be guarantor.

Traditionally, formality has implied the use of a seal. Instead of this traditional requirement, currently a printed form is required for contracts for the sale, or other

[278] On the use of the notarial form in German law, including an interesting empirical analysis see Flik 2003.
[279] On the Statute of Frauds see Rabel 1947, Note 1957, Johnson 1998b.
[280] On a law and economics analysis of consideration, see Trebilcock 1993: ch. 8 (165–187).
[281] Whittaker 2002: 199–200.

disposition of, an interest in land.[282] The rationale for the proof form is interpreted literally here, the clear policy being to avoid the possibility that one or the other party may be able to go behind the document and introduce extrinsic evidence to establish a contract. In 1989 when the requirement of sealing for deeds executed by individuals was formally abolished, it was replaced with a requirement of signature and attestation by two witnesses.[283]

In contrast to Continental laws, in English law authentication by public authorities is exceptional. Officials are necessarily involved in marriage ceremonies, and in contracts for sale or other disposition of interests in land. The Land Registration Act (2002) provides that a land transaction is "not effective to confer title on the transferee until the transfer document is lodged, duly stamped, at HM Land Registry for an amendment of the Proprietorship Register." In this way, the registration of title was replaced by "title by registration".[284]

United States and elsewhere. In the United States, contrary to England, the Statute of Frauds is still valid law.[285] The Uniform Commercial Code includes several further provisions requiring formalities.[286] Besides, consumer protection legislation, such as the Truth in Lending Act, also imposes various formal requirements.[287]

The Statute of Frauds in common law countries typically has the sanction of non-enforceability (proof form). In other cases the effects of noncompliance can be nullity, unenforceability for either party, or unenforceability for one party. In some cases, the issue is solved via interpretation.

In the European Union, harmonization of contact law brought about "a renaissance of formalism".[288] For instance, the Directive on electronic signatures authorizes Member States to introduce new formal requirements as long as they may be

[282] Law of Property Act (1989), section 1, see Whittaker 2002: 202–203.
[283] Whittaker 2002: 203.
[284] Land Registration Act (2002) section 91(3) – see Whittaker 2002: 207. n. 43.
[285] Scott – Kraus 2003: 569–600.
[286] § 2-201 (Statute of Frauds), 2A-201 (lease contracts), 8-319 (sale of securities), 9-203 (agreement for a security interest), 1-206 (sale of personal property of value above $500).
[287] http://www.fdic.gov/regulations/laws/rules/6500-200.html
[288] Whittaker 2002.

complied with electronically.[289] Another example, the transparency requirement in the European Directive on Unfair Terms in Consumer Contracts[290], will be discussed in section 4.5.

Common features and trends

In sum, one can roughly distinguish between the following four types of requirements, going from the simple to the strict:[291]

(1) Use of paper. The contract must be evidenced, contained, or notified in writing.

(2) Authentication by a party to a contract. A traditional example from English law is the requirement of sealing, originating from the 1677 Statute of Frauds. With the development of literacy, signature has become the most important formality.

(3) Requirements of attestation by a non-party of the signature of a document by its party. Traditionally, this requires attestation by witnesses but the 'certification' of electronic signatures also belongs here.

(4) The involvement of public authorities, e.g. a notary in the contractual process. In continental European countries, the notary is a private person acting for reward, but exercising a truly public function. Common law countries have other institutions for the same purpose.

Which transactions are subject to formal requirements? For certain transactions, legal systems require relatively strict formalities. This is the case with unilateral obligations, or certain transaction with a large impact, mostly related to marriage and inheritance.

For unilateral (non-synallagmatic) obligations, e.g. promises of a gift, the enforceability of promises is more limited than for mutual ones. Promises of a gift are "suspect" in almost every legal order[292] – here the risks are usually high, while the costs, which are comprised mainly of the discouragement of donative contracts, are

[289] Directive 1999/93/EC of the European Parliament and of the Council of 13 December 1999 on a Community framework for electronic signatures *OJ L 13, 19.1.2000*, 12–20. Cf. Whittaker 2002.
[290] Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts. *OJ L 95, 21.4.1993*, 29–34.
[291] Whittaker 2002.
[292] E.g. art. 932 of the French Code Civil provides that "a donor is not bound until the donee has expressly accepted the promise of the gift in a notarial act."

typically considered low. In common law, the consideration doctrine renders 'gratuitous' promises unenforceable, unless the other party relied on the promise. Another exception of the consideration doctrine in common law is the enforcement of charitable donations. Formally, it is done through a presumption of reliance or consideration, but in some cases courts candidly acknowledge that the "real basis for enforcing a charitable subscription is one of public policy – that enforcement if a charitable subscription is a desirable social goal."[293]

While the institutional arrangement varies (certificate by courts, notarial document, witnesses, etc.), formalities are also more strict, *ceteris paribus*, when the transaction has a large impact. This applies to highly personal decisions where a special importance is attached to the autonomy and deliberateness of the choice, like in the case of surrogate motherhood, marriage or various transactions related to inheritance.

Paternalism and formalities

Formal requirements may serve various functions. Not every function is related to the protection of individuals from self-harming contracts; there are non-paternalistic justifications as well. Also, paternalism is "ambivalent" towards formalism. Regardless of this ambivalence, the link between the two is straightforward.

As it has already been stressed by Austin, Savigny, Jhering and other classic scholars in jurisprudence, legal formalities are useful for protecting individuals from ill-considered decisions.[294] From the perspective of soft paternalism, formalities work as *Seriositätsindizen* (indicia of seriousness).[295] The chief, economically reasonable, potentially efficiency-enhancing function of formal requirements is to make the conclusion of the contract more difficult, and in this way more deliberate, and as a result more rational. The signature for instance not only authenticates the document, it also warns the party of the legal significance and the possibly prejudicial effects of his adhesion to the transaction.

[293] *Jewish Federation v. Barndess*, 560 A.2d 1353, 1354 (N.J. Super. Ct. Law Div. 1989), cited by Farnsworth 2000: 404 n. 105. The reasonableness of this special treatment of unilateral obligations and the exception of charities is controversially discussed in legal commentary. See Gordley 1995, Farnsworth 2000, R. Posner 1998: 108–109.
[294] For references see Mehren 1998.
[295] Kötz – Flessner 1997: 77.

Do bounded rationality and emotional biases justify the writing requirement? While in the long run one can observe a tendency towards formlessness, due to improved literacy and technical development, the social norms expressed in contractual practices move in the opposite direction: towards the general use of written contracts. Business firms have self-interest in documenting their transactions for intra-firm reasons as well. Furthermore, in the last centuries, the everyday lay notion of a 'contract' has been attached to the symbolic form of a signed written document. It is somewhat unclear how this notion has changed with the use of electronic contracting.[296] At any rate, it seems questionable whether the simple writing requirement has a significant practical impact. As an instrument of paternalism it might indeed be too weak. Due to routinization, the manifest gesture of signing a document does not imply an empirically well-founded presumption that the contractual consent was well-considered and informed.[297] Still, the extra transaction costs of writing are not necessarily wasted, as long as they can deter some myopic or impulsive decisions.

Based on this simple cost-benefit consideration, bounded rationality may justify writing requirements for "high-value contracts, contracts likely to be entered into under circumstances of emotional stress, and contracts that reach far into the future".[298] Other things being equal, if the potential benefits of such rules in terms of protection are higher, this can justify even stricter formalities.

Viewed from within their preventive function, however, formalities are two sided. On the one hand, formalities can indeed protect unsophisticated parties from being bound by an ill-considered contract. However, if these parties are uninformed about formal requirements, they can be later disappointed, when it turns out that despite their intentions they have not entered into legally binding obligations. Stricter requirements increase transaction costs, information costs and accentuate the difference in sophistication between the parties. The more formalities required, the greater the tendency towards non-observation, resulting in increased legal uncertainty. Formalities also open up the possibility for opportunistic behavior. The "requirement of a writing

[296] The regulation of electronic contracting is beyond the scope of this work.
[297] See Hillman – Rachlinksi 2002.
[298] Hermalin – Katz – Craswell 2006: 46.

operates as a trap for the unwary by inappropriately providing a defense to a party who regrets an unfavorable oral agreement".[299]

Thus, paternalism can provide an anti-formalist argument as well. In fact, courts often exempt unsophisticated agents from strict formalities and "save" the contract, and the "weak party" as well. The administration of formal requirements can be individualized, when judges have the discretion to grant exemptions. This increases transaction costs. If there has been significant reliance on the contract, it is enforced despite the nonobservance of the formality. This is common, especially if the other party proves blameworthy in not informing his partner (usually a customer) about the formalities required by law.[300]

Courts use different techniques to avoid the result that one party benefits from the invalidation of the contract at the expense of the other. If the form and the transaction construct an "indissoluble unity", the remedy is non-contractual: the law of tort, unjust enrichment or restitution applies.[301] If the two can be dissolved, there are essentially two ways to avoid the undesired result. The first is, that the transaction is undone and restitution granted. This serves the cautionary and the channeling functions as well as deterrence. Alternatively, the transaction can be given effect and contractual relief applied. This serves the evidentiary function.[302] The question then arises: what is meant by these functions?

Non-paternalistic functions

The legal literature identifies several purposes for these formal requirements. According to Lon Fuller's classical distinction, contractual formality has three functions:[303]

(1) The evidentiary function – formality provides evidence that a contract exists.

(2) The cautionary function – formality forces the parties to slow down and think about what they are doing.

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[299] Scott – Kraus 2003: 570.
[300] Formal requirements are linked to consumer protection in another way as well: making written form mandatory serves as a proof that the information deemed necessary is provided to the consumer. On this widely discussed topic from an EU law perspective see Mankowski 2005.
[301] More precisely, some of these remedies are also considered contractual. The doctrinal boundary between contract and tort is idiosyncratic for legal systems; the issue is beyond the scope of this work.
[302] Mehren 1998.
[303] Fuller 1941.

(3) The channeling function – formality is a simple and cheap test of enforceability. It is a signal to courts and to laymen that the contract is good and enforceable. Forms are the most useful to parties who want to make agreements that will be enforced by a court. In other words, if one wants to make a legally binding promise either as the promisor or promisee, it is helpful to use a form.

In the preceding section I have discussed the second function as an instance of paternalism. As to the third one, channeling, formalities help by separating pre-contractual negotiations from the contract. That contracts can be entered into only voluntarily is a dogmatic cornerstone of classical contract theory. Recent developments, however, have expanded contractual obligations to include pre-contractual negotiations to some extent.[304] This raises many interesting questions. For instance, in the online world, contracting practices make the moment of the conclusion of a contract less apparent, at least for an average customer. These issues, aptly formulated as problems of freedom *from* contract, are the subject of lively discussion in legal scholarship, including from a law and economics perspective.[305]

In modern legal systems the functions of the formalities are more diverse than simply evidencing contracts, warning a would-be party against inconsiderate action, or the 'channeling' of legal transactions.[306] Although rarely by *design*, formalities also have a deterrence effect. Increased formalities raise costs mainly by making the conclusion of certain (efficient) transactions uneconomical.

Formalities are instrumental in facilitating information disclosure as well. The mandatory disclosure requirements often regulate the form in which information should be conveyed to the other party.[307] These issues are discussed in section 4.3.4.

Formal requirements can be economically justified for several reasons: (1) as a means to encourage information provision to the general public; (2) for coordination; or

[304] See e.g. § 311 II, III BGB.
[305] See Symposium 2004.
[306] Other scholars discuss an even larger variety of reasons for using formal requirements. Thus Heldrich (1941) argues that formalities provide (1) clarity as to the assumption of a legally binding obligation, (2) clarity as to the content of the obligation, (3) evidence of the transaction, (4) protection against ill-considered actions, (5) information for third parties about the transaction, (6) counseling (by a notary), (7) community surveillance of the assumption of certain types of obligations, (8) deterrence of the assumption of certain types of obligations. According to Mehren (1998), here (1) and (2) belong to the channeling function, (4) and (6) to the cautionary, (3) and (5) o the evidentiary one. While all the previous ones advance autonomy, (7) and (8) serve deterrent function and thus limit autonomy.
[307] Kötz – Flessner 1997: 123.

(3) by fulfilling the administrative needs of the legal system. Thus a written contract can reduce the information costs of third parties who have an interest in determining the status of assets in which they also may have a claim. Offer and acceptance rules work as social conventions ensuring that both parties attach the same meaning to certain actions during the contract formation. If parties do not fully internalize the costs of adjudicating their disputes, there is a potentially non-paternalistic justification for evidentiary rules. The court system can reduce its costs by requiring that evidence be presented in standard forms.[308]

On the other hand, in the law and economics literature, the now-standard Fullerian justification of formalities has been questioned. As Eric Posner argues, the reasons Fuller mentions might be sound, but these functions can also be fulfilled without making formalities mandatory.[309] Posner claims that formalities are designed to protect against fraud, as we have seen above with regard to the Statue of Frauds. These requirements should ensure that contractual liability is not imposed on a party who did not make a legally enforceable promise. They can be thus supported by both autonomy and welfare arguments. But why do rational and autonomous individuals need the law to require them to provide evidence of their agreement? If the parties alone have to live with the risk that they will be unable to prevail in a subsequent dispute, the law should not compel them to provide other or more evidence than they see fit.

Even a non-mandatory written form can provide evidence, warnings and channeling. The very fact of deviating from the default rule is then a proof that the contracting parties have been cautious and deliberate enough about their obligations. The real benefit of a mandatory writing requirement, according to Posner is that it makes perjury, i.e. false claims of obligation more difficult (costly).

4.3.2. Mandatory cooling-off

In the context of consumer contracts, one of the most wide-spread formal requirements is the mandatory provision of a withdrawal right, often called cooling-off period. This is a short term within which one of the parties (usually the consumer) can withdraw from

[308] Hermalin – Katz – Craswell 2006: 43–44.
[309] Posner 1996: 1980–1986.

the contract unilaterally without giving a cause. Regulations making the cooling-off period mandatory are in force both in the United States and in many European legal systems, largely as an implementation of various EU directives.[310] While in the US the cooling-off period is very short, ending (for good economic reasons) before the delivery of the good, in the EU a number of directives and national rules provide for differentiated regulations of various lengths, and usually the good is already delivered during the period.

As its name already indicates, the main reason for providing a mandatory cooling-off period is to cure the problems of weakness of will and other defects of rationality in one of the contracting parties. Various emotional and cognitive biases are typically present in door-step selling situations where aggressive sales techniques are often used, or in the case of distance purchases. More generally, a withdrawal period can be helpful when, for reasons related to the contracting situation, it is not to be expected that one party is in the position to make a deliberate choice.

On the other hand, in certain markets sellers of goods voluntarily "tie themselves" and grant a cooling-off period to the buyers. For instance, it is not uncommon that publishers are willing to refund the price of a book "without any further question" to buyers who return it within 30 days. This withdrawal period is much longer then what would be necessary for the paternalistic reason of letting the buyer "cool off". Thus it probably serves other purposes and fulfills other consumer preferences in the particular market.

Another complication is this: if the only economic function of cooling-off periods were to make the withdrawal from contracts concluded under cognitive or emotional distress possible, the actual use of the good would not be necessary. So the American consumer protection rule where the good is only delivered after the period has elapsed would be sufficient for cooling off.

Still, in the law and economics literature, another justification for a longer cooling-off period has been suggested.[311] It is said that in case of experience goods this period serves to allow for information to be gathered about the qualities of the

[310] For an overview of the European rules see Schulte-Nölke 2007, esp. 697–713. For a law and economics analysis see Rekaiti – van den Bergh 2000.
[311] Rekaiti – van den Bergh 2000, Haupt 2003.

purchased good. The economic problem of verifying and maintaining the quality of experience goods and credence goods is a real one. A voluntarily granted withdrawal right can indeed serve as a kind of warranty. However, it is not the only means serving this function and it is also uncertain whether this is generally the most effective one.

In the consumer contracting practice, withdrawal rights are usually regulated in the standard terms of the contract. Unless they are individually negotiable and the consumer opts out, the withdrawal right is priced accordingly into the contract. One element of the costs of the right is related to the moral hazard surrounding the buyer's use of the good. In principle, one could imagine a continuum of cooling-off periods of different lengths and conditions, all correspondingly priced, the buyer getting to choose from the menu. There are multiple reasons we still do not observe such menus. One is that such a practice would raise transaction costs significantly and the benefits of standardization would get lost.

The question can be also raised whether the voluntary provision of withdrawal periods make the legal intervention (mandatory cooling-off periods) redundant. It seems that withdrawal rights fulfill different functions in different markets. When the underlying economic problem is asymmetric and non-verifiable information or reputation, a cooling-off period or "money-back guarantee" is often offered by sellers on a voluntary basis.

In other markets, where the circumstances of contract formation are problematic, mandatory and literal cooling-off periods for the buyer might be warranted. The issue of emotionally heated choice is not equally serious in each type of sale situation. Also, cooling-off periods have some costs and drawbacks. The contract price is higher for every customer. Additionally, consumers do not have immediate access to the good or service even if urgently needed. Taking these effects into account, a cautious policy recommendation would be that withdrawal rights should be provided mandatorily only for contracts where problems are typically and systematically present. This can be especially the case with door-to-door or distance selling.

In practice, mandatory withdrawal or confirmation periods are granted in quite different contexts. Often, they are related to situations where emotional biases are strong and the stake is large enough to make *ex post* regret weigh heavily. Marriage and

divorce, surrogate motherhood and prostitution arguably belong in this category.[312] In the case of marriage, many legal systems provide a relatively long mandatory waiting or deliberation period before the union, in order to make a deliberate decision more probable. The main purpose of such rules is to provide sufficient time for reconsideration and an eventual change of mind and withdrawal before the conclusion of a long-term contract of great emotional and material significance.[313] As empirical data suggest, when newly married, people are usually over-optimistic about the success of their new relationship.[314] This effect may be counteracted by a waiting period which prevents totally spontaneous unions. However, its general effectiveness is uncertain.

Covenant marriage, which is currently available in three states of US, provides an opposite example.[315] The proclaimed goal of covenant marriage legislation is to contribute to the stability of marriages. The way to achieve this objective is allowing couples to make divorce more difficult in a self-imposed way. Couples are granted the choice to marry either in a liberal regime with no-fault divorce, or under the rules of the covenant marriage which allow divorce only under restrictive conditions.

Another example of withdrawal rights concerns the regulation of prostitution, i.e. contracts for sexual services under German contract law. A recent amendment of the BGB made such contracts legally enforceable but in an asymmetric way.[316] Since 2002, under certain conditions contracts for prostitution have been enforceable. At the same time, the prostitute as service provider enjoys a strong right to withdrawal from the contract at any point of time, even after payment by the client. The client has very limited remedies for non-performance. To be sure, this is a very special type of contract. Whether such an easy withdrawal is a sensible policy instrument in regulating prostitution or not, in a more general context it would be problematic. Contract law would be at an end if withdrawal was possible in every case of regret.

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[312] See Trebilcock 1993. As to divorce, Michael Trebilcock argues for a 60 days cooling-off period for separation agreements. For surrogate motherhood contracts he proposes to allow withdrawal for the biological mother after delivery.

[313] Another purpose might be to allow for others to object, provided they are informed.

[314] Cf. Eisenberg 1995.

[315] For data and references on covenant marriage see http://www.divorcereform.org/cov.html

[316] Prostitutionsgesetz. For the text of the legislation and practical commentary, see http://fhh.hamburg.de/stadt/Aktuell/behoerden/bsg/gesundheit/gesundheitsfoerderung-und-vorsorge/zz-stammdaten/download/prostitutionsgesetz,property=source.pdf

Returning to the domain of the regular sale of consumer goods, it should be analyzed empirically, how widespread and how differentiated the use of regulated and voluntarily granted withdrawal is, in practice. Ad hoc empirical findings show that actual withdrawal from contracts is rare.[317] Although it is hard to find an explanation for this in terms of standard law and economics, there are several psychological mechanisms that could be behind this low rate: cognitive dissonance reduction, the endowment effect (loss aversion), and self-confirming bias. Even if the buyers regret their choice afterwards, they tend to keep the good. As it has often been observed, out-of-pocket costs count more than opportunity costs; people value goods they physically possess higher than the amount they would be willing to pay for having it. If one has bought the good for cash but has it now as an endowment, he is unwilling to sell it for the initial purchase price. One may also be reluctant to send it back because in this way they would have to recognize and acknowledge that they made a wrong choice. This reluctance is aggrieved if making use of the right requires costly or burdensome procedures. In sum, it is possible that the paternalistic rule allowing people to "cool off" does not work effectively because there are other related emotional and cognitive mechanisms that have not been taken into account.

If the cooling-off period is justified in the first place, the other biases inhibiting its use should be also eliminated. One way to get around the biases that inhibit consumers from actual withdrawal is to modify the cooling-off rule in the following way. The buyer is provided a short period to confirm his decision to buy the good. Without confirmation, the contract would not be valid. As some commentators suggest, this would provide an argument for changing withdrawal periods into confirmation periods.[318]

4.3.3. Mandatory advice

There are large differences with regards to the degree and extent of contractual restrictions across countries. For instance, in England there are relatively strict formal requirements, which must be complied with, before an individual is able to pledge their

[317] Eidenmüller (2005) cites data about withdrawal rates between 0.8 to 1.8 %. Epstein 2006a: 129 cites anecdotal evidence for the irrelevance of the rule in practice.
[318] Eidenmüller 2005.

land as surety against their spouse's loan, while in Germany the limits placed upon this, are much less strict.[319] As mentioned above (section 4.3.1), one kind of qualified formality is to require that (one of) the parties take the advice of a third, uninterested party before signing the contract. This advisory party can be a financial consultant for credit contracts, or a notary in other cases. As we have seen, in Continental legal systems many contract types require a notarial form. The idea here is that the legal expertise of the notary should provide a safeguard against uninformed or misinformed self-binding obligations.[320] This brings the notarial form close to the mandatory independent advice requirement. To be sure, there is much variance in the doctrinal and technical details of these requirements across jurisdictions. This leads to one asking a general question first, as with formalities and withdrawal rights: why is the seeking of such advice made mandatory?

In practice, contracting parties often use the services of advisors and experts on their own initiative. In theoretical terms, to ask for such services is a second-order decision which can work as a device to cope with one's lack of information or bounded rationality.[321] Making this assistance mandatory is potentially paternalistic; it needs further justification. One justification may be the existence of possible third-party effects. When the validity of a contract requires the assistance, authentication or other collaboration of a public authority, this may facilitate the control of the contract's content under other aspects (e.g. taxation or other third party interests). However, when such considerations are not present, the economic rationale of the rule is questionable.

From an economic perspective, the problem is similar to product liability or a warranty. Making these terms mandatory is often characterized as mandatory insurance. There is now a huge economic literature discussing when such regulation is efficient and what its distributive consequences are.[322] The two main factors that matter in this respect are the market structure and the homogeneity or heterogeneity of the customers. Specifically, with regard to independent advice this means the following. Unless the advice is financed out of taxes or its price is otherwise regulated, the costs of such expert services are borne by the customers, i.e. the class of the (alleged) beneficiaries,

[319] See Collins 1999: 174–175.
[320] On the precise rules see Mehren 1998.
[321] Sunstein – Ullmann-Margalit 2000.
[322] See, e.g. Schäfer – Ott 2004, Rubin 2000.

either separately, or included as part of the underlying contract price. Whether there is a cross-subsidization within the class depends on its homogeneity and on the competitive structure of the market.[323]

The issue might also have a political economy aspect as well. The mandatory use of experts is somewhat similar to the case when professional licensing is justified by "the customers' need for protection". In such cases, economists often find that the true motivation behind the regulation is the rent-seeking activity of a well-organized group of professionals. These professional groups are trying to create, extend and/or protect the market for their services. Such possibilities should make one careful about the arguments for mandatory contract terms which are coming from stakeholders.

A special case of mandatory advice is related to suretyship and guarantee contracts. Currently, these are the subject of an ongoing discussion on a new European regulation.[324] For a couple of years, some public attention has been attracted to these issues by controversial judicial decisions in Germany (*Bürgschaftsfälle*), England, and elsewhere. In some of these cases, family members, typically wives and parents were exempted from their contractual obligations as sureties, essentially on fairness grounds. Sometimes even their constitutional rights have been evoked.[325]

Do these people need special legal protection? If so, in which form? As Michael Trebilcock and Steven Elliott have argued in a thoughtful paper, financial arrangements involving family members confront the economic analysis of law with extremely complex problems.[326] On the one hand, within the family, calculativeness is less pregnant, while altruism is frequent. On the other hand, strong personal ties often imply power relations of such intensity that they would require, in an extra-familial context, a strict legal response. Still, there are strong reasons against interference with family finances.

From an economic perspective, what mainly matters are the incentive effects of such protective rules. In this view, even if it is put into practice through *ex post* judicial decisions, paternalism should be assessed from an *ex ante* perspective. There is a wide

[323] Craswell 1991.
[324] See e.g. *European Review of Private Law* vol. 1 (2005) issue 3.
[325] On the impact of constitutional law and human right on contract law see the Conclusion, esp. note 439, below.
[326] Trebilcock – Elliott 2001.

range of options, from non-intervention through case-by-case assessment, to general prohibition. Trebilcock and Elliott suggest that paternalistic protection by mandatory procedural rules represents a sensible solution. They consider the best way to handle family surety cases is by requiring the surety to take independent advice on the legal and economic consequences of her obligations and to make this rule mandatory. This procedural limitation on freedom contract is, of course, costly. Nevertheless, it serves as a safeguard against more serious losses On the other hand; it still leaves the ultimate decision with the surety.[327]

4.3.4. Information provision and disclosure

Contract law deals with several situations where typically, at least one contractual party has imperfect information. Both asymmetric and symmetric informational imperfections are possible cases for soft paternalistic intervention, i.e. regulation promoting well-informed choices.

In general, the regulation of information provision and disclosure is not easily distinguished from paternalism. The question here is: how much information is required for the exercise of an autonomous choice. Or stated differently, if one party to a contract is substantially less informed about some aspect of the subject matter than the other, should contracts be unenforced or enforced on different terms, on that account. The problem is, of course, that information is almost always imperfect. In terms of the doctrines of common law these cases of information failure include fraud, negligent misrepresentation, innocent misrepresentation and material non-disclosure.

Symmetric information imperfections are covered by contract doctrines such as frustration, contract modification and mutual mistake. These legal doctrines define the scope of permissible private or judicial adjustments to contractual relationships in the light of new information. The law and economics literature generally argues that in long-term relationships there are a range of contractual and other strategies for adjusting the allocation of unknown and remote risks: explicit insurance, hedging in futures markets, indexing clauses, ‘gross inequities’ clauses, arbitration, and others. The absence of such devices from a long-term contract arguably implies that the promisor

[327] Ibid.

agreed to assume the risk in question. Still, there might be cases when this sort of informational deficiency justifies mandatory legal rules.[328]

Economists in general view information regulation not as paternalism, not even as addressing individual consumers. It is rather considered as the correction of a market failure, the improvement of market efficiency which is a macro phenomenon. The starting point for the economic literature on information-based market failures is that the information possessed by consumers about product characteristics and prices in markets is incomplete.[329] The implied role of government concerning information about product characteristics is to encourage market forces to provide incentives to reveal the quality of products. These information remedies can be categorized into three classes: (1) removing information restraints; (2) correcting misleading information; and (3) encouraging the supply of additional information.

Examples of the first class mentioned above would be "to prohibit restrictions on advertising by professionals such as optometrists, dentists, accountants and lawyers" and "canceling general trademarks such as aspirin and cellophane."[330] The second implies legal restrictions on fraudulent claims in product advertising and on product packaging, while the third requires the "standardization of the definition of terms and the establishment of scoring systems for measuring important product characteristics; mandating disclosure, often linked to a standardized metric."[331]

Disclosure rules in contracts regulation require the knowledgeable party to supply a less knowledgeable party with different types of information, either before or after, the conclusion of the contract. Recently, the consumer protection policy of the European Union has been mainly focusing on information provision.[332] Information-forcing or penalty default rules (cf. section 4.1.1.) give indirect incentives for such disclosure.

Government regulation of the content, presentation, location, structure and format of the information on product labels is crucial. However it is also important to acknowledge that "providing too much information on a product label can be

[328] For more on this see Trebilcock 1993: ch.6 (p 127–146).
[329] Magat 1998: 308–309.
[330] Magat 1998: 309.
[331] Ibid.
[332] For a critique of the information model of EU consumer protection based on behavioral law and economics see Rehberg 2007.

counterproductive in the sense that label clutter reduces total recall of the information on it."[333]

Either disclosed by central agencies, or contracting partners (producers), such information is usually technically complex and the consumer has limited abilities to process it. For information-based regulation to work, information-processing by consumers is crucial. In this respect, behavioral law and economics scholars have proposed several new insights.

I have already discussed the regulative idea of "debiasing through law" and mentioned its implications for product safety regulation.[334] It is a well-established fact that consumers are asymmetrically uninformed about the safety features of most of the products they purchase. Mandatory disclosure requirements are a wide-spread legislative response to this kind of informational asymmetry, both in the United States and in Europe.[335] In principle, this is a preferable way of intervention, as information provision respects individual choice. In practice, disclosure does not necessarily work well. One reason for this is that people do not process the information in a rational way. Not only that they deviate from Bayesian theory. Even if their understanding (estimations) of the general risk probabilities is correct in a statistical sense, they are overly optimistic about the occurrence of safety risks in their own specific case. In the psychological literature this is called over-optimism bias. The idea of debiasing through law is to remedy this bias by making use of another, the availability heuristic. By using vivid and personified examples, the tendency towards underestimation of personal risks can be compensated. If people are confronted by a story about a recent real-life case of harm caused by a defective product, they become more aware or even overly aware of the risks involved.

To be sure, this rudimentary idea of debiasing through law should be refined in many ways before making actual use of it in information regulation. Even if the psychological argument is sound, a traditional legal scholar would definitely have a large number of doctrinal and systemic arguments as to why the idea cannot be easily put in legal form. Still, the basic notion behind this regulatory idea is plausible, some

[333] Magat 1998: 310.
[334] Jolls – Sunstein 2006, see section 2.4.3.
[335] See e.g. Grundmann – Kerber – Weatherhill 2001.

would even say trivial. The way information is communicated matters. Consequently, information should be provided to people in a way that allows them to process it properly. Or if they process it poorly, the way of provision should be calibrated accordingly.

In sum, the mere provision of more and more detailed information does not necessarily make the consumers' choice more rational and autonomous. "The maximal effectiveness achievable by information remedies is limited: public policy makers must choose among (1) less then perfectly effective information-based policies, (2) imperfect forms of direct and more restrictive regulation, such as product bans and quality standards that override market decision making, and (3) no intervention thus unregulated but inefficient markets."[336] Information provision is an imperfect tool for paternalistic intervention.

4.4. Substantive limits of freedom of contract

As we have seen, procedural rules require certain actions to be taken (or not taken) either before contracting or during the contractual relationship, without constraining the parties from agreeing on terms they find fit. Substantive rules, in contrast forbid the agreement on certain contractual terms or on certain subjects. Instead of the *how* they regulate *what* individuals can legally (enforceably) promise to another. Logically, substantive rules can be either mandatory or default rules. Substantive limits are extremely numerous and varied in modern legal systems, especially in their mandatory variant. Most rules of labor law, tenancy law, or consumer protection law belong here. As long as these rules are imposed on individuals in order to promote their good, these are the most straightforward examples of paternalistic intervention in contracts. Because of the heterogeneity and extent of such rules, no systematic analysis is provided here. In this section I will rather focus on a few general clauses that are characteristic of most modern contract law regimes.

[336] Magat 1998: 312.

4.4.1. Unconscionability and unfairness: procedure and substance

Besides formal requirements, modern contract law regimes regulate the content, i.e. the substantive provisions of different contracts to a great extent. In a couple of cases, these two aspects are not clearly separated. When a contract term is unenforced for unfairness, unconscionability or gross disparity, the procedural and substantive reasons evoked are often combined. At any rate, most of these rules can be backed by paternalistic justifications.

The Anglo–American doctrine of unconscionability[337] technically operates as an excuse. In the case of a sales contract, when the seller wants to collect the price, the buyer may refuse, by referring to the formal and substantive unconscionability of the contract as an excuse for non-performance. This doctrine has been interpreted in an enormous amount of legal literature, especially in the US.[338] In different European contract law regimes, there are other doctrines that serve a similar function. This substantive control of the contract is usually done *ex post* by the judiciary, by applying a general clause of the respective civil code, most notably some version of an objectivized requirement of good faith. It may be interesting to identify and analyze the case-groups where unconscionability stands as a legal *façon de parler* for paternalism.

Let me start the comparative overview with the rule of the UNIDROIT Principles on International Commercial Contracts. It should be noted right at the beginning that between merchants judicial cases about contract terms based on gross unfairness *per se* are extremely rare. Nevertheless, art. 3.10 of the Principles on "gross disparity" is designed to police the combination of procedural and substantive unfairness. In this rule the civil law concept of *lésion* merges with the common law notion of unconscionability. The rule seeks to identify remedies for abuse of the weaker party which keep the contract alive, rather than undo it as is the case under most national laws.[339]

[337] An early law and economics analysis of unconscionability is Epstein 1975. For the comparison of mainstream and behavioral economic arguments on unconscionability see Korobkin 2003, 2004. See also Schwartz 1977, Collins 1999: ch. 11, Hatzis – Zervogianni 2006, Spector 2006.
[338] Scott – Kraus 2003: 553–569.
[339] Bonell 1997.

In national laws, there are different solutions. One approach, followed by Germany's civil code (BGB §138), the Scandinavian Contract Law (Arts. 31 and 36) and the Civil Code of Québec (Arts 1406 and 1437) is to deal with procedural and substantive unfairness separately. Thus, besides cases where one party takes unfair advantage of the weakness of the other party in order to obtain an excessively favorable bargain, there are cases where contract terms are deemed to be "grossly unfair" *per se*, and set aside even without procedural unfairness.

The other approach is to combine the two aspects in a single provision. This makes it possible to grant relief only for substantive unfairness. This is the case with art. 3(1) of the 93/13 EC Directive, or art. 110 of the Algerian Civil Code, albeit for standard forms only.

The UNIDROIT rule has two requirements for avoiding a contract or an individual term.[340] There should be "gross disparity between the obligations of the parties which gives one party an excessive advantage". Therefore the disparity between the values exchanged must be excessive. The disequilibrium must be so great as to shock the conscience of a reasonable person.[341] Second, "the excessive advantage must be unjustifiable". This is in line with the tendency which is becoming more and more prevalent in domestic laws, to consider procedural and substantive unfairness as two distinct, but in most cases interrelated matters.

This interrelatedness is the case in a third group of contract codes, namely art. 21 of the Swiss OR, art. 1448 (1) Italian civil code, §18 of the Israeli General Part of the Law of Contracts. French, German, English, Australian and US courts also are inclined to find unconscionability where elements of both procedural and substantive unfairness are present.[342] The former means the absence of a meaningful choice by one party. Courts speak of the latter occurring when the contract reallocates the risks of the bargain in an objectively unreasonable or unexpected manner.[343]

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[340] Bonell 1997: 162–168.
[341] Comment 1. to Art 3.10 of the UNIDROIT Principles.
[342] Bonell 1997.
[343] As to the remedies, France, Belgium and Austria know gross imparity (*laesio enormis*). The civil codes in these countries provide that the judge should set a fair price. In England, the remedy is rescission. In Switzerland the High Court has the power to modify the contract. In Germany, BGB allows for the adjustment of excessive penalty clauses or, for instance, in a long term beer supply contract, the duration clause can be adjusted to be reasonable. In the UNIDROIT Principles the sanction is, normally,

In fact, unconscionability is not always about the substance of the contract. Imagine there is a fully riskless, but simply involuntary, exchange at issue. Here to make a judicial remedy available might be necessary in order to provide incentives against coercion, fraud or misrepresentation (cf. section 4.2). Still, as long as it is practically impossible to test the state of mind of the contracting parties, and the other doctrines would need this proof, unconscionability can be used as a *proxy for involuntariness*. If the consent was not voluntary or informed, and the requirements for a formation defense are difficult to prove for practical or evidentiary reasons, unconscionability can provide relief. This is the way Richard Epstein interprets the unconscionability doctrine. As he argues, obviously inefficient contracts should be taken as presumptive evidence of some underlying problem such as incapacity or fraud, which are sometimes too hard to prove directly.[344] As an empirical generalization, gross disparity or value inequality between the two performances may signal involuntariness. Based on this generalization, voluntariness and full information might be ascertained through substantive fairness rules.

In fact, as Richard Posner argues, this is the way some courts interpret the rule in the US. "Inadequacy of consideration is always potentially relevant as circumstantial evidence of duress, mistake, fraud, or some other ground for setting aside the contract. The less adequate it is, the stronger the evidentiary effect will be."[345]

In the other extreme, the question can be raised whether purely substantive limits on contractual freedom can be justified in order to protect the interests of one contracting party? This would be a clear-cut case of hard paternalism. Suppose the contract was formed fully rationally but under uncertainty. If unconscionability is applied in case of the transfer of a good of uncertain value, this may facilitate simple opportunism by the buyer. After finding out that he had had bad luck, i.e. the low-value case materialized, he refuses to pay and asks the court for assistance to rescind from the contract. Only those with bad luck go to court, or more precisely their partners have to go there because of non-payment. To give relief in these cases is clearly inefficient as it gives incentives to engage in opportunism.

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the avoidance of the contract or its individual terms. But on request of either of the parties, the court or arbitral tribunal decides whether to avoid or adapt the contract, and, if adapted, on which terms.

[344] Epstein 1975.

[345] R. Posner 1998: 111.

It follows from the very binding nature of contracts that the realization of a previously known risk or in other words, *ex post* regret is not a sufficient reason to allow withdrawal. We discussed in section 4.3.2 cooling-off periods as procedural techniques which relax this bindingness to some extent. The justification of this exception is related to the circumstances surrounding the conclusion of the contract. Also, in a few other cases the *ex post* welfare or interests of a party may matter and eventually justify withdrawal, but these cases are rare exceptions. At any rate, procedurally fair but risky exchanges are not the central domain of application of the unconscionability doctrine.

When *ex ante*, i.e. at the time of conclusion, the consent was substantively voluntary and well-informed (in the sense discussed in section 4.2.), no procedural unfairness occurred. In such cases, autonomy-based theories cannot justify intervention. In contrast, a simple welfare-based theory can. Indeed, such an intervention would be a pure case of paternalism: overriding a voluntary action of someone in order to promote her welfare.

The claim that people know their interest best is an empirical generalization. In the rare cases when it is false, mandatory terms, judicial modification or non-enforcement of the contract can be, in the main, justified paternalistically. This raises the question: should then clearly inefficient contracts be left unenforced or modified? At first sight, welfarism implies this. However, the answer would only be affirmative if we abstracted from the institutional setting in which the question is raised and the wider set of incentive effects such intervention induces. If we take these into account, the welfarist case for paternalistic intervention becomes much weaker.

As a matter of fact, there can be clearly inefficient contracts which the parties conclude substantially knowingly and voluntarily, after an erroneous evaluation of the promised performance. In some individual cases, courts can be better at judging the efficiency of the transaction than the paternalised party. “If an expensive English-language encyclopedia has been sold to a childless couple that does not even speak English, or if fifty years’ worth of dance lessons have been sold to an eighty-year-old

widow, it is difficult to argue that – at least in these cases – a court could not make a better judgment that made by the individuals involved."[346]

Granted this might be the case, the next question is whether courts are, *as a rule*, better at identifying such cases than the parties themselves. Courts also make errors in identifying inefficiency. It is a close question whether the total loss from errors can be minimized by allowing or prohibiting such interventions. In many modern contract laws, there are rules that help judges in classifying cases, or set further restrictive conditions for granting relief. For instance, to qualify for a remedy, the unconscionability has to be 'extreme', 'gross', 'obvious', etc.[347]

An additional argument against intervention is more theoretical. It is based on the consideration that it is not only the efficiency of the *performance* of contracts which matters, even from an economic perspective. As Richard Craswell has argued, modern economic theory of contracts links the enforceability of promises not simply to the efficiency of performance but to the overall incentive effects the contract generates. The set of actions to be taken into account when calculating the net incentive effects includes pre-contractual behavior, reliance, precaution against non-performance, mitigation and a number of other choices and decisions.[348]

Especially in unconscionability cases, two further effects are relevant. The non-enforcement of such contracts would "change sellers' incentives to seek out certain kinds of customer, or to raise the price charged to an entire class of customers who might later be released by courts."[349]

After the American case *Williams v. Walker–Thomas Furniture Co.*[350] had been decided in favor of the low-income customer, based in part on the argument that a contract with a cross-collateralization clause is unconscionable, much attention has focused on both legal and economic aspects of the problem. The federal government commissioned sociological and economic research on the characteristics of the consumer durable markets where cross-collateralization and other 'unfair' clauses were supposed to be especially prevalent. It turned out that both in economic and in

[346] Craswell 2001: 37–38.
[347] Cf. the Latin term laesio *enormis.*
[348] Craswell 2001.
[349] Craswell 2001: 38, cf. Schwartz 1977: 1076–1082.
[350] *121 U.S. App. D.C. 315, 350F. 2d 445* (1965).

sociological terms, there are significant differences between the low-income and middle-income segments of these markets.[351] One of the differences is this: "Low income customers may be purchasing a particular sales method more amenable to their backgrounds and traditions. Immigrants from a rural world may seek not only the physical good but also a personalized sales method. Prices to customers will rise with the increased costs of buying from a sales person who knows one's name, one's family, and one's interests and who consents to talk about them."[352]

This suggests that the reason for higher prices in certain market segments is not simply oppression, fraud and the like. Rather it reflects economic characteristics, such as higher credit risk, collecting costs or marketing costs in the particular market segment. These contracts are not necessarily unconscionable; ergo they should not be abolished. "The court should look to comparable markets and adjust for cost differences to the seller."[353]

To be sure, this argument cannot answer all fairness-related concerns. There are different ways to understand "unfairness" in consumer contracts. According to economic theory, the test should be based on what reasonable parties would have agreed to in the absence of transaction costs. For instance, it is reasonable to assume that they would have allocated risks to the cheapest cost avoider. When it is not reasonable to prevent the risk but insurance can be bought, risk should be allocated to the cheapest insurer; when insurance is not available, to the superior risk-bearer.

In fact, there are many empirical investigations into whether real-world contracts are unfair in this economic sense. As anecdotal evidence, consider the recent examples when the bounded rationality of customers is exploited by health clubs or mobile phone companies which charge high switching costs or exit costs. Nevertheless, even when it can be established that the contract price or a particular practice is not efficient, the remedy for unconscionability may not lie with the courts. Such practices are often also sanctioned in competition law, for good reasons.

If the existence of oppressive terms or exorbitant prices is not due to fraud, duress or misrepresentation, then they may be related to market imperfections. Private

[351] See Collins 1999: 106–7, 262–265, Korobkin 2004.
[352] Kornhauser 1976: 1171.
[353] Kornhauser 1976: 1180.

litigation is a very ineffective way to redress such problems. There are economic arguments against judicial intervention in such cases.

As discussed above, non-enforcement leads to a moral hazard problem for the "weaker party". It can also induce opportunistic behavior by the stronger party who can take his chances and include potentially unconscionable clauses in the contract, considering that in the worst scenario, his surplus is reduced by the court to the normal rate. One solution to this latter opportunism may be to void the contract if the key terms are unfair or unreasonable, but this remedy is not always available or desirable. Judicial solutions to unfairness also lead to inequity, as private adjudication is by its nature unable to compensate every consumer for their losses. "Persons who failed to purchase because of too high prices or too low quality have no cause of action though these unrealized sales represent the efficiency loss of the market."[354]

In sum, procedural unfairness can justify soft paternalistic intervention both under an autonomy and welfare account. Substantive unfairness can be given an economic interpretation as well. But private litigation is an ineffective and potentially counter-effective remedy: legislative or administrative remedies are thus necessary. Contract law and the judicial remedies for unfairness should concentrate on procedure and not on substance.[355]

4.4.2. 'Immorality' as paternalism?

There is a striking similarity across jurisdictions about the typical cases where either the nature of the transaction itself or the motivations behind it are deemed "against good morals".[356] Here I only refer to one group of cases, those related to sexual morality. For instance, a contract for taking contraceptives is against good morals and void in Germany.[357] The German Administrative Court has ruled that peep shows are illegal as violating the inalienable human dignity of women.[358] In contrast, as noted in section 4.3.2, for paternalistic reasons the contract for sexual services is not illegal as such but it

[354] Ibid.
[355] Cf. Hatzis 2006a.
[356] For an overview of these case-groups in French, German, Swiss and English law, see Menyhárd 2004: 89–92.
[357] Kötz – Flessner 1997: 110 n.91.
[358] *BVerwGE* 64, 274; 84, 314. Cf. Enderlein 1996: 158ff.

is practically unenforceable against the prostitute. (Recall, this is formally a kind of cooling-off period that can be used by the "seller", after the performance of the "buyer".)

In other countries where prostitution is illegal, arguments similar to those discussed with regard to commodification (section 2.2.5.) and exploitation (section 4.2.3.) can also be raised. By prohibiting, usually poor, individuals to make their life by offering sexual services, their revealed preference for this work is overruled and their voluntary choice limited. As a consequence, it leads to the double bind effect, as discussed above. As a result, the persons supposed to be protected may come out worse off with the prohibition than without. To be sure, the prohibition of contracts violating sexual morality can be backed by several non-paternalistic arguments. Social burdens, externalities, exploitation might all be relevant. What makes the issue a deep moral problem is that a fundamental conflict between autonomy and human dignity seems to be at stake. Whether such a conflict is in fact possible will be further discussed in the Conclusion.[359]

4.5. Paternalism through contract interpretation: the contra proferentem rule

4.5.1. Policy purposes and the incentive effects of contract interpretation

Much has been written in the doctrinal legal literature on the modes of contract interpretation – explaining their historical background, comparing various jurisdictions, interpreting and systematizing case law, or arguing for a particular interpretative method.[360] It seems probable that there is no single method that would be overall

[359] Besides immorality, another doctrinal category should be mentioned. Illegality is a catch-all category of various reasons which only have in common that they are prohibitions outside the domain of contract law. As discussed above (section 2.2.5.) these restrictions can be either justified by externalities or backed by legal moralism.

[360] On the doctrine in the US see Scott – Kraus 2003: ch. 6; on contract interpretation in European jurisdictions see Kötz – Flessner 1997: ch. 7; on France see Ghestin – Jamin – Billain 2001: 18–75. Useful overviews of legal scholarship on contract interpretation: Farnsworth 1967 (focusing on common law countries) and McMeel 2005 (with main focus on England).

desirable, and thus, that a pluralist approach should be preferred.[361] This insight alone, however, is too general to be useful in institutional design or as a theory of adjudication. It should be fleshed out with empirical hypotheses and normative criteria for the prediction and evaluation of the likely consequences of the use of different methods of interpretation under different circumstances. Now, in order to build such a full-fleshed theory, much more information would be necessary than is currently available. It is thus not surprising that most theorists merely suggest a couple of heuristics, i.e. relatively simple rules. These heuristic rules should guide interpretation for groups of cases that show certain common characteristics; but they usually leave the domain of application and the "rules of conflict" between heuristics unspecified. For instance, a rule of thumb can look like this: "when X prevails, follow a more formalist interpretation, other things being the same".[362]

Still, there is one important, though elementary, insight that should inform every normative theory of contract interpretation that aspires to be of practical import: the method of interpretation influences how parties write their contract. More generally, rules of interpretation are not simply tools in an *ex post* epistemic (hermeneutic) exercise: they have a profound effect on party behavior *ex ante*, both on the drafting of individual contracts and more widely on the changes in business standards and trade usages. A theory of contract interpretation should take these incentive effects into account.[363]

[361] Cf. Greenawalt 2005. As George Cohen (2000: 97) notes, "courts do not – and never will – use pure interpretive methodologies, but tend to switch back and forth depending on the circumstances." Of course, legal scholars have a lot to say on the question which pattern this "switching" should follow. From a law and economics perspective, Cohen suggests that the choice between textualism and contextualism should depend on (1) the transaction costs of drafting, (2) the relative likelihood of court error and (3) the risk of opportunistic behavior (Cohen 2000: 78).

[362] For instance, textual-formal interpretation is relatively more important for experienced commercial parties while contextual (substantive) interpretation is better suited to transactions involving consumers and other non-sophisticated parties (Katz 2004: 538). Katz lists several simple heuristics for the choice between formal and substantive contract interpretation. For alternative suggestions see Schwartz – Scott 2003: pt. IV (p. 569–594), Kostritsky 2007.

[363] For the law and economics literature on different aspects of contract interpretation see e.g. Goetz – Scott 1985, Ayres – Gertner 1989, E. Posner 1998, Cohen 2000, R. Posner 2005, Shavell 2006, Hermalin – Katz – Craswell 2006: 63–94, Kostritsky 2007. For economic arguments against paternalism in business contracts see Schwartz – Scott 2003: 609–618.

In the doctrinal legal literature the common intention of the parties is considered the "natural" or straightforward starting point of contract interpretation.[364] This is mainly due to the fact that the implicit, or often explicit, contractual theories behind the rules of Western legal systems (i.e. bargain theory, will theory, party autonomy) are reflected in contract interpretation. As we have seen in chapter 3, there are both deontological and consequentialist arguments supporting the view that the main function of contract law is to enforce promises, when certain conditions are fulfilled, and thus provide legal assistance to private parties in realizing their goals in a cooperative way.

It is important to note that this link between contract theory and method of interpretation applies to the exceptions as well. Freedom of contract is a general principle of contract law; still many substantive rules are not supposed to enforce the parties' intentions, actual or hypothetical. Rather, they set limits to freedom of contract. Similarly, while the objective of contract interpretation is, at least ultimately, the enforcement of the parties' bargain, in some cases the immediate goal is not to find and give effect to the intentions of the parties but to achieve other ends.[365] In fact, the question whether and how interpretation can be used in contract regulation has been constantly raised in contract law scholarship since its inception.

In this section I analyze the different versions of the *contra proferentem* doctrine. *Contra proferentem* refers to a specific group of contract interpretation rules which divert from the general concern with parties' intentions and reflect policy considerations, in part paternalistic ones. The doctrine provides that ambiguities in the language of a written contract should be construed against the drafter of the unclear contract clause. According to a modern American commentator, the "rule is not actually

[364] Besides national legal systems (art. 1156 French Civil code; §133, 157 German BGB; Art 1362 Italian Codice Civile; Art 18 Swiss Law of Obligations; §1425 Québec Civil code; 2-202 UCC; Restatement (Second) of Contracts, etc.), various international agreements and "soft" legal instruments contain rules on contract interpretation (Art 8 CISG; Art 4 UNIDROIT Principles; Ch 5.101 Principles of European Contract Law.).

[365] "*It is striking that some interpretative rules of construction take as their starting point not the intent of the drafting parties (which would resemble majoritarian gap-filling), but instead the interpretation which is least favorable to the drafter. Such rules are strong evidence that common law lawmakers have long understood the value of information-forcing rules. The contra in contra proferentem rightly suggests a penalty; the interpretative presumption is not chosen because we think that the most negative interpretation is what the drafter or even the draftee normally wants, but rather because the rule of construction is a stick to force drafters to educate non drafters."* Ayres 2006: 596. Below, I discuss the information-forcing function of the *contra proferentem* rule in detail.

one of interpretation, because its application does not assist in determining the meaning that the two parties gave to the words, or even the meaning that a reasonable person would have assigned to the language used. It is chiefly a rule of policy, generally favoring the underdog."[366]

On the explanatory level, I discuss the origins and different versions of the *contra proferentem* rule as an element of the interpretative canons in these contract law regimes and the ways the rule has been used in the service of various policy purposes, including paternalism. Normatively, I analyze the potential justifications for the *contra proferentem* rule. I argue that the *contra proferentem* rule should be conceived of, and used as a penalty default rule, i.e. an instrument to incentivize the drafting of contracts in optimally clear language. I also discuss the interpretation of insurance policies as an example.

4.5.2. Comparative overview

In the Romanistic legal systems, there are several maxims of interpretation in the respective civil codes. One maxim provides that terms shall be interpreted in light of the whole contract or statement in which they appear; another that contract terms shall be interpreted so as to give effect to all the terms rather than to deprive some of them of effect.[367] These maxims are rooted in Roman law, as collected in Justinian's Digest and further commented upon during the late Middle Ages and the early modern period. The Roman law rules themselves can be traced back mostly to the period when Greek philosophy (dialectics and rhetoric) had some impact on Roman legal thinking. Nowadays, the general opinion about these maxims is that they are of little practical use as *codified* rules: they merely state what common sense would tell the judge anyway.[368]

[366] Corbin 1998: 306.

[367] See art. 1157, 1158 French Code civil, art. 1284 and 1286 Spanish Código civil, art. 1367–1369 Italian Codice civile, art. 4.4–4.5 UNIDROIT Principles. In the Middle Ages, these maxims were transmitted to and became known in English law as well. During the drafting discussions of the German BGB the codification or otherwise of these non-substantive rules was explicitly considered and rejected. Later codifications, like the Hungarian (1959) or the Dutch Civil code (1992) do not contain maxims of interpretation either.

[368] In France, this list of maxims is sarcastically called "*guide-âne*" in commentaries. Indeed, their relevance is minor as the *Cour de Cassation* has decided very early that these interpretative rules do not have a normative (obligatory) character – they simply serve as facultative rules or recommendations to judges. In practice, this means that the judgment of a lower court cannot be revised based on the violation

Origins and Continental development

Among these maxims is art. 1162 of the French Code civil, the rule *contra stipulatorem* which originates from the Roman jurist, Iuventius Celsus.[369] This rule is also codified in a number of other legal systems but, as we shall see, it is of a very different nature than other interpretative maxims. In modern contract law, the *contra proferentem* rule means that an ambiguous contract term should be construed or interpreted against the drafter, or more precisely against the party who "proffers" it or who wishes to rely on it in a contract dispute. Some version of this rule can be found in common law jurisdictions (UK, USA, Canada, India), the Romanistic legal family (French, Belgian, several Latin American civil codes), as well as in the Austrian civil code as a general contract law rule.[370] Later, starting with Italy in the 1940s, the rule has been codified in the rules for standard form contracts in many countries. In a third wave, from the 1970s, the *contra proferentem* rule has been explicitly used as a means of consumer protection – now figuring in the various legal instruments used for regulating consumer contracts.

According to art. 1162 of the French Code Civil, "in case of doubt, an agreement shall be interpreted against the one who has stipulated, and in favor of the one who has contracted the obligation".[371] According to art. 1602 (2), in a sales contract "any

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of the maxims. Similar applies to England: "The 'canons of construction' and the Latin maxims which most lawyers associate with the exercise of interpretation are almost redundant in practice." McMeel 2005: 262.

[369] On the origin of the *contra stipulatorem*/*contra proferentem* rule see Troje 1961, Wacke 1981, Krampe 1983, 2004, Honsell 1986. These accounts subscribe to different (partly incompatible) theories regarding the original function and meaning of the rule.

[370] Characteristically, the rule was included in all the European codifications until the end of the 19th century, e.g. in the 1794 Allgemeines Landrecht in Prussia (I 5 §266), the 1865 Civil code of Saxony, and the civil codes based on the French one (Italian Civil Code of 1865, old Dutch Civil Code) but not in the general contract law rules of the later ones, like the German BGB (1900), the new Italian (1942) or Dutch Civil Code (1992). As I will discuss later, these countries have codified the *contra proferentem* rule for standard form contracts only. Later, mainly in accord with the European directive, every (non-negotiated) consumer contracts became subject to the rule too.

[371] Translation from Legisfrance, http://195.83.177.9/code/liste.phtml?lang=uk&c=22&r=448. Although historically art. 1162 derives from the Roman rule *contra stipulatorem*; the drafters of the Code civil (Domat and Pothier) understood the rule as a special case of art. 1315 which allocates the burden of proof to the party who is claiming the fulfillment of an obligation. Thus if the non-drafting party wants to take advantage of a clause, in the codificators' view it should be interpreted against him. Alternatively, we can interpret art. 1162 as a rule against the drafter (with reference to the function of the rule in the Roman *stipulatio*). Ghestin et al. argue (2001: 47) to cut short the dispute between the two historically rooted interpretations of art. 1162 and understand it as a mandatory interpretative rule for the courts in favor of the consumer. But this pragmatic solution is neither necessary nor sufficient. It is not necessary because

obscure or ambiguous agreement shall be interpreted against the seller."[372] The first rule, called *contra stipulatorem*, works in a tricky way. Within a typical bilateral contract, it can favor either party. Reading the rule literally, in case of doubt every contractual duty is to be interpreted against the promisee (creditor) and in favor of the promisor, i.e. the party who is obliged to fulfill the duty (debtor). In contrast, the presumption for sales contracts always works against the seller. At first sight, both of these rules seem to be at odds with the ascertainment of the common intention of the parties. Especially the first one looks too complicated to serve any clear purpose. In order to understand the original meaning of these rules, one has to go back to their Roman law origins.[373]

In the Middle Ages, along with other fundamental changes in contract law doctrine and theory, these two specific rules (*ambiguitas contra stipulatorem* and *ambiguitas contra venditorem/locatorem*) were generalized and given the current common name: *ambiguitas contra proferentem*, meaning "in doubt against the drafter". The medieval jurist Bartolus interpreted and to some extent supplemented the rule in the sense that it also applied "to the party in whose interest the ambiguous term has been added to the contract". The usual justification for the rule was that he who has caused an ambiguity could (and should) have spoken more clearly. During all these centuries, the rule was claimed to be a last resort rule. At least rhetorically, judges argued that the rule

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the Consumer Code already provides a rule in favor of the consumer. And it is not sufficient because it does not tell how to use art. 1162 when both parties are professionals or both private. In my view, art. 1162 should be interpreted as an against-the-drafter rule; the burden-of-proof issue being regulated by art. 1315.

[372] Translation from Legisfrance, http://195.83.177.9/code/liste.phtml?lang=uk&c=22&r=523

[373] The *contra stipulatorem* rule is only mentioned in a small number of places in the Digest and nowhere else in Roman law sources: *D. 34, 5, 26* (Celsus), *D. 45, 1, 38, 18* (Ulpianus), *D. 45, 1, 99pr* (Celsus). The rule applied to an ancient formal verbal contract called *stipulatio*. In order to make a promise binding and enforceable, one of the parties, the stipulator asked a question ("do you promise me X?"), immediately after which the promisor had to answer with the exact same words ("I do promise you X"). In this way, a unilateral obligation was created in favor of the stipulator. As by the construction of the ritual the stipulator was the one who formulated the words of the obligation and the other party was not able to modify or supplement the terms, Roman jurists argued that any ambiguity should work against him. This is the origin of the *contra stipulatorem* rule.

Later, in classical Roman law, several less formal (consensual) contracts emerged, *emptio-venditio* and *locatio-conductio* among them. In both *emptio-venditio* (sales contract) and *locatio-conductio* (a catch-all term for various labor, service, lease and rental contracts) the essential terms of the contract have been usually supplemented by so-called additional formless agreements (*pacta*) regarding additional special provisions. These agreements were in practice formulated by the vendor. The interpretative presumption *contra venditorem/locatorem* which also figures in a few Digest rules worked thus against the drafter of ambiguous *pacta* and has been justified by Roman jurists Papinian and Paulus as "the vendor could have spoken more clearly". *D. 2, 14, 39* (Papinian), *D. 18, 1, 21* (Paulus), *D. 50, 17, 172pr* (Paulus).

is only applicable when all regular interpretative methods were insufficient to clarify the ambiguity.

Common law development

In common law countries the age-old maxim *verba chartarum fortius accipiuntur contra proferentem*, already referred to by Bacon, Coke and Blackstone, has been used not only in contract interpretation and the closely linked law of evidence, but in the law of deeds as well.[374]

In Britain for several centuries the *contra proferentem* doctrine has primarily been applied to contract clauses that purport to limit or exclude liability.[375] As a rule of contractual construction, it provides that terms designed to exclude or limit a party's liability are to be construed against him, i.e. restrictively. The policy purpose is clear: judges construe exclusion terms narrowly as they regard it "inherently improbable that one party to a contract should intend to absolve the other party from the consequences of his own negligence". Courts do not apply the rule with the same rigor to clauses which merely limit, instead of exclude, liability. This limitation on freedom of contract is in most exclusion cases rather procedural: they turn on the question whether the intention of one party to limit or exclude liability has been made sufficiently clear to the other. Traditionally, there have been only very few absolute (mandatory) limits in English contract law, the most important being that liability for a fundamental breach of contract cannot be excluded.[376]

In the United States, "disclaimers and other limitations of liability" are also subject to judicial scrutiny and restrictions under common law. As Allan Farnsworth notes, a drafter of such exclusion clauses should keep five different kinds of restrictive doctrines in mind: public policy, unconscionability, contradictions in drafting, judicial insistence on informed consent and narrow interpretation.[377] These rules are not only characteristic of the case law of recent decades. Some of them figure in the Uniform

[374] Note 1897, McMeel 2005: 258–259, Treitel 1999: 202–204.
[375] Treitel 1999: 202–203.
[376] It is unclear, however, whether this rule is substantive or a doctrine of construction only. In the latter case, it merely amounts to a refutable presumption that liability for a serious (fundamental) breach of contract is not excluded.
[377] Farnsworth 2004: vol I. §4.29a.

Commercial Code and the Restatement (Second) of Contracts as well.[378] Some of them are procedural, others substantive. As to the forth limitation (informed consent), in the UCC this rule amounts to a statutory requirement of conspicuousness for disclaimers of warranty and the requirement of a separate signature of clauses that might otherwise cause surprise to the non-drafting party. As to the fifth limit (narrow interpretation), like in the UK, it has produced an almost unending string of cases. In the US, narrow interpretation of clauses that limit the liability for negligence, that restrict remedies to repair or replacement, and that exclude compensation for consequential damages, is particularly characteristic. In all these cases, ambiguities lead to the invalidity of exclusionary clauses. However, when formulated unambiguously, these claims are enforceable, as a general rule.

Standard form contracts

Strictly speaking, the *contra proferentem* rule can be applied only when it is clear which party formulated the clause in question. This is rarely the case when the deal was negotiated between the parties.[379] At any rate, from the late 19th century, the rule has been typically only applied to standard form contracts (general conditions of business, boilerplates).

As mass-production made standard-form contracts more necessary and more and more generally used, courts started regulating them through different indirect ways. Under codified law, this started without statutory basis and with semi-covered reference to policy purposes. At first, the judiciary of codified legal systems seemed to be in trouble. Still, through general clauses and interpretative techniques courts effectively

[378] Scott – Kraus 2003: ch. 6.

[379] There are examples for this though. One is related to Article 4.6. of the UNIDROIT Principles which provides that "If contract terms supplied by one party are unclear, an interpretation against that party is preferred." The *Official Comment* remarks that this is not an all-or-nothing rule: the extent of its applicability depends on how much the contract term was the subject of further negotiations. "The extent to which this rule applies will depend on the circumstances of the case; the less the contract term in question was the subject of further negotiations between the parties, the greater the justification for interpreting it against the party who included it in the contract." (Official Comment on art. 4.6 of the UNIDROIT Principles). The flexibility is even greater. There is at least one reported case where the contract was drafted by one party, the rule was nonetheless applied in a gradual manner (Arbitral Award by an Ad hoc Arbitration Court in Buenos Aires on 10.12.1997, published in *Uniform Law Review / Revue de droit uniforme* 1998, 178-179.

started regulating standard forms. An important tool in this intervention was the reasonable expectations doctrine.

For instance, in Germany the *contra proferentem* was only codified in 1977 for application to standard form contracts. Regardless of this, courts interpreted standard form contracts against banks, insurers, railway companies, etc. (and policed their contracts in other ways) for many decades before.[380] They justified this with the (uncodified) Roman law maxim that the drafter could have formulated the contract more clearly. Any doubt about the meaning of standard terms was resolved against the party who drafted or chose them, by adopting a form drafted by someone else. German courts have witnessed considerable inventiveness and flexibility in the use of other doctrinal techniques as well, e.g. the general clauses in §138 and §242 of the BGB in the regulation of standard forms, and in general in putting contracts under substantive control.

Later, regulation became more direct. An interesting sign of the abandonment of the indirect policy use of the *contra proferentem* rule in favor of more direct intervention is the following. Already in 1953, the general business conditions of an insurance policy were being interpreted *in favor* of the insurer in some cases. As Krampe argues, the reason for this is not that the court did not find any ambiguity. Rather, the substantive control of insurance contracts rendered the indirect way of interpretation unnecessary. The court felt free, so to say, to return to the original narrow use of the rule.[381]

The interpretation *pro adhaerente* (in favor of the party adhering to a standard form) has also been used in a judge-made fashion in Anglo–American, Scandinavian and in French and Belgian law as well.

The two countries mentioned last are interesting as they show both the difficulties judges face when they try to apply the archaic formulation of the *contra stipulatorem* rule to standard form contracts, and the different solutions the two systems found. In France and Belgium, courts apply *contra proferentem* to standard forms as a judge-made rule: there is no clear legal basis for this rule.[382] Standard clauses should be

[380] Krampe 1983.
[381] Krampe 1983: 40.
[382] Delvaux (1996) argues that the legal basis of the rule could be *culpa in contrahendo* (art. 1382).

interpreted against the drafter or the party who makes use of them for his own account, e.g. by taking them from a professional organization. This *contra proferentem* rule is not to be confused with the *contra stipulatorem* rule mentioned above (art. 1162 of the Code Civil; Belgium has an identical rule).[383] The two only lead to the same result when the clause to be interpreted refers to the obligation of the adhering party. For an ambiguous clause containing the obligation of the drafter, the *contra stipulatorem* rule would decide in favor of the drafter. Indeed, in France, at least in insurance contracts, courts have applied the *contra stipulatorem* rule both ways, i.e. eventually also in favor of the insurer (as drafter). In Belgium, in contrast, courts give clear precedence to the judge-made rule over the statutory provision in art. 1162. Legal scholarship approves this *contra legem* practice.[384] This means that also the insurer's (drafter's) obligations are interpreted against him if the clause of the standard form in question is deemed to be ambiguous.

As early as 1910, a special provision had been enacted in Switzerland for the interpretation of insurance contracts. This provision extended insurance coverage to certain events or dangers that have the same characteristics as the danger against which insurance was provided, unless the contract excluded these events from coverage in a determinate and unambiguous way.[385] This rule is, in essence, a transparency requirement which reminds one of more recent disclosure (information-forcing) rules. At present, there are statutory provisions that mandate a *contra proferentem* interpretation of any standard form contract, including those between professionals, in countries such as Austria, Germany, Italy and Spain.[386]

Consumer contracts

In the European Union, since 1994 there has been an interpretive presumption in favor of consumers. The 93/13/EC Directive on Unfair Terms in Consumer Contracts has a

[383] To make things even more complicated, there is a potential conflict between *contra proferentem* and art. 1602(2) (*contra venditorem*) as well. The rule applied is that when the buyer drafted a sales contract, ambiguities are decided in favor of the seller. Art. 1602 is overridden by the *contra proferentem* rule.
[384] Kullmann 1996: 375–381.
[385] Art. 33 *Versicherungsvertragsgesetz* (1910).
[386] Austria: §915 ABGB, Italy: art. 1370 Codice Civile, Spain: art. 1288 Código civil, Germany: §305c II BGB.

provision to this effect: "Where there is doubt about the meaning of a term, the interpretation most favorable to the consumer shall prevail."

The Directive is based on the idea that consumers should be empowered through information provision.[387] It includes a transparency requirement in Art 5 (1), providing that "in the case of contracts where all or certain terms offered to the consumer are in writing, these terms must always be drafted in plain, intelligible language." As this transparency requirement for written[388] consumer contracts appears in the same Article as the *contra proferentem* rule, this would suggest that the latter is a kind of sanction for not-plain or unintelligible language.

Commentators argue rather convincingly that this is not the case.[389] Ambiguity is only one kind of intransparency, another would be unambiguous terms in small print or in technical language. The *contra proferentem* rule does not provide a sanction for all kinds of intransparency.[390] On the other hand, the *contra proferentem* rule is not merely a sanction for a specific type of intransparency. The requirement of unambiguity can be stricter than "plain and intelligible". As Treitel puts it: "language which is plain and intelligible may nevertheless be ambiguous; the fascination of oracular statements lies precisely in the fact that they combine these qualities". This makes one wonder whether the term "plain and intelligible" itself is plain and intelligible enough, at least insofar as it relates to "ambiguity". The former discrepancy does not seem to raise serious problems when, as we have seen in case of warranty disclaimers in the US, clauses that are not transparent or conspicuous enough, cannot be enforced against the consumer. As to the latter discrepancy, when the *contra proferentem* rule requires something more than plain and intelligible language, this is not problematic either: if the stricter rule is violated, the stricter sanction is justified.

In sum, the *contra proferentem* rule has had a long and varied career from ancient, magic-laden formalistic contracts to mass-scale standardized contracts in 21st century e-business. This interpretative doctrine applies in three contexts: as a general contract law rule against the party who has proposed or takes benefits from an ambiguous clause;

[387] For analyses of the Directive from a law and economics perspective, see e.g. Van Wijck – Theeuwes 2000 and Geest 2002.
[388] The transparency requirement does not apply to oral contracts.
[389] For the contrary view, see Whittaker 2002: 215. To note, Whittaker shows convincingly how in England the transparency rule as a formality became an instrument for regulating substance.
[390] Ferrante 2005, Hondius 1996.

against the drafter or user of an ambiguous standard form; and in favor of the consumer. In many legal systems these three interpretative presumptions have been formulated in different ages and with different wordings; this makes complicated meta-rules of precedence and hierarchy necessary.[391] In more recent codes, legislators combine all three rules more easily. For instance, Article 6.193 Section 4 of the Lithuanian Civil Code provides: "In the event of doubt concerning contractual conditions, these shall be interpreted against the contracting party that proposed such conditions, and in favor of the party that accepted them. In all cases, the conditions of a contract must be interpreted in favor of consumers or a party who concludes a contract by way of adherence." The lack of clear meta-rules might raise some technical problems for the courts. More interesting than these technical problems is, however, the question as to what policy purposes the *contra proferentem* rule and its variants might justifiably serve.

4.5.3. The contra proferentem rule as a policy instrument

Legal commentators refer to various rationales behind the rule:

(1) Nobody should benefit from his own wrong. Failure to make clear to the other party the meaning and effect of a contract clause is a wrong.

(2) A party may be responsible for the formulation of a particular contract term, either because that party has drafted it or otherwise supplied it, for example, by using standard terms prepared by others. Such a party should bear the risk of the ambiguity of the term chosen.

(3) The ambiguity might have misled the other party and induced him to conclude the contract.

(4) There is unequal bargaining power between the parties.[392]

[391] On the complex doctrinal difficulties raised by the contra proferentem rule in Québec see Lluelles 2003.

[392] According to Hein Kötz, interpretative presumptions "represent a legal value judgment and seek to promote the meaning most consonant with that value judgment." (Kötz – Flessner 1997: 114–115) They reflect the widespread but inaccurate belief that creditor and seller are always rich and powerful, debtor and buyer weak and poor and therefore in need of protection. To that extent they are unpersuasive, but they make good sense where the creditor or seller actually drafted the clause in issue. It is right that the risk of ambiguity in a contract should be borne by the party who could more cheaply avoid it, and that is usually the party who selected or drafted the clause rather than the party to whom it was presented.

These justifications will be discussed below in turn.

Protection of the weak?

While courts sometimes rhetorically refer to the first two reasons mentioned above, when the case before them is about standard forms or consumer contracts, they typically justify the interpretation against the drafter with the third or the forth. In certain categories of contracts the *contra proferentem* rule has been applied, almost automatically, in cases between a consumer and a large business firm, without any effort to solve the ambiguity with traditional methods of contract interpretation. In the insurance context, for example, even the meaning of the rule had undergone a change. The "ambiguity rule" has started to refer to an unqualified interpretation of ambiguities against the insurer.

As we have seen, one possible technique for substantive control of the contract is through the *contra proferentem* rule. This means to interpret the clause as ambiguous and read it in an artificial and unexpected manner in favor of the consumer.[393] In this case, the judge only construes the clause so artificially, because he regards it substantially unfair *ab initio*, and wishes to "protect" the consumer from it. He tries to do this without openly invalidating the clause and directly infringing the principle of freedom of contract. As interpretative presumptions serve primarily to reduce ambiguity, they presuppose unclear meaning. Thus, "in their eagerness to protect the consumer from unfair standard-form terms, courts have proved remarkably clever at discovering (or divining) »ambiguities« in them."[394] This was especially true when the courts had no statutory power to strike down clauses they found unfairly prejudicial to consumers. Now, since such provisions have been enacted in most Western countries, there seems to be no need to do indirectly what is better done directly by controlling the substance of standard forms in an open manner.

Even if open control is possible, courts still tend to justify the interpretation of standard form contracts against their drafter or user by arguments based on market power or fairness. This practice has become more nuanced only in recent decades. Although there are significant differences between jurisdictions, some common

[393] For English, French, German cases using this technique see Kötz – Flessner 1997: 141.
[394] Kötz – Flessner 1997: 115.

tendencies can be found in the cases. American case law has refined the conditions under which the *contra proferentem* rule is applicable.[395] Thus the parties' mutual participation in the drafting of their contract makes the rule inapplicable. Interpretation of a contract against its author is also considered inappropriate if both parties are equally sophisticated in the use of language.

Regulation of standard forms and consumer contracts

When economists are asked the question, why are standard form contracts so widespread, the short answer usually is that in a mass-production economy, transaction costs are reduced significantly in this way. Contrary to public belief, by themselves, standard forms do not imply superior economic or bargaining power. "Simply observing the fact of standard form contracts yields no meaningful implications as to the underlying structure of the market. Indeed, we observe them being used in many settings where manifestly the market is highly competitive. [...] [E]ven in the absence of standard form contracts, we see many goods being offered on a take it or leave it basis in some of the most competitive retail markets in the economy."[396]

Nevertheless, combined with asymmetric information and certain characteristics of the market, standard form contracts can harm non-drafting parties (both businesses and consumers) by being both inefficient and unfair. Entrepreneurs do not compete with regards to those contract terms, be they product or service characteristics, which consumers, often for good reasons, do not observe. They compete only with regard to observable dimensions, such as price and a few observable quality features.[397] There are

[395] Corbin 1998: §24.27 (p. 282–306).

[396] "It is an easy step from the observation that there is no negotiation to the conclusion that the purchaser lacked a free choice and therefore should not be bound by onerous terms. But there is an innocent explanation: that the seller is trying to avoid the costs of negotiating and drafting a separate agreement with each purchaser. (…) Consistent with the innocent explanation, large and sophisticated buyers, as well as individual customers, often make purchases pursuant to printed contracts." R. Posner 1998: 127.

[397] "*When confronted with an oppressive contract, one must ask why and how did the market arrive at the production of a »bad« or nonoptimal good. Conventional economic theory has few models of product selection. One model suggest the difficulty is an informational one: the ordinary consumer cannot distinguish between good quality and bad quality goods. Since it is more expensive to produce high quality goods and purchasers cannot distinguish the good from the bad, the market will produce low quality merchandise. Complex, fine pine print standard forms might be viewed as goods whose quality people cannot determine. […] As consumers are making decisions upon price grounds, a seller offering a better warranty must either suffer a lower profit margin at the same price or charge a higher price and*

good economic reasons why standard forms are subject to judicial (*ex post*) as well as regulatory (*ex ante*) control.[398]

Are there efficiency arguments for the use of the *contra proferentem* rule for this kind of "semi-covered" regulation? As it has been observed, "[i]nterpretive presumptions that favor consumers and insureds encourage sellers and insurers to draft detailed and explicit contracts, which increases the chances that the less sophisticated party will understand her contractual obligations."[399] This is how many economically minded lawyers understand the effects or functions of the *contra proferentem* rule, as applied to standard forms and consumer contracts, at first glance.

At second glance, these effects seem less certain. The arguments leading to uncertainty are similar to those discussed with regard to information disclosure in section 4.3.4. In fact, they apply more generally to the decentralized *ex post* control of standard form consumer contracts. The contra proferentem rule is also such a mechanism of regulatory intervention.

Rational ignorance and costly information processing. To begin with, the mechanism by which the penalty default rule operates is by reducing the receiver's information processing costs. It functions only if the contracting party reads the contract. Unfortunately, this rule cannot reduce these costs to such an extent that the typical receiver actually reads the contract. If the consumer does not devote time and effort to reading contract forms, the penalty default rule is not able to perform its function of making the consumer informed. Second, information disclosure in itself does very little to improve consumer protection unless consumers are able to make sense of the information and process it appropriately. Many consumer contracts are technically complex. Thus even a consumer who is able to read his rights and obligations in an optimally clear language, still may not be aware of the implications of the text.

To interpret an exemption clause restrictively in the spirit of the *contra proferentem* rule, or even to deprive it of legal validity for unfairness, may be a wholly ineffective means of control. If a contract contained such an ambiguous or invalid

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attempt to disseminate information to prevent a loss of sales because of the raised price. Dissemination of information might be difficult." Kornhauser 1976: 1177.

[398] For a succinct overview see Katz 1998.

[399] Posner 2006: 580.

clause, the consumer might believe that he is bound by it and so not pursue his claim. Even if he did make a claim, the supplier might settle with the consumer out of court so as to avoid a judicial declaration of invalidity, and then continue to use the clause.[400] A further difficulty is that the benefits from pro-consumer interpretations are very short-lived. The firm whose contract clauses were interpreted against him can draft other clauses to the same effect which are clear enough to withstand detrimental interpretation. Clarity, in itself, does not guarantee either efficiency or fairness. For these reasons the covert control of substance should be changed to an open control of standard (pre-formulated) terms.

The clarity and the substance of the clause are two different issues. In judicial practice they are often mixed or linked: when the term is unclear, it can be interpreted in a welfare-increasing, or receiver-friendly, way. That is what the *contra proferentem* rule actually does: as a sanction for ambiguity, it interprets the clause in favor of the consumer. This is not necessarily the most welfare-increasing way to interpret the clause.

There is a somewhat similar interaction between the rules of the EU Directive on Unfair Terms in Consumer Contracts, at least as implemented in England. The transparency rule and the fairness test work together. As already noted, the EU Directive combines all type of contract terms under fairness control, with the exception of terms which are required by law, terms which are 'individually negotiated', and so-called 'core terms', i.e. the substance of the main obligation and the price. In each member state, the court has the duty and the power to raise the issue of fairness of a contract term within the ambit of the regulations.

Besides, as mentioned, the written terms should be in plain and intelligible language. This implies the extension of the fairness test. When the subject matter of the contract, or the price, is not written in plain and intelligible language, these terms are not exempted from fairness control. Intransparency may also lead to the intervention of public authorities or private bodies, who can ultimately seek an injunction against the use of the terms in question, just like in case of the term's unfairness. Furthermore, somewhat in the shadow of this rule, a kind of preventative control is also provided

[400] Treitel 1999: 258.

through the negotiations of regulators and businesses whose terms have been the subject of complaint. As a result, the requirement of transparency creates a system of control with considerably more normative impact than merely rendering a term non-binding against the consumer.

It seems that when this more substantive regulatory control is effective, the term in question will be clear enough so that the *contra proferentem* rule becomes superfluous. This leads to the question: when does the rule come to play a role anyway? The answer is, only when something turns out wrong and the non-drafting party seeks remedy or modification. Ambiguity itself, without regard to the substance, does not bring a contract term before the court. In sum, these considerations imply that the *contra proferentem* rule plays a rather minor role as an instrument of substantive control.

Optimally clear drafting

Although in many cases the *contra proferentem* rule is apparently "protecting the weak", it would be mistaken to think that the use of interpretative presumptions only makes sense when there is "structural inequality" or "unequal bargaining power" between the parties.

As mentioned, the UNIDROIT Principles which are designed for international commercial contracts also include such a rule. In this context, a power imbalance between the parties is much less plausible. Nevertheless, the *contra proferentem* rule may make good economic sense in this context as well. By filling in a gap with a default rule which is unfavorable to the better informed party, i.e. a penalty default rule, the law forces her to reveal this information either to the other party or to the court.

My claim is that the *contra proferentem* rule should be understood as creating incentives to improve the drafting efforts of (one of) the contracting parties. Functionally, it is equivalent to an information-forcing (penalty) default rule. It "might encourage the drafter to be more explicit and to provide more details about obligations. This may reduce the chance that the other party will misunderstand the contract; it also may facilitate judicial interpretation of the contract."[401] This argument is based on the

[401] Posner 2006: 579. See also Hermalin–Craswell–Katz 2006: 93, Ayres 2006: 596.

empirical generalization that usually the drafting party is the cheaper ambiguity, or risk avoider.

Despite obvious similarities, the rule should be distinguished from the information disclosure rules, discussed above in section 4.3.4. The main difference between them is that while the former rule regulates the language of the contract and information about the rights and obligations of the parties, the latter has to do with information about the behavior of the parties or the quality of the good or service transferred. The first is aimed at individual transactions, the second at the market level. Also, in many cases, the information that should be disclosed is non-observable or at least non-verifiable, and consequently not covered by contract language. Another difference is that in many cases the asymmetric informational advantage is held by the non-drafting party. Such cases can be subject to an information-forcing rule as well, but in the opposite direction as the *contra proferentem* rule.

In an economic sense, one can define an optimal degree of clarity in contract language. The optimal degree of clarity would minimize the sum of ambiguity costs and drafting costs. Ambiguity costs are the losses resulting from frustrated reliance expectations, while drafting costs refer to the efforts of drafting that reduce ambiguities. By definition, the drafter has control over the language used in the contract. This notion of control can be the basis for making the drafter responsible for unclear drafting.[402]

There are several problems that complicate the determination of what is optimal language clarity. First, human language remains inherently imperfect. It is hard to define what complete clarity would mean.

Second, unambiguous contract language not only provides information to the non-drafting party; it economizes on public resources as well. Adjudication is subsidized by public funds. As parties use the court system, they externalize the costs of their dispute to some extent. They should be encouraged to solve interpretative difficulties by eliminating ambiguities *ex ante*, to the extent that it can be done cost-effectively. The second complication is then related to the fact that the optimal degree of clarity also depends on whether one wants to provide clarity in favor of the non-drafting party or for third parties, most commonly the judge.

[402] See Abraham 1996: 433–434.

Third, if the *contra proferentem* rule is understood in an absolutist sense, this is similar to making the drafter strictly liable for ambiguities. On the other hand, when only a reasonable or optimal degree of clarity is required, this is similar to a negligence rule.[403] The choice between the strict liability and negligence rules depends on a number of considerations which have been extensively discussed in the economic analysis of tort law.[404]

Fourth, contract language often uses standard terms, the meaning of which is different from their ordinary language meaning (e.g. trade usage). In many industries and trades, the currently used formulas contain standardized language. Sometimes these range from, unclear to incomprehensible, for "ordinary people" or contracting partners outside the network. If the courts interpret ambiguity with respect to ordinary language, they systematically interpret standardized contract terms against their meaning in the industry. Regardless, such decisions do not necessarily give sufficient incentives to the firms to adapt contract language to ordinary meaning. This stickiness, in fact, has economic reasons.

From an economic perspective, standardization is usually accompanied by network externalities and learning effects. Individually, each firm has an incentive to stick to the standard term because of the sheer fact that its meaning is now standardized and the consequences of its use are predictable. Individual deviation from standardized language would be costly. Setting up new standards in accord with court decisions is even more difficult. It is almost impossible for these to come about without the coordinated common efforts of the firms. In general, network effects increase the level of ambiguity and make it less responsive to the incentive effects of the *contra proferentem* rule.[405]

These network effects are especially important in the insurance industry. In the case of insurance, the calculation and pricing of various risks depends crucially on the predictability of court decisions. Insurers are reluctant to change the language of insurance policies even if courts systematically decide against them.

[403] On the analogy to strict liability versus negligence in tort law see Abraham 1996.
[404] See e.g. Shavell 2004: pt. 1.
[405] See Goetz – Scott 1985, Hill 2001, Boardman 2006.

All this does not mean, however, that the interpretative presumption should be abandoned. Rather, it should be used to induce unambiguous drafting. However, it must be kept in mind that being a rule of last resort, unconscionability and other formal or substantial policy instruments, when applicable, should have priority over the *contra proferentem* rule.

If the contract term has only one reasonable meaning, then ambiguity should not be imputed *ex post* in order to void the clause or the contract. In this case the court can refuse to give effect to the clause directly. What if the term has several possible meanings, some desirable some undesirable? In this case the substantive fairness or unconscionability test can be in conflict with the *contra proferentem* rule. The question arises then, which is the more punitive interpretation. The one which favors the consumer but turns the clause non-abusive, or the one which apparently favors the professional but exposes him to the gravest sanction, the removal of the clause from the contract?

Some authors suggest that the substance of the terms should be tested first, by evaluating the fairness of the term in its interpretation most *unfavorable* to the consumer. If the term passes this test, only then can the most favorable interpretation be implemented.[406] At first sight, this is an odd way to protect consumers, especially if the interpretation most unfavorable to them is not the most plausible reading of the language. Nevertheless, there is at least one argument in favor of this apparently unreasonable approach.

This argument is related to the abstract control of standard forms. According to the EU Directive on Unfair Terms in Consumer Contracts, standard forms should be subject to some "abstract" control in each member state.407 This occurs in various ways in each country: through class action by consumer associations, administrative control by regulatory bodies, or a consumer ombudsman etc. In these abstract control cases the fairness of the standard form is examined in a relatively non-contextual way, i.e. not in the context of the specific facts of a litigated case. Here, generally, when the language is ambiguous, the clause in the standard form is presumed to be prejudicial to consumers, i.e. the non-professional, non-drafter parties. The burden of proof that the

[406] Coderch – Garcia 2001: 14.
[407] Art 7 (2)–(3), Council Directive 93/13/EEC of 5 April 1993 on unfair terms in consumer contracts.

clause is not unfair lies with the drafter. This "duplex interpretation rule" serves the same purpose as *contra proferentem*, only through a reversed means.

4.5.4. An example: insurance policy interpretation

The *contra proferentem* rule plays an especially interesting role in insurance law. Insurance policies are written in notoriously incomprehensible language. They are to a large extent standard form contracts. Insurance is economically significant for consumers and other unsophisticated parties as well. Insurance law is probably the legal area where the *contra proferentem* rule has been most frequently invoked. In the US, a large volume of case law and much scholarly commentary have been produced on this topic.

In both the United States and several European countries, the *contra proferentem* rule (also called the ambiguity rule) has played a crucial role in deciding insurance policy coverage cases in the last few decades. It is often mentioned in the case law that the purpose of the rule is to aid the party whose bargaining power was less than that of the draftsperson. American courts often hold that disparity of bargaining power is likely to exist when anyone applies for an insurance policy.[408] Furthermore, in the US the fact that a policy is in the form required by a statute does not render the *contra proferentem* rule inapplicable. Part of the reason for this is that insurers may have had a large hand in the drafting of the statute.[409] Thus insurance law provides us with a rich field of study where the economic effects of the *contra proferentem* rule can be analyzed.

The *contra proferentem* rule (ambiguity rule) can be understood either in a narrow or a broad sense. The narrow sense is the traditional use of the rule as a last resort or a tie-breaker rule. This means that after all the usual methods of contract interpretation have been applied, but the term still remains ambiguous, the term should be construed to have the meaning least favorable to the drafter. In the second half of the last century, US courts started to use the rule in a broad sense. This means that they ruled against the drafter right at the start, without actually or seriously interpreting the exclusion clause.

[408] Rappaport 1995. „In fact, insurance policies are so commonly drafted by insurance companies that the principle is routinely transformed into a rule that ambiguities in an insurance policy are to be interpreted in favor of coverage." Abraham 1996: 531 n. 2.
[409] Corbin 1998: 295.

They understood the rule to serve as a protection for uninformed insureds against substantive unfairness.

The courts have, either implicitly or explicitly, argued in the following way. An ambiguous insurance policy disappoints the reasonable expectations of the insured and is difficult to understand. It is unfair that the text is not provided until the contract is concluded and is not subject to bargaining. Insureds should be protected against terms they have not received before purchase. Furthermore, even if they had received them earlier, they could not have read the policy because of the fine print. Even if they could have read the fine print, they could not practically have understood the technical language in which it had been written.[410]

Based on these arguments, ambiguity in insurance policies has been interpreted broadly and the courts have granted coverage to the insured very easily. The broad interpretation of the *contra proferentem* rule is problematic. What the rule can offer is some degree of language precision and transparency – but even this is only possible if the network effects are weak. All the other benefits are only temporary or bring more costs with them.

The rule does not protect against inefficient terms. Or if it is stretched to be used for that, it results in uncertainty. It does not necessarily promote efficient risk allocation either. This would not only require that insurable risks are covered but that non insurable risks are excluded from coverage.

Economic analysis suggests that the *contra proferentem* rule should not be used for wide-ranging policy purposes. There are good reasons to think that it is ineffective or has unintended side-effects. An elementary insight of the economic approach is that in all cases of regulatory intervention in favor of the "weaker party" there is a trade-off. This trade-off is between the protection of the disadvantaged party in individual cases ex *post*, and the negative incentive effect of the rule from an *ex ante* perspective.

Of course, there is an economic argument for the ambiguity rule as well. Between the two parties, the insurance company may be the superior bearer of the risk of ambiguity, i.e. the risk that the insurance coverage will turn out to be less extensive than it appeared to be. This "means that the insured is buying some additional insurance, and

[410] Miller 1988, Rappaport 1995, Abraham 1996, Chandler 2000: 848–850, Johnson 2003, Duncan 2006.

probably insurance that he wants."[411] This extension of insurance coverage might be the correct solution in regular cases. It is an empirical question whether the benefits for insureds are greater that the costs implied by higher premium rates. Also, the detrimental effects mentioned in previous chapters should be taken into account.

Some of these effects have been observed and identified as the consequence of insurance regulation. Arguably this has also contributed to later developments in the interpretation of insurance policies. With time there have been some changes in the case law: in some cases, sophisticated policyholders were considered exempt from the protection.[412] Additionally, the rule was not applied in the rare cases where the policy was drafted by the insured or her agent.[413] Currently in the US, the tendency is once again towards the use the *contra proferentem* rule only as a tie-breaker, i.e. to prefer standard methods of contract interpretation first.[414] This evolution, however, has been simultaneous with more direct regulation of insurance policies.

One element of this evolution has been the emergence of the so-called "sophisticated policyholder defense" which excludes certain business-like insureds from this over-protective rule.[415] But is there a reason to abandon the *contra proferentem* rule altogether in the case of sophisticated policyholders? The answer is probably negative. When understood in its traditional, narrow sense, the *contra proferentem* rule is still useful as a last resort rule of contract interpretation, even when the policyholder is sophisticated and not less powerful economically.

There is another obvious consequence of the abandonment of the upfront use of the rule. If one accepts that the main function of the *contra proferentem* rule is to give incentives for using optimal clarity in language, then this should also apply in the rare cases when the insured (or her broker) is the drafter of the policy. Although there have been no American cases decided in favor of the insurance company on this basis, there are some European ones. Also, there are numerous US cases where the claim of the

[411] R. Posner 1998: 120.
[412] Cf. the cases cited in Johnson 2003: 29–30.
[413] Johnson 2003: 27–29.
[414] To be more than anecdotal, this statement should be substantiated with statistical data. As Eyal Zamir suggested to me in personal communication, in US case law judicial references to the "tie-breaker" character of the rule are still rather rhetorical.
[415] Stempel 1993, Johnson 2003: 28–29.

insured was rejected and the fact that she drafted the contract was mentioned among the reasons for this.[416]

Currently, although there is much diversity among jurisdictions, the *contra proferentem* rule is in many cases once again only a tie-breaker.[417] The story of the indiscriminate and broad use of the *contra proferentem* rule in the US provides an example of the *ex post* paternalistic view of judges. While courts have to decide individual cases where the policyholder suffered losses, they do not easily see the costs of the rule which come in the form of increased premia, and potentially the non-availability of insurance in certain areas or for certain potential policyholder groups (due to the increased premia).

To be sure, the insurance market is also characterized by information asymmetry and anticompetitive effects.[418] An ambiguous policy might disappoint the reasonable expectations of policyholders. The policy is often difficult to understand. Arguably it is unfair as well as inefficient that the text of the policy is not provided until the contract is concluded. Contract terms that are optimally clear, can nonetheless be inefficient, unfair or exploitative. On the other hand, not everything that seems unfair *ex post* is inefficient *ex ante*. Arguably, if courts do not apply the interpretative rule, they have other doctrines at their disposal to ensure procedural and substantive control: unconscionability, duress, undue influence, unilateral mistake. As it has long since been argued in the law and economics literature, judicial policymaking comes at a high price. There are many other market and non-market mechanisms that help uninformed consumers. Amongst there are comparison shopping, brochures, agents, reliance on reputation on the one hand; self-regulation via industry standards, statutory and administrative regulation on the other.

[416] Johnson 2003: 23–27.
[417] Johnson 2003.
[418] In addition, there are specificities in the insurance industry. The information asymmetries have special nature. The market is not fully competitive. In the US, the policy language is jointly drafted by insurance companies in certain lines, by the Insurance Services Office (ISO). The committees of the ISO draft insurance policy language which tends to be standardized among the industry. In the early 90s there was an antitrust lawsuit against ISO – then special legislation was enacted.

4.5.5. Against paternalism through contract interpretation

Deviations from the common intentions of the parties in contract interpretation is sometimes attributed to ideological concerns and "an appetite for benefiting whichever of the parties is perceived to be in a weaker bargaining position".[419] There is, however, a more reasonable explanation and justification for at least some of the deviations. The *contra proferentem* doctrine is an information-forcing rule that can promote optimal completeness and clarity in contracts. Whether the contract is standardized or not, all things being equal, the risk of ambiguity in a contract should be borne by the party who could more cheaply avoid it, and that is usually the party who selected or drafted the clause rather than the party to whom it was presented. However, such interpretative presumptions are ill-suited for achieving ambitious policy purposes. Whatever the role of policy considerations like paternalism is, or should be, in law generally, these purposes are not effectively promoted by contract interpretation. Nevertheless, policymakers and courts should be aware that contract interpretation has far-reaching consequences for contractual behavior.

4.6. Paternalism in a complex legal system

In modern legal systems contract law is part of a larger set of rules. As already argued throughout this chapter, it is often the case that a policy purpose can be achieved more effectively by one instrument than by another. Sometimes, this choice is not as obvious as in other cases. The full appreciation of the role of paternalistic considerations in contract law raises some systemic issues as well. These can be formulated as questions about the structural place of paternalism or, in other words, about the importance of doctrinal boundaries in the legal system. In this final section I discuss these questions.

4.6.1. Comparison, interaction and choice between regulatory instruments

We have analyzed several contractual doctrines that are intuitively classified as paternalistic. Still, in an economic sense they operate rather differently.

[419] McMeel 2005: 258, 259.

Disclosure and unconscionability compared

Let me indicate briefly the differences between mandatory disclosure and unconscionability. Suppose two parties freely conclude a contract about the transfer of an asset, the value of which is uncertain at the time of contracting. The value can be low or high, and both parties have a probabilistic expectation about this. The private ordering paradigm, be it ultimately justified with welfare or autonomy arguments, or otherwise, sets a presumption against judicial intervention in this transaction.

Disclosure rules in this case are about communicating the information that there is a risk. The information may be written in fine print and thus there are arguments for requiring larger fonts and conspicuousness. This can be justified in pure economic terms: it is less costly for the seller to produce the information. Another important point is that duties to provide information refer to the time before the realization of the risk.

The other doctrine, unconscionability works differently. Technically, it works as an excuse when the seller wants to collect money and the buyer, after finding out that he has had bad luck, and the low-value case has been realized, asks the court for assistance to rescind from the contract. Should the courts excuse the buyer, based on "consumer sovereignty", the idea that "consumers should get what they want" or on some other justifications? As discussed in section 4.4.1, if unconscionability is applied to such cases of the transfer of a good of uncertain value, this allows for opportunism. Only those with bad luck go to the court, or their contracting partners have to go there because of non-payment. This suggests that the remedy should not be available in such cases, but, of course, the doctrine is not only or primarily applied to the case of risky exchanges. There may be a fully risk-free, but simply involuntary exchange at issue where a judicial remedy should be available. This remedy might be unconscionability or unfairness, even if in the case at hand we face coercion or fraud. As the state of mind of the contracting parties is difficult to prove, unconscionability is used here as a *proxy for involuntariness*. Thus this use is not paternalistic in any meaningful sense. Nevertheless, as we have seen in section 4.2 above, both rules can be instruments of paternalism.

As we have also seen, there is scope for justified paternalistic intervention in cases where there (1) are systematic cognitive failures or insufficient cognitive capacities; (2)

is insufficient information (asymmetric information); and, (3) to some extent where there are insufficient outside opportunities (necessity, situational or structural monopoly). The last category draws attention to the limitations of private law. I have especially discussed two of them. First, prohibiting certain contracts can hardly increase the range of opportunities.[420] Second, judges have very limited opportunities to influence market structures.

Contract law vs. regulation: institutional competence

From a theoretical perspective, be it philosophical or economic, the actual doctrinal boundaries of contract law look accidental, if not irrelevant. For a theory of contracts, it is the purpose (the *telos*, function, or point) of a certain institution and the regulation thereof which matters. Irrespective of the specific reason why a given theory favors or would limit contractual freedom, such as autonomy, happiness, or efficiency, the rules that are relevant for such a theory often lie outside contract law in a doctrinal sense.

For instance, the regulation or prohibition of the marketing and/or purchase of certain goods in administrative or criminal law are also limits on freedom of contract. Contract law usually refers to such public law limitations by declaring illegal contractual terms invalid as "contracts forbidden by statute".[421] It is mainly a matter of convention whether labor law which includes a lot of paternalistic rules is considered a part of civil law or a separate field of law. Irrespective of how this categorization is made, employment contracts are regulated heavily for occupational safety reasons via the rules of administrative law.

Consumer law vs. general contract law

During the 20th century there has been a dual tendency in the private law of Western countries. They have introduced substantive limitations to freedom of contract while keeping their contract laws (civil codes) and the principle of freedom of contract unchanged as a formalistic "liberal" façade. The traditional rules on mistake, fraud,

[420] See the discussion on exploitation in section 4.2.3.
[421] See section 2.5.1 and note 360, above. Cf. Beale et al. 2002: ch 3.1 (p. 295–332).

duress, incapacity etc. were considered to fit well with will theory.[422] General clauses and interpretative doctrines provided some flexibility. Later on, socially motivated legislation was enacted, aimed at protecting tenants, employees, and consumers. This brought about a large body of rules which did not fit easily in the body of rules (civil code) based on classical theory.

In the last decades, consumer protection legislation has produced a large body of technical regulations. The doctrinal (systemic) status of consumer protection law is not uniform. For instance, there are large differences among the member states of the European Union with regard to the consumer *aquis*: some have integrated these rules fully or partially in their civil codes, while others keep them separate.[423] In a recent paper, Ugo Mattei made some important observations about the ideological and political motivations behind this separation of consumer law and general contract law.[424]

The question is also normatively relevant. From the perspective of paternalism, the business sophistication of the subjects obviously matters, and should matter. It is also an interesting question with regards to paternalism, whether there are systematic differences between contracting parties that make segmentation and thus a differentiated regulation of contracts reasonable.

In a recent article Robert Scott and Alan Schwartz reformulate some widely used intuitive and doctrinal categorizations from an economic perspective and suggest that four different types of contract (transaction) should be distinguished:[425]

(1) a firm sells to another firm,

(2) an individual sells to another individual,

(3) a firm sells to an individual,

(4) an individual sells to a firm.

Category 1 is the area of commercial or business law (with the exclusion of some small businesses), category 2 contracts are primarily regulated by family law and property law, category 3 contracts are primarily regulated by consumer protection law, real property law (mostly leases), and the securities law, while category 4 is mainly the

[422] See section 3.2.1., above.
[423] For a detailed overview of the implementation in the member states see Schulte-Nölke 2007.
[424] See Mattei 1999.
[425] Schwartz – Scott 2003: 544.

domain of labor law. Scott and Schwartz argue that contract law should be different for these categories of transactions.

Consequently, this rather formal typology suggests that in these different contexts the role of paternalism and the extent of freedom of contract should differ.

4.6.2. Backwards induction from competence?

Why would such doctrinal problems matter for an economic analysis? The answer seems to be related to the relative institutional competence of *ex ante* vs. *ex post* regulators.[426]

The issue of competence has a feedback effect on the functions of contract law. It is not only ineffective but unreasonable to burden a decentralized, judicially administered system like the contract law regime, with functions that other branches and mechanisms of regulation can achieve better, including the possibility that the purpose is beyond the competence of the regulatory state altogether. An important lesson in this respect is that there are problems (market failures) which cannot be addressed appropriately in a judicial manner. This consideration provides an argument for the use of a mix of policy instruments[427] which also applies to paternalism. In general, the plurality of potentially confronting purposes of contract law can be achieved only by a plurality of institutions.

Somewhat more radically, Richard Craswell has suggested that in order to determine whether a contract term is (un)fair, or even whether a contract is concluded voluntarily or not, one first has to look at the remedies available, and then infer back to the enforceability of the problematic term.[428] Craswell adopts the property rule–liability rule framework[429] to contract formation problems in order to see which remedies should be used in deciding contract formation cases. A property rule protection of contractual consent would mean that the consent was not proper and the contract is unenforceable.

[426] Craswell 1993b, 1995.
[427] Trebilcock 1993: 248–261. See also Komesar 1994 and R. Posner 1998: ch. 13 ("The choice between regulation and common law") and ch. 19 ("The market, the adversary system, and the legislative process as methods of resource allocation").
[428] Craswell 1993b, 1995.
[429] See Calabresi – Melamed 1972.

A liability rule protection would mean that the judge replaces the unreasonable terms with reasonable ones.

Craswell's radicalism comes from the idea that the available remedies determine whether the term should be declared unconscionable. From a legal (in contrast to a moral) perspective, a contract is declared not to have been consented to voluntarily and when and only when the choice among the available remedies based on their respective costs and benefits dictate that. In determining which way to choose, Craswell explicitly speaks of two factors: (1) the relative institutional competence of the judge and the legislator to determine what is efficient; and (2) the position of the party offering the contract (term) to modify his behavior.

Craswell analyzes several typical cases for the possibility of unconscionability in terms of institutional competence. One example is duress, i.e. when A makes B sign a contract at gunpoint. The availability of remedies dictate that the contract should be voided and B should be protected by property rule. The reason for this is that in such situations A can easily change his behavior, and the circumstances surrounding the contract formation can be proven with relative ease in front of a judge. On the other hand, when this is not the case, the contract should be considered voluntary in the eyes of the law.

5. Conclusion

5.1. Contract regulation: summary assessment

The fact that the number of regulatory contract law doctrines in the table above (section 3.3.3.) is larger than the number of problems might suggest that economic theory cannot fully capture the problems the various doctrines are intended to solve. Contract regimes follow a number of goals besides correcting market failures. On the other hand, there are contract law doctrines that at first glance look paternalist. In the previous chapter, I have discussed a number of legal instruments which, in modern legal systems typically serve paternalistic purposes and analyzed whether these purposes can be interpreted in economic terms.

The legal tools assessing these problems are extremely varied. Regulators have a wide set of instruments at their disposal: formation defenses; mandatory rules and default rules; procedural (formal) requirements (formalities, cooling-off periods, information disclosure); substantive rules; rules of interpretation (construction).

We have also seen that contract law is not the only, or the best, policy instrument in cases of paternalism. Some market failures should be addressed primarily through public-law-type regulation.[430] Trebilcock argues for a "relative institutional division of labor" among regulatory techniques. He suggests that the "law of contracts will be principally concerned with autonomy issues in evaluating claims of coercion, antitrust and regulatory law [with] issues of consumer welfare, and the social welfare system [with] issues of distributive justice".[431]

When we look at this carefully argued proposal by Trebilcock, it does not even mention paternalism. Is it possible to explain paternalism away in a sufficiently extended law and economics approach? I think that paternalism should indeed be considered a residual category. If we can find a (possibly implicit) reason for intervention in terms of a market failure or some third party effect, we should give priority to these, and not attribute the regulation to paternalistic purposes. Still, this strategy is mainly pragmatic and I intend to apply it only to the domain of contract law.

[430] On the interaction of consumer protection law and competition law see, e.g. Gomez 2003.
[431] Trebilcock 1993: 101.

As we have seen in the safety helmet and smoking ban examples (section 2.2.4.), social burden arguments are not always relevant in terms of common moral intuitions. Similarly, there are legal areas like criminal law or medical law where market failures and externalities, if relevant at all, count as only rather weak arguments.

5.2. From principle to policy: mediating maxims

The empirical psychological insights discussed in section 2.4.1 have showed that the issue of paternalism is an "uncertain case".[432] Outright anti-paternalism should not be replaced by uncritical paternalism. With regard to policy, the empirical research is inconclusive because it does not provide a normative standard. The normative standards are the subject of a different kind of discussion; the major philosophical positions have been exposed in section 2.2.2 above.

In this regard let me indicate that: there are good arguments for the practical convergence of autonomy and consequentialist theories;[433] that there are conceptions of perfectionism and liberalism that do not exclude each other;[434] and that to some extent perfectionism can also be combined with economic theory.[435] This suggests the possibility of finding an overlapping consensus regarding the proper role of paternalism in contract law. More precisely, one criterion of the choice between contract theories should be whether the theory takes the public nature of the institution into account. In other words, whether the theory makes an overlapping consensus possible, despite the deep philosophical differences between grand theories.[436] A related meta-theoretical criterion is whether the theory is compatible with the common moral intuitions of the community to which the institution pertains.

If these criteria are acceptable, the maxims I suggest below should be judged based on how high they score on these two related scales. The core of this overlapping consensus will namely consist of "mediating maxims."[437] These are reasons about institutions and mechanisms that summarize lessons from general philosophical theories

[432] Rachlinksi 2003.
[433] Brock 1988. See 2.2.2. above.
[434] Marneffe 1998.
[435] Deneulin 2002, Buckley 2005a, 2005b.
[436] Cf. Aaken 2007.
[437] Husak 2003: 397.

and empirical research on one hand and provide building blocks for a reasonable legal policy on the other. In choosing between the various instruments for paternalistic intervention, one should follow the following principles.

Transparency

Transparency requires that the objective of a particular regulation should not be camouflaged by legal techniques or rhetoric; laws should be enacted for their genuine reason. Eliminative redefinitions can have their use in theoretical constructs but paternalism should not be hidden behind alleged market failures. As we have seen, historically, the motivations behind the introduction of legal rules and doctrines might have been varied. What I am concerned with is the functional relationship between various legal means and paternalism as an end (policy purpose).

Constitutional values vs. direct moralism

In contract law, one should be cautious with purely perfectionist reasons. In this domain, as a rule, state neutrality should be preferred over legal moralism. Freedom of contract is often seen as an aspect of private autonomy. It involves one' freedom to commit to enforceable agreements and in this way to cooperate with others or achieve the other goals one chooses. On the other hand, it is often this very notion of autonomy which seems to limit the validity or enforceability of an agreement. This becomes more intriguing when we refer to yet another value, human dignity. How should this concept be interpreted in relation to paternalism? One way is to say that dignity is not for the free disposition of the individual; rather it is one's ontological or metaphysical quality. This interpretation can, in turn, offer a justification for legal moralism. In this spirit, the law can protect this abstract value of human dignity even against one's autonomous will. A weaker interpretation is to see autonomy and (for instance) non-commodified sexuality as two conflicting aspects of human dignity which have to be balanced. A third conceptualization would be to put the whole discussion under the label of autonomy and see the controversial cases as conflicts between short-term and long-term autonomy.

For a lawyer, these questions seem interesting at most only as the philosophical background behind contract law rules which prohibit certain contracts for "immorality". In fact, lawyers are at unease when addressing such problems precisely because they are aware of the dangers of stepping beyond the boundaries of legal arguments. However, in the last few decades such reasons have become legally relevant. In fact, the interpretation of autonomy and human dignity has become the bread and butter of constitutional lawyers. They considered themselves as being within the law's ambit, when discussing constitutional principles and values.

Coming closer to paternalism, a possible extension of the argument in this work would be to find links to the multifaceted discussion currently going on about such problems under the label of "the impact of constitutional law on private law".[438]

Harm-prevention and basic goods

As already hinted at in section 2.4, an important point where public paternalism differs from personal paternalism is its impersonal and often coercive nature. From this it follows that harm prevention should have precedence over welfare promotion. In other words, the law should be mainly concerned with the promotion of basic or primary goods, in the Rawlsian sense. These are the goods which are necessary for a person irrespective of his personal conception of 'the good'. Paternalistic efforts of contract law should be restricted to the protection and fulfillment of basic needs, and only external conditions should be manipulated (not the mental processes).

On the other hand, the state should encourage other institutions which can take individual (rather than standardized) needs into account.[439] This raises the question as to the necessity of the legal regulation of private paternalism. Here I can only make some sketchy remarks.

In a large, specialized society everybody relies on the special skills, knowledge, and expertise of others. There is a multiplicity of principal-agent problems as one has to trust many personally unknown specialists. Contracts, when designed rationally and enforced effectively, provide a mechanism through which to cope with information

[438] There is a huge literature on the subject. For three collections of essays see Rabello – Sarcevic 1994, Friedmann – Barak-Erez 2001, Grundmann 2008.
[439] Kultgen 1995: 161–162.

asymmetries. Paternalism is also present at the level of private transactions, and not always in an unobjectionable form. Besides, some personal relationships are essentially paternalistic (parent–child, etc.). Some of these are regulated by contracts, some by public (administrative) law but potentially all should be within the reach of law. The specificities of different life spheres should be taken into account.

Minimal intrusiveness

Among the various instruments of contract law, other things being equal, the least intrusive should be preferred.[440] Consequently, information provision should be preferred to prohibition. Procedural restrictions should be preferred over substantive ones. Soft paternalism and autonomy-promoting interventions should be preferred to hard paternalism.

Hard paternalism is not supported by autonomy-based theories but can be compatible with welfarist and perfectionist theories of contract. In essence, here a substantially voluntary contract is declared unenforceable, or sanctioned for being against the interest of one or both contract parties.

On the other hand, soft paternalism and autonomy-promoting interventions refer to those relatively uncontroversial mechanisms which aim at improving the rationality of the subject without prohibiting his own decision, or aim at safeguarding or improving individual decision-making competence. This is the general idea behind "libertarian paternalism" (section 2.4.3.). In these cases the normative controversy is transmitted to the policy level.

In fact, as we have seen throughout the thesis, this is the level of discussion where the prospects of an economic approach to both freedom of contract and its limits seem the best.

[440] Aaken 2006 refers to the principle of the gentlest paternalism ("das Prinzip des schonendsten Paternalismus").

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