

**Freedom of choice and paternalism in contract law:
prospects and limits of an economic approach**

Thesis Summary

Péter Cserne

Supervisor: Prof. Dr. Hans-Bernd Schäfer

**Universität Hamburg
Fakultät Rechtswissenschaft**

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My thesis discusses how, and to what extent, economic analysis can explain and/or justify the limitations on freedom of contract, with special emphasis on paternalism. In order to summarize the main findings of my research, in the following I briefly present the motivating problem and the aims of the inquiry; I discuss the methodological commitments of the work; finally, I present the structure and the main results of the thesis.

The Problem

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. The interest is nurtured by theoretical considerations as well. Contract regulation and paternalism draw attention to the philosophical and methodological difficulties involved in the justification of the limitations on freedom of contract. They also demonstrate that empirical findings on human behavior may lead, in many cases, to conclusions 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 arises 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.

Aims

On closer look, these problems are in part substantive, in part methodological. The first

is related to the different ways in which the law of contracts confronts the problem of paternalism in various jurisdictions. At the same time, the analysis of such problems will confront us with challenges concerning the methodological and theoretical aspects of conducting an economic analysis of contract law. Traditional economic arguments against paternalism and for freedom of contract should be reassessed in light of recent empirical and theoretical studies.

My goal is to discuss the justifiability of paternalistic contract law rules in different legal systems in light of an extended law and economics approach. The main research questions addressed by the thesis can be grouped into three categories.

(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?

The term 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. 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.

Methods

Lawyers' usual doctrinal methods, embedded in a “legal world view” are 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 should be 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.

In order to assess the problems of paternalism in contract law properly, an empirically based policy-oriented view is both fruitful and necessary. This implies taking into account not only practical philosophy, but insights from both economic theory and empirical research as well. Economic, psychological, sociological etc. analyses *of* law are legitimate theoretical approaches. They provide insights to law from an external point of view. While interdisciplinarity does not imply that lawyers should become economists, psychologists or philosophers, in the domain of policy, 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. To be sure, 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.

As for disciplinary commitments, 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.

The methodological starting point is rational choice theory, as applied in the law and economics literature, but I will also discuss several limitations, corrections and extensions to this approach. 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. Firstly, I incorporate the empirical findings of behavioral decision theory which offer a more realistic view of the situations susceptible for paternalistic intervention. Secondly, I refer to the recent insights from the analysis of freedom of choice in social choice theory suggesting the possibility to include the non-welfarist dimension of the subject in economic analysis.

Structure and results

The thesis commences with an analysis of the conceptual and normative problems of paternalism, and then discusses theories of contract law. In the substantive part, I focus on legal policy questions in contract law and analyze and criticize in detail some contract law rules and doctrines that at first glance look paternalist.

Paternalism. Chapter 2 is on paternalism. Here I discuss the concept and the possible justifications and limits of paternalism, focusing on philosophical, economic and psychological approaches.

I use the following definition of paternalism. 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); and (3) acts without the consent of the subject. As to the justification of paternalism, the relevance of three values is discussed: freedom or autonomy; welfare or interests; and benevolence. These refer to three conflicting philosophical positions: deontological, consequentialist, and perfectionism. I argue that in the limited domain of contract law, one can find an overlapping consensus among these normative positions.

In this chapter, I also discuss, and mostly reject, the possibility of justifying paternalism with the consent of the subject; I distinguish paternalism from related reasons for regulatory intervention; I draw attention to the normative consequences of the difference between private (individual) and legal (institutional) paternalism. When legal *rules* are enacted for paternalistic reasons, some additional problems, such as the over- and under-

inclusiveness of rules arise. A separate section is devoted to the methodological tools economic theories offer for analyzing paternalism, another to the empirical findings in psychological research on human decision making and choice behavior which are possibly relevant for paternalism.

The psychological, pragmatic, economic and philosophical arguments, and counter-arguments, 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 psychological insights and some of the anti-paternalist arguments. I discuss three such regulatory ideas: asymmetric paternalism, libertarian paternalism, and debiasing through law.

Contract theory. 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. From an economic perspective, legally enforceable contracts provide one way to insure the benefits of cooperation in non-simultaneous transactions. Consequently, Richard Posner distinguishes five economic functions of contract law: (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.¹

The economic reasons for intervention in contracts 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 different types of transaction costs and addressed accordingly, either within contract law or in public law-type regulation.

Paternalistic contract doctrines. Rules and doctrines of contract law can be linked to various regulatory functions. Cooter and Ulen identify the links between the reasons for

¹ Posner 1998: 108.

setting limits to contractual freedom, and the typical rules that serve these reasons, and summarize it in the following table.²

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 about facts	Buyer and seller make same mistake about facts	Encourage precaution and risk-spreading	Liability for the least-cost risk-bearer
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

While Cooter and Ulen focus on American contract law, in chapter 4 I provide a comparative law and economics analysis of selected contract doctrines and techniques, which may be used for paternalistic purposes. To be sure, while in this chapter contract law rules drawn from a number of legal systems, including Germany, England, France, Italy and the United States are analyzed, my work is not a contribution to comparative law in the traditional doctrinal sense.

First I explain why the distinction between mandatory and default rules is less clear than traditionally thought, in both conceptual and empirical sense. In the next sections I am concerned with particular rules and doctrines in modern Western contract laws. These include formation defenses (coercion, fraud), incapacity (incompetence); contractual formalities (the use of writing, authentication, etc.); various procedural safeguards of voluntariness and deliberateness (cooling-off periods, mandatory third-party advice, information disclosure); some substantive limits on freedom of contract, such as

² Cooter – Ulen 2004: 294. (Table 7.5)

unconscionability, gross imparity, immorality; finally some paternalistic uses of contract interpretation, especially the contra proferentem rule.

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 light of both theoretical and pragmatic considerations, I come to the conclusion that 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, among which I especially discuss two: firstly, prohibiting certain contracts can hardly increase the range of opportunities; secondly, judges have very limited opportunities to influence market structures. The specificities of consumer protection law and the characteristics of administrative law are also discussed in this context.

In comparing the different legal solutions of various national jurisdictions, one can see contract law as one among the alternative instruments of contract regulation. As to this institutional division of labor, in agreement with Michael Trebilcock, I suggest that the law of contracts should be principally concerned with autonomy issues in evaluating claims of coercion; antitrust and regulatory law with the issues of consumer welfare; and the social welfare system with issues of distributive justice.³

Conclusion. In the concluding chapter I discuss some heuristic rules, called “mediating maxims”, concerning the desirable degree and ways, of paternalistic intervention in contracting. These maxims are reasons about institutions and mechanisms that summarize lessons from general philosophical theories 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: contract regulation should be transparent; it should give precedence to constitutional values over direct moralism; harm prevention should have

3 Trebilcock 1993: 101.

precedence over welfare promotion, while on the other hand, the state should encourage other institutions which can take individual (rather than standardized) needs into account; among the various instruments of contract law, other things being equal, the least intrusive should be preferred. 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.

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