2020

Statutes and the Common Law of Contracts: A Shared Methodology

Juliet P. Kostritsky
Case Western University School of Law, juliet.kostritsky@case.edu

12

Statutes and the Common Law of Contracts: A Shared Methodology

Juliet P Kostritsky

I. Introduction

This chapter explores the intersection between, or the impact of, statutes on contract law, and compares the relative importance of, and intersections between, statutory and common law in contract. Unquestionably, statutes have increased in importance; 'we live in a statutory era'.[1] Those who highlight the rise of statutory intervention in contract often argue that legislative regulation has largely displaced the common law of contracts[2] and that there is little left to the core of contract law.[3]

To judge the meaning of these statutory developments for contract law, one must situate them in context. That context must include not only an understanding of statutes and their institutional role in society,[4] but also the role of courts in developing common law rules[5] – and the particular way in which statutes and the common law operate within bargained-for contractual exchange. Traditionally, scholars viewed statutes as intrusions into private ordering requiring justification[6] while regarding the common

---

[1] See D Farber and PP Frickey, 'In the Shadow of the Legislature: The Common Law in the Age of New Public Law' (1991) 89 *Michigan Law Review* 875, 876. See generally G Calabresi, *A Common Law For the Age of Statutes* (Cambridge, Harvard University Press, 1999).

[2] See eg, EJ Leib, 'What is the Relational Theory of Consumer Form Contract?' in J Braucher, J Kidwell and W Whitford (eds) *Revisiting the Contracts Scholarship of Stewart Macaulay* (Oxford, Hart Publishing, 2013) 259, 262 (discussing displacement of contract law in consumer context).

[3] See D Kennedy, 'Form and Substance in Private Law Adjudication' (1985) 89 *Harvard Law Review* 1685, 1737 (discussing the concept of core and periphery in which the core of contract law is deemed to be private and the public, regulatory aspects of contract law are marginalised at the periphery).

[4] Scholars of statutory law see problems with legislatures being dominated by 'special interest groups' due to collective action problems that 'make it difficult to organize large groups of individuals to seek broadly dispersed public goods'. Farber and Frickey, 'In the Shadow of the Legislature' (1991) 880.

[5] ibid (finding that there is still a viable role for courts despite legislative onslaught because the types of interest group lobbying to solve narrow problems still leaves room for courts to provide remedies when the statutory scheme fails to address a problem). They warn 'against reading negative implications into the precise contours of the complicated statutory scheme'. ibid 898.

[6] ibid 875.

law of tort, property and contract as embodying an 'autonomous private order'.[7] However, recognising that both private law (through common law) and public law (through statutes) intervene in private contractual arrangements by adding or forbidding terms may change the traditional dichotomous view. The particular intervention, as well as the effects of, and justification for, intervention by courts or the legislature into private contracts should be analysed. Intervention must be built on realistic assumptions about how parties behave and react to common law rules and statutes[8] as well as an assessment of how such legal interventions will serve parties' private goals, or more broadly public ones – thus bringing social context into contract law. A comparative approach should also ask: why does intervention follow one course rather than another? What approach will best improve goal achievement after accounting for the costs of intervention?

When is a statutory or common law intervention welfare-enhancing as compared to goal achievement *without* intervention?[9] The assessment of intervention by these various 'institutions'[10] must be made on a comparative basis.[11] How much, and in what circumstances, should legislatures intervene? When is the legislature better or worse than common law courts in intervening, and why?

At one level, because contracts are devised in societies governed by statutes, the parties to those contracts must be subject to those laws. A key question, as yet undertheorised, is why and when

---

[7] ibid 885–86. Property, tort and contract operated fundamentally to protect private rights.

[8] The examination of the influence of statutes on contract law necessarily differs from examining the effects of statutes on tort law in one important respect – statutes affecting contract law must consider that parties have the ability to craft agreements ex ante in a way that tort actors do not. For a thoughtful exploration of the effects of statutes on tort law, see TT Arvind and J Steel, 'Introduction: Legislation and the Scope of Tort Law' in TT Arvind and J Steele (eds), *Tort Law and the Legislature* (Oxford, Hart Publishing, 2013). That difference affects intervention choices by the legislature. For a discussion of the realistic behavioral assumptions affecting transacting parties see OE Williamson, *Economic Institutions of Capitalism* (New York, The Free Press, 1985) 44–50.

[9] Assessing welfare enhancement must include a comparative assessment of whether intervention by a legislature or court will help the parties achieve their desired goals without introducing costs that reduce the overall net benefits when compared to non-intervention. As Professor Coffey explains: 'the intervention must promise a net-of-cognizable-intervention-costs improvement of goal achievement (as compared to the level of desired effect reached without intervention)'. RJ Coffey, 'Methodological Perspective' (2002) 6 A manuscript by my colleague. (unpublished manuscript, on file with author).

[10] If broadly defined, courts, private exchanges and statutes are institutions. 'Institutions define and limit the set of choices of individuals.' DC North, *Institutions, Institutional Change and Economic Performance* 4, 2nd edn (Cambridge University Press. USA1990). 'Institutions include any form of constraint that human beings devise to shape human interaction.' ibid. These institutions also extend to private organisations like the New York Stock Exchange, which establishes rules to govern the voluntary arrangements of participants who join. See, eg, the NYSE Rules, at http://wallstreet.cch.com/nyse/rules (2019).

[11] See O Williamson, *Mechanisms of Governance* (Oxford, Oxford University Press, 1996) 7 (discussing remediableness 'according to which an outcome for which no superior alternative can be described with net gains is presumed to be efficient'); N Komesar, 'In Search of a General Approach to Legal Analysis: A Comparative Institutional Alternative' (1980) 79 *Michigan Law Review* 1350, 1350 (examining different decision-makers and evaluating them according to a criterion of 'choosing the best, or least imperfect, institution to implement a given societal goal'). In this chapter, a comparative analysis also assesses legal intervention against leaving the solution to parties' private strategies.

statutes or common law rules would be needed to govern, supplement or forbid parties' private arrangements, and whether statutes and the common law share a common methodology. Examining statutes and moving beyond a merely case-centric view of contracts prompts a new insight: not only do statutes influence the common law of contracts, but also that statutes and common law interventions in contracts are driven by the same taxonomy – a shared methodology – of intervening to add terms when obstacles prevent the parties from reaching a complete contract, the costs of intervention do not outweigh the benefits, and such intervention will improve welfare.[12]

Courts intervene in contracts in many ways: they may add trade usages or default rules of remedies or fiduciary duties to an agreement, forbid certain contractual waivers (as in the implied warranty of habitability[13]), or withhold enforcement.[14] Statutes also intervene in private contracts by providing background default rules; other statutes regulate contracts by mandating certain disclosure or forbidding certain contracts.

This chapter treats statutory and judicial interventions – through the common law of rule formulation and extension – as different forms of collective intervention into private contracts. In the financial contracting literature,[15] intervention refers to cases in which courts or legislatures take actions that add or subtract terms from parties' contracts or refuse to enforce private contracts,[16] rather than letting the market operate without any interference.

With either legislative or common law intervention in contracts,[17] the goals of the contracting parties provide the foundation for analysis. In any exchange, parties seek to maximise surplus while minimising costs. Contract law 'allow[s] parties to act in a manner consistent with their voluntary preferences'.[18] Thus, intervention, whether by common law courts or the legislature, should depend on

---

[12] See JS Wiley, Jr, 'A Capture Theory of Antitrust Federalism' (1986) 99 *Harvard Law Review* 713, 749 fn 167 (cited in TJ Zywicki, 'A Unanimity-Reinforcing Model of Efficiency in the Common Law: An Institutional Comparison of Common Law and Legislative Solutions to Large-Number Externality Problems' (1996) 46 *Case Western Reserve Law Review* 961, 966 fn 17) (explaining Pareto efficiency as holding 'one condition to be superior to another only if at least one person is better off and no one is worse off').

[13] WZ Hirsch, JG Hirsch and S Margolis, 'Regression Analysis of the Effects of Habitability Laws Upon Rent: An Empirical Observation of the Ackerman-Komesar Debate' (1975) 63 *California Law Review* 1098.

[14] See part IX below (discussing denying enforcement to contracts with forbidden terms).

[15] The intervention question – whether courts or legislatures should intervene in parties' private contracts – arises in the context of securities laws. Scholars analyse whether securities laws will enhance efficiency and improve welfare. See FH Easterbrook and DR Fischel, 'Mandatory Disclosure and the Protection of Investors' (1984) 70 *Virginia Law Review* 669.

[16] See UCC § 2-302.

[17] For an example of the scholarly recognition of the importance of statutes in contracts, see generally Q Zhou and L DiMatteo, 'Three Sales Laws and the Common law of Contracts' in *Comparative Contract Law: British and American Perspective* (Oxford, Oxford University Press, 2015).

[18] PM Gerhart, JP Kostritsky and RJ Coffey, 'The Birth of an Interventional Choice – A Justificational Analysis' (summer 2005) (unpublished manuscript, on file with author).

whether the parties can achieve and maximise welfare on their own, or whether transaction costs or other bargaining obstacles prevent that. Could the parties achieve their goals through pure contract without needing to resort to governmental enforcement or other collective interventions – interventions that entail costs? How can governmental intervention, either in the form of a common law rule or statute, or some combination of statute and common law,[19] facilitate contracting and help the parties achieve goals that they could not achieve on their own? Finally, when should common law courts or legislatures forbid or mandate certain terms in a contract or otherwise intervene in private contracts?

To assess the welfare effects of certain interventions, courts and legislatures should use empirical studies to evaluate whether 'a particular set of institutional terms may reduce [costs] (by comparison to one or more possible term sets) without introducing new costs that offset or exceed the costs introduced';[20] that comparison will determine if one intervention is superior to another by achieving articulated goals more efficiently.[21] Constant readjustment of intervention and comparison may be needed to avoid 'unintended consequences'[22] that add costs to contracts without solving problems.

This chapter in part II considers differences and similarities between legislatures and courts. Part III examines private ordering that successfully navigates problems between two parties without any collective intervention. Parts IV and V use that baseline to explain why and when a court or a legislature would intervene in a private arrangement. Part IV describes when legislatures and courts might add norms or trade usages of private parties to the parties' contract – a form of intervention by adding non-adjudicable norms[23] to an express contract through an incorporation strategy – and part V discusses when and why legislatures and courts might add remedial default rules. Part VI examines how legislative intervention may be required to achieve goals parties cannot accomplish on their own by contract. Part VII discusses when statutes and common law rules facilitate contracting by minimising transaction costs and maximising value. Part VIII examines when intervention should take the form of mandated disclosure and who should develop the parameters for such disclosures. When are mandated disclosures effective and when does mandated disclosure fail as a solution to informational asymmetries and other contracting problems? Part IX examines what effect, if any, legislative prohibitions have on the common law of contracts. If legislatures forbid the inclusion of certain terms in contracts, when and

[19] Federal Rule 10b-5 is a legislative anti-fraud provision, but the content of insider trading rules derives largely from common law cases on duty. See JC Coffee, Jr, 'Mapping the Future of Insider Trading Law: Of Boundaries, Gaps and Strategies' [2013] *ECGI Working Paper Series in Law* 204, 4.

[20] Email from Ronald J Coffey, Professor Emeritus, Case Western Reserve University, to Professor Juliet P Kostritsky, Case Western Reserve University (1 June 2013, on file with author).

[21] Because achievement of one goal may hinder achievement of another goal, intervenors – whether legislatures or courts – need to confront the concept of covariance, asking 'how much of one must be foregone to capture a measure of the other.' Coffey (n 9).

[22] See O Ben-Shahar and CE Schneider, 'The Failure of Mandated Disclosure' (2011) 159 *University of Pennsylvania Law Review* 647, 647.

[23] See, eg, J Kraus, 'Legal Design and the Evolution of Commercial Norms' (1997) 26 *Journal of Legal Studies*377; RE Scott, 'The Limits of Behavioral Theories of Law and Social Norms' (2000) 86 *Virginia Law Review* 1603.

why do parties contract around legislative provisions to achieve their private goals?[24] What do all of these interventions and their effects suggest about any limits on governmental interventions as well as the need to constantly reevaluate the effectiveness of interventions using a method that examines all costs and benefits?

By providing a justificatory framework for intervention tied to bargaining obstacles,[25] the success of private ordering in certain contexts, and a method of comparing costs and benefits of intervention by different institutions, one can assess whether and why certain interventions are effective, and why others fail. These insights can guide future interveners – whether legislatures or courts – in private contracts.

II. Courts and Legislatures: Differences and Similarities

To fully understand *why* and *how* statutes passed by legislatures and rules developed by courts intervene in parties' contracts, the general role that statutes and common law courts play deserves scrutiny. Courts and legislatures operate in different realms; courts only address disputes that are brought to them by one of the parties whereas legislatures can proactively identify a problem without having to wait for a party to initiate the process, gathering information before drafting statutes to address those problems.[26] Statutes state general rules applicable to a wide class of parties;[27] courts' decisions are narrowly targeted to the parties' dispute.[28]

While institutional differences certainly exist between courts and legislatures,[29] at a fundamental level there is a commonality in the decision to enact a statute or to develop a common law rule in the context of a particular case. When common law courts decide cases and interpret precedent, or create an exception to prior precedent, they inevitably do more than decide the controversy ex post.

[24] See, eg, S Sanga, 'Incomplete Contracts: An Empirical Approach' (2018) 34 *Journal of Law, Economics, & Organization* 650.

[25] JP Kostritsky, 'Taxonomy for Justifying Legal Intervention in An Imperfect World: What to Do When Parties Have Not Achieved Bargains Or Have Drafted Incomplete Contracts' [2004] *Wisconsin Law Review* 323.

[26] See L Anderlini, L Felli and A Riboni, 'Statute Law or Case Law' (1 July 2008), available at https://ssrn.com/abstract=1168662; Farber and Frickey (n 1). See also RA Posner, *Economic Analysis of Law*, 7th ed (New York, Wolters Kluwer, 2007) § 19.3 (discussing legislative considerations, and inefficiencies, in lawmaking).

[27] For that reason, statutes can appropriately act when there are large groups of homogeneous parties that would be subject to a rule and flexibility is not required. See I Ehrlich and RA Posner, 'An Economic Analysis of Legal Rulemaking' (1974) 3 *Journal of Legal Studies* 257 (discussing 'a relatively broad span of activity' characteristic of legislation).

[28] See Calabresi, *A Common Law* (1999).

[29] Email from Professor Peter M Gerhart, Case Western Reserve University to Professor Juliet P Kostritsky, Case Western Reserve University (5 July 2018, on file with author).

This is because prior case law necessarily 'underdetermines'[30] the outcome of subsequent cases. In making decisions about the parameters of the holding of a prior case that differs from the current case, a court must resort to a normative framework. That is why 'economic theory treats common law adjudication, especially of hard cases, as the effective equivalent of legislating new legal rules'.[31]

If courts use a framework that references goals and a model of behaviour of the parties, then judicial decision-making resembles legislation. Although cases are decided ex post after events have occurred[32] a court deciding a case must reference how the decision – including particular rule formulations or *implied terms* – will promote parties' private goals, including welfare maximisation. Legislatures passing statutes that affect private contracts will also consider how the legislation will affect the goals of future parties deciding to enter contracts. If a legislature considers social goals, it should also consider the effects on private parties. That will enable it to determine if the overall benefits of addressing those externalities[33] outweigh the costs of intervention.

III. Private Ordering without Intervention or Contracting

Because the protection of private contracts is essential, in judging the justification for, and effects of, statutory and judicial intervention, one should first consider the realm of private transacting where parties resolve matters between themselves rather than adopt an explicitly enforceable contract. If parties reach an accommodation on their own completely outside of contract, legal intervention, whether judicial or legislative, would be superfluous.

Understanding the commonalities in the rule-making of courts and legislatures that add terms to contracts may be easier if one examines how parties reach an exchange resolution without an adjudicator of any kind being involved, and devise informal constraints. Parties could later devise contracts to address the same controversy and invoke third-party enforcement.

In general, parties will try to achieve their goals while minimising the costs of doing so.[34] If there are no barriers to the parties reaching an exchange and they do not do so, there would presumably be

---

[30] R Craswell, 'Do Trade Customs Exist' in JS Kraus and SD Walt (eds), *The Jurisprudential Foundations of Corporate and Commercial Law* (Cambridge, Cambridge University Press, 2000); JS Kraus and SD Walt, 'In Defense of the Incorporation Strategy' in Kraus and Walt (eds), *Jurisprudential Foundations* (ibid) at 122.

[31] J Kraus, 'The Methodological Commitments of Contemporary Contract Theory' in JL Coleman and S Shapiro (eds), *The Oxford Handbook On Jurisprudence And Legal Theory* (Oxford, Oxford University Press, 2002). A narrow view of judicial decision-making might argue to the contrary that 'every pronouncement of legal decisionmakers is so nuanced by factual peculiarities that it cannot be interpreted as based on value selection'. Coffey, Methodological Perspective (n 9) at 4.

[32] That difference of courts addressing issues ex post leads courts to address issues 'myopically.' See Anderlini et al, 'Statute Law' (2008) 1.

[33] See AC Pigou, *The Economics of Welfare*, 4th edn (London, Macmillan, 1932) 192 (discussing the link between externalities and legislative intervention) (cited in Zywicki, 'A Unanimity-Reinforcing Model' (1996) 961).

[34] Gerhart, Kostritsky and Coffey, 'The Birth of an Interventional Choice' (2005).

little welfare justification for legal intervention. The absence of a contract would reflect the parties' determination that no welfare improvements could be gained from an exchange. An example follows.

Imagine two next-door neighbors, one playing loud music and the other objecting to it.[35] Each party knows who the other is and can identify the source of the noise. Not knowing exactly how the law would address the problem were they to complain, they might reach a resolution: one party – the noise objector – might take out the noisemaker's garbage, hoping the noisemaker turns down the volume. Alternatively, the noisemaker could take out the garbage of the noise objector to deter complaints. Either resolution would comprise a private arrangement that internalises the externality of the loud music – a kind of implicit contract or private strategy.[36] Alternately, the parties could adjust their behaviour by conforming to a norm.[37] In these cases, there is no need for any judicial or statutory intervention. When there are no obvious barriers to a private agreement, a court is unlikely to intervene with implied terms. Likewise, a legislature is unlikely to intervene to regulate the controversy. There are no market imperfections and no gains from trade.

IV. Non-adjudicable Norm Omitted from Express Contract: Should Law Add a Term?

The noise controversy example illustrates how parties reach private solutions. They could have but did not reach a contractual solution; instead, they selected another institution – a non-adjudicable private strategy. Numerous other examples of private arrangements operating without collective governmental intervention in contract or exchange exist. For example, the Maghribi traders successfully developed a norm that constrained the behaviour of agents and also developed private mechanisms for enforcement where state power was undeveloped.[38] Another norm might standardise weights and measures to 'minimise … measurement costs in markets'.[39] In the example of the neighbors with the noise problem (outlined above), a private contractual practice with respect to neighbors' modulation of the music volume and trash collection could become prevalent as a general norm for noise controversies (in the community).

---

[35] ibid.

[36] Implicit contracts can exist between employers and employees and these implicit arrangements deal with unexpected changes (such as slackening demand). Because third-party observers 'are not sufficiently informed' and explicit contracts will not be achievable, parties will rely on implicit contracts that are self-enforcing due to self-interest. C Azariadis, 'Implicit Contracts' in J Eatwell, M Milgate and P Newman (eds), *Allocation Information and Markets* (Basingstoke, Palgrave Macmillan, 1982). See also C Bull, 'The Existence of Self-Enforcing Implicit Contracts' (1987) 102 *Quarterly Journal of Economics* 147.

[37] Gerhart, Kostritsky and Coffey (n 18).

[38] See A Greif, *Institutions and the Path to the Modern Economy Lessons from Medieval Trade* (Cambridge, Cambridge University Press, 2006) 59–63.

[39] RE Zupko, *Revolution in Measurement: Western European Weights and Measures in the Age of Science* (Philadelphia, American Philosophical Society, 1990) 183–84.

How norms become incorporated into law as additional terms of a contract through common law default rules[40] or through statues[41] should be analysed under a common methodology. The decision to add terms or to intervene should depend on a cost comparison of a self-enforcing norm and 'the costs of alternative arrangements – such as common law, statute, and the particular advantage and disadvantage of each solution in such contracts'.[42]

When norms develop, intervention by either courts or a legislature might arise as an issue if parties fail to adhere to a norm. Those aware of a 'propensity to diverge'[43] might include the norm as an express term of their contract. But if the parties fail to include the norm or practice in their contract, a court or a legislature faces the issue of whether to intervene by incorporating the norm as a term in the contract. A court or legislature might decide that the best practice would be one of non-interference through legal recognition of the norm. They use the norm as an input[44] or source for the legal intervention. The Uniform Commercial Code (UCC) adopts such an incorporation strategy by making trade usages, course of performance and course of dealing automatically part of the parties' agreement.[45] Courts also incorporate trade usages into parties' contracts, often to control opportunistic behaviour.[46]

If a court or the legislature adverts to the goals of the contracting parties in deciding whether intervention to add norms to a contract would improve welfare, it could recognise such norms to save the parties the transaction costs of expressly incorporating them. That strategy might be cost-minimising when the parties use customary language, not realising that they would need to translate those customary meanings into express terms in order for the express terms to include their customary meanings.[47] The transaction costs thus include not just drafting but even the costs of conceptualising that there is a need to draft.[48]

---

[40] See JP Kostritsky, 'The Law and Economics of Norms' (2013) 48 *Texas International Law Journal* 465, 497.

[41] See UCC § 2-202.

[42] Kostritsky, 'Norms' (2013) 483.

[43] Email from Ronald J Coffey, Professor Emeritus, Case Western Reserve University, to Juliet P Kostritsky, Case Western Reserve University (2 May 1996, on file with author).

[44] Kostritsky (n 40) 485.

[45] UCC § 2-201(b)(3). UCC § 2-202 provides that unless the parties explicitly negate them, the parties' private norms and trade usages can be used to explain or supplement parties' private contracts.

[46] See JP Kostritsky, 'Judicial Incorporation of Trade Usages: A Functional Solution to the Opportunism Problem' (2006) 39 *Connecticut Law Review* 451.

[47] Kraus and Walt (n 30) 199 (discussing increased specification costs). See also Kostritsky (n 40) 498.

[48] Kraus and Walt (n 30) 199. See also JP Kostritsky, 'Contract Interpretation: Judicial Rule Not Party Choice' in Larry DiMatteo Qi Zhou, Severine Saintier, and Keith Rowley (eds), *Commercial Contract Law: A Transatlantic Perspective* (Cambridge, Cambridge University Press, 2013) 258 fn 92. **There is an accent over the e in Severine JK**

A court or legislature deciding whether to add norms to a contract and then to enforce such an augmented contract should consider whether the parties have already reached implicit or non-adjudicable norms or practices that are effectively *self-enforcing*. If not, would legal recognition and enforcement of a norm enhance value for both parties by saving on specification costs[49] or by curbing the prospect of opportunistic behaviour? Non-adjudicable norms might be self-enforcing, or might depend on enforcement by third-party organisations. Conventions such as driving on the right side of the road would be self-enforcing, whereas informal norms dealing with measurement of weights in merchant trade might develop privately and then depend on additional third-party sanctions.

The incorporation decision, whether in the form of a statutory or judicial decision to incorporate the norm, should depend on the common methodology – the justificatory framework for assessing all interventions in private exchanges. Does the legal formalisation adopting the content of the eligible input of a norm or the legal enforcement of a norm (two separate questions) save parties' costs and increase surplus?

A court or legislature might decide not to intervene to incorporate the norm as a term of the contract if it viewed the norm as an implicit understanding that the parties intended to enforce solely through private means of enforcement.[50] A legislature or court might also decline to enforce the norm if the lawmaker concluded that the parties would want the flexibility to depart from following the norm to respond to circumstances – opting to not be bound to a past practice.[51] The court or legislature would be more likely to decline to adopt the norm if it believed the parties could bargain or rebargain once the issue had surfaced.[52] Finally, if parties are better able to judge whether the norm should apply,[53] a court or legislature might decline to adopt the norm.

If, however, the court or the legislature decides that norms save parties costs by policing opportunism that would otherwise act as a drag on gains from trade, a court or legislature might decide to incorporate the norm into private contracts. In that way, intervention might help parties achieve more of what they wanted ex ante by policing a behaviour – opportunism – that would otherwise decrease gains from trade.[54] Intervention would therefore be welfare-enhancing. The legal decision-maker in deciding whether to incorporate the private norm into the contract – either by a statute or

---

[49] Kraus and Walt (n 30) 193.

[50] These include threats of reputational or other enforcement mechanisms such as a collective boycott. Greif, *Institutions* (2006).

[51] See Kraus and Walt (n 30) 208.

[52] See A Schwartz and J Watson, 'The Law and Economics of Costly Contracting' (2004) 20 *Journal of Law, Economics, & Organization* 2 (examining party preferences on whether renegotiation should be restricted).

[53] Kraus and Walt (n 30) 208*.*

[54] See Williamson, 'Economic Institutions' (1985) 33–36 (connecting need to minimise opportunism to increased gains from trade).

common law rule – will consider the deadweight losses from uncontrolled opportunism as well as potential mistakes by decision-makers in understanding the norm.[55]

Legal recognition of private norms – a type of intervention – should thus depend in part on whether the adopting lawmaker thinks that, as a general matter, courts or legislatures would be able to facilitate the achievement of the parties' goals by aptly discerning norms, in effect deferring to the parties' express arrangements,[56] or declining to enforce such norms unless the parties expressly incorporated them.[57] Norm incorporation may also depend on whether a court or legislature thinks that legally enforcing or recognising a norm will crowd out or complement private enforcement strategies parties have, because crowding out would be considered a cost of intervention.[58]

This structured methodology for explaining why courts might intervene by adding terms such as norms to private contracts based on the barriers to contracting can also explain instances in which statutory interventions add to the parties' terms through default rules, such as the UCC Article 2 default rules or statutory or common law fiduciary duty rules. These statutes or common law rules can be justified as assisting the parties in achieving their private goals by helping them overcome costs or obstacles that private counterstrategies could not solve or when such strategies would be more costly than a law-supplied rule.[59] It can also explain why remedial default rules exist.[60]

V. Private Agreements Formed without Statutes: Government Intervention to Enforce or Add Remedial Defaults

When barriers to contracting do not exist, parties can form a business association by deliberately entering into an enforceable contract. There is no need for a statute – a collective intervention – telling the parties how to split the profits. However, unless the parties could depend solely on informal

[55] See Kraus and Walt (n 30) 194 (discussing the problem of errors in incorporation strategy).

[56] See DV Snyder, 'Language and Formalities in Commercial Contracts: A Defense of Custom and Conduct' (2001) 54 *SMU Law Review* 617, 618 ('Custom ... is part of the language that parties use to express themselves to each other').

[57] This approach would run counter to § 2-202, which assumes that norms (trade usages, etc) will be incorporated unless specifically negated. See UCC § 2-202 cmt 2.

[58] See JP Kostritsky, 'A Bargaining Dynamic Transaction Cost Approach to Understanding Framework Contracts' (2019) 68 *American University Law Review* 1621, 1693 (discussing crowding out). If the law crowds out private or self-enforcement, legal intervention could add to the costs of goal achievement. There are reasons to think that crowding out concerns are exaggerated or misplaced.

[59] Coffey, email (n 43). See also RJ Coffey, 'This is the Way I Would Set Up the Intractability Analysis' (unpublished manuscript, on file with author).

[60] For default rules to persist, they must 'solve a problem that a reasonable portion of contractors will face in a way that is acceptable to those contractors.' A Schwartz, 'The Default Rule Paradigm and the Limits of Contract Law' (1993) 3 *Southern California Interdisciplinary Law Journal* 389, 392. This 'acceptability constraint' (ibid) is consistent with the common methodology described in this chapter – legal intervention is justified only when the benefits of the intervention outweigh any offsetting costs of intervention (or inaction).

reputational sanctions, they might need to resort to a court to enforce the partnership. If the court decided to enforce the contract by awarding damages, it would be adding a remedial default rule – a form of collective intervention.

Professor Whitford has recently suggested that eliminating all default rule contractual remedies would cause parties to be reluctant to contract at all, or they might 'demand a larger risk premium'.[61] Therefore, courts may decide that intervening in private contracts by adding a remedial default rule is justified because 'it is hard to believe the benefits of eliminating the availability of remedies as a default remedy would exceed its costs'.[62] This intervention is consistent with the welfare-maximising common methodology articulated here.

The justification for supplying a remedial default rule is that it will minimise costs for the parties – the same justification that underlies other decisions by courts or legislatures to add other terms to parties' contracts. A remedial default rule saves parties the costs that they would otherwise incur if they had to charge a premium to make up for the absence of such defaults without creating new offsetting costs that outweigh the costs saved.

The British courts' decision at common law to adopt expectation damages as a default rule, adding to every contract damages calculated on the position that the party would have been in had the contract been performed,[63] is based on the parties' bargain. One recent argument explained that the success of remedial default rules is because they are 'formulas [that] are transcontextual because they are content free'.[64] The fact that the remedial default takes the form of a 'transcontextual' formula that is tied to the parties' own deal and is easily applied satisfies the cost analysis, but is not a reason for its adoption as a default rule. Courts could have declined to adopt a remedial default rule at all, forcing parties to stipulate to damages in every contract. Courts could have adopted an altogether different remedial default rule such as punitive damages. That courts adopted a default rule of expectation damages and used a formula to achieve that goal evidences that courts wanted to avoid the costs of parties needing to charge a premium for the absence of default rules. It wanted a rule that, because of the formula, would not impose offsetting costs that outweighed the benefits and would not lead to costly inefficiencies of a contrary rule, such as punitive damages.[65]

---

[61] See WC Whitford, 'A Relational Perspective on Contract Law's Default Rules, With An Emphasis on Remedies' in D Campbell and R Halsom (eds), *Research Handbook in Private Law Remedies* (Cheltenham, Edward Elgar, 2019).

[62] ibid 31.

[63] A Schwartz and RE Scott, 'The Common Law of Contract and the Default Rule Project' (2016) 102 *Virginia Law Review* 1523, 1547. See also *Robinson v Harman* (1848) 154 ER 363, 365, 1 Ex 850, 855 ('[W]here a party sustains a loss by reason of a breach of contract, he is, so far as money can do it, to be placed in the same situation, with respect to damages, as if the contract had been performed.')

[64] Schwartz and Scott, Default Rule Project' (2016) 1523.

[65] Expectation damages encourage efficient breach whereas punitive damages may discourage efficient breaches. See eg, G Klass, 'Efficient Breach' in G Klass, G Letsas, and P Saprai (eds), *The Philosophical Foundations of Contract Law* (Oxford, Oxford University Press, 2014) 362–87 ('[T]he theory of efficient breach ... recommends expectation damages because expectation damages give parties a reason to perform when and only when performance will increase overall social welfare.'). But see WS Dodge, 'The Case for Punitive Damages in Contracts' (1999) 48 *Duke*

A further question with remedial default rules for damages is whether the default rule should be added by a legislative rule or a judicially developed default rule. Default rule remedial issues arise when the parties have already reached a bargain. There is thus no need for the legislature to intervene to solve an externality problem that the parties cannot solve by contract. Should the legislature nonetheless have a role in designing remedial default rules? Would that intervention be better than a judicially supplied default rule? Damage default rules might best be developed by courts when no externalities are present, the cost of not supplying a remedy is welfare-reducing, and courts can slowly develop the contours of the remedial default scheme including the role of mitigation, uncertainty and foreseeability, and the theories of damages informed by scholarship of great contracts scholars such as Fuller and Purdue.[66] Bright line rules for some aspects of remedies seem inappropriate, so incremental consideration through case law would have a comparative advantage. However, once a remedial scheme is fully developed by courts, a legislature might enact a remedial default scheme for a particular context, such as the sale of goods.[67]

VI. Statutes Intervening to Help Parties Achieve Goals they could not Achieve Privately

The inability to bargain to a solution affects the decision and the manner in which the legislature intervenes. A statute may solve a problem that parties could not solve by private agreement, or could not solve because of budget constraints. If the parties are unknown, bargains cannot be negotiated. Several examples illustrate the advantage of legislative intervention to solve contracting problems: first, to regulate dog owners, second, to provide unlimited liability for corporations and third, to enact bankruptcy statutes. When an exchange cannot be achieved at all, relying on the common law of contracts with its commitment to enforcing private agreements will not work. Legislatures seem uniquely situated to intervene and have advantages over intervention by a court because, without a contract being formed, the role a court could play would be a *null set*. Thus, the inability to reach an agreement by contracting may justify legislative intervention by regulation if the common methodology indicates that intervention will increase overall welfare when the benefits outweigh the offsetting costs. In other instances, where the contract is achieved but incomplete, the legislature may *add* a term.

A. Solving Externalities

Collective intervention by legislatures responds to difficulties that parties face solving a problem by contract. A private contractual resolution may not occur when the parties do not directly interact. Private norms or private contracting might fail to solve externality problems, as when dog owners fail to

---

Law Journal 629 (arguing that punitives are more efficient because costs of forcing the breaching party to negotiate for a liability release are lower than costs of litigation of establishing expectancy damages).

[66] LL Fuller and W Purdue, 'The Reliance Interest in Contract Damages' (1936–37) 46 *Yale Law Journal* 52 (examining protection of the reliance interest as a separate element of damages).

[67] See, eg, UCC §§ 2-703–715.

clean up after their dogs.[68] Yet, a contract between the offending dog owners and the homeowner victims would likely be difficult to achieve.[69] Without extraordinary search costs, the homeowner could not know which dog owner had failed to supervise their dog. The law might intervene and pass a statute requiring owners to pick up dog litter or face sanctions. Statutory intervention would respond to the difficulty of the parties reaching a bargain on their own.[70] The passage of such a law might in turn facilitate public norms,[71] demonstrating a successful interplay of different institutions, both public and private, to solve problems.

The comparison for intervention should consider several costs. First, there are transactions costs (as the cost of reaching bargains with pet owners regarding negative externalities of pet activity). There is also the cost of legal intervention and the associated cost of legal enforcement. However, that latter cost may be mitigated by a norm that arises to report violators once the law is passed. So there are contracting costs, the costs of judicial action in trespass (as an *alternative* institutional solution), and the cost of legal intervention as reduced by informal norm enforcement. A comparison suggests that legal intervention in the form of a 'pooper scooper' law is the most effective solution to an externality problem as the transaction costs of private agreements are high, judicial intervention in contracts is a null set (because they don't exist) and the legislature can intervene with a bright line rule.[72]

B. Legislation when Parties cannot Solve: Limited Liability

A statutory intervention to solve contracting difficulties also explains why legislatures intervene with a statute granting corporations limited liability.[73] If two parties come together to form a business entity for the first time, those parties are entitled to be held liable only to the extent of their capital

---

[68] See DH Cole and PZ Grossman (eds), *Principles of Law and Economics* (New York, Wolters Kluwer, 2011) 18 (defining externalities in which 'some of the costs or benefits associated with the transactions are not borne by those participating in the transaction but externalized to others').

[69] See Kostritsky, 'Taxonomy' (2004).

[70] This statutory intervention could also spark informal enforcement by members of the public who would feel empowered to informally sanction dog owners who violated the law.

[71] See Scott, 'The Limits of Behavioral Theories' (2000) 1603.

[72] This example illustrates how the common methodology of this chapter guides *which* lawmaker should intervene, not merely whether intervention is appropriate. Though statutes have been considered the proper mode of legal intervention to solve large-number externality problems, scholars have called into question this 'conventional wisdom': Zywicki (n 12) 961. Legislatures are prone to 'overrepresenting third parties not directly involved with the issue at hand,' ibid 983, which 'Separat[es] influence over results from the costs of those results': ibid 986. By contrast, when a judge is the legal decision-maker to resolve a large-number externality problem, 'The judge can internalize the effects of a decision in a manner that the legislator, acting as a representative of a large voting block, cannot': ibid 989. By considering whether the common law would be more efficient at solving a contract law problem than a statute, the common methodology of this chapter is thus illustrative.

[73] Del Code Ann Tit 6, § 18-101. Limited liability becomes a part of an investor's contract.

contributions as against third parties.[74] Shareholders are not liable for a firm's debts or torts. Why would the law intervene and protect the initial shareholders by adding a limited liability term to their contract? Why couldn't the shareholders bargain for that limited liability as against third parties? Why couldn't the common law imply a term in the shareholders' contract with the firm? Normally, common law courts supply terms under majoritarian default rules on the theory that both parties would have preferred that term.[75] However, majoritarian preferences depend on weighing an exchange between two contracting parties; it would not ordinarily include a term binding unrelated or unknown third parties. Thus, a legislative response would be the only response to solve the problem.

The justification for intervention is that the initial parties simply cannot achieve limited liability by private contract in such a way as to bind third parties. The law decides that the benefits of intervention in the form of a limited liability addition to their contract incentivise parties to invest, and that those benefits outweigh any negative externalities. Limited liability thus serves to 'externalize some portion of the business' total risk exposure to creditors'.[76]

C. Legislation to Solve a Timing Problem Hindering Contracts: Bankruptcy

Another way in which the law can respond to bargaining obstacles that parties cannot resolve privately is by solving 'time-inconsistency problem[s]' through enactment of bankruptcy statutes.[77] Beginning in England in 1581,[78] the law decided to subject creditor–borrower contracts to the rules of bankruptcy. In one sense, the intervention is simply part of the not unremarkable 'general common law rule that courts in construing contracts shall incorporate relevant, unmentioned laws as implied contract terms'.[79]

The law could, however, have declined to intervene by statute and forced parties to contract for protections for creditors should a debtor become insolvent. If bankruptcy law were not mandatory, creditors would prefer private debt collection remedies that would result in a '"run" on the debtor's assets'.[80] Because later creditors are unwilling to give up private debt collection even though a co-ordinated process will maximise value, the law intervenes to maximise the value of the debtor's assets. The unwillingness of creditors to include a co-ordination clause arises because of a 'time inconsistency

---

[74] S Bainbridge, *Corporate Law*, 2nd edn (New York, Foundation Press, 2009) 115.

[75] I Ayres and R Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 *Yale Law Journal* 87.

[76] ibid 115.

[77] SD Longhofer, 'Protection for Whom? Creditor Conflict and Bankruptcy' (2004) 6 *American Law and Economics Review* 249, 253.

[78] An Act Against Such Persons as Do Make Bankrupt 34 & 35 Hen VIII, c 4 (1542–43).

[79] SW Feldman, 'Statutes and Rules of Law as Implied Contract Terms: The Divergent Approaches and a Proposed Solution' (2017) 19 *University of Pennsylvania Journal of Business Law* 809, 810.

[80] Longhofer, 'Protection for Whom?' (2004) 251.

problem induced by the sequential nature of a debtor's contracts with creditors'.[81] If there are earlier and later lenders to a single borrower, the later lender can offer terms agreeing not to co-ordinate with other lenders; that offer comes with a lower interest rate for the borrower that both the later lender and the borrower prefer.[82] Absent a law mandating co-ordination, creditors will be inclined to 'get in line today (by example, getting a sheriff to execute on the debtor's equipment)'.[83] That may be worse for creditors as a whole because holding onto the assets will maximise value.[84] The ad hoc liquidation that occurs when there is no bankruptcy statute results in deadweight loss[85] leading to worse results than would occur with legislatively mandated co-ordination.

Bankruptcy law solves a problem that creditors do not want to resolve by contract. The time sequence problem hinders parties from reaching efficient results. The earlier lenders have terms already and will not be able to contract with later lenders because they do not yet exist. The later lenders and borrowers borrowing from such lenders will likely refuse co-ordination clauses. Had the lending all occurred at the same time with all lenders and borrowers acting together, parties might be incentivised to include co-ordination clauses which would maximise value for all creditors when viewed ex ante. Because private contractors won't solve the problem, a judicial response arising out of the common law of contracts implying terms in creditor–borrower contracts would be hard to justify under traditional models of majoritarian preferences. Statutes, through the addition of the bankruptcy statute as a term in all contracts, can overcome private parties' disinclination to adopt efficient co-ordination clauses caused by a time inconsistency problem – a type of bargaining obstacle – and benefit welfare through preventing runs on assets which outweigh costs.[86]

---

[81] ibid 253.

[82] *Ibid.*

[83] ibid 257.

[84] ibid 250.

[85] ibid 252.

[86] Common law courts' interpretation of bankruptcy statutes has also interestingly yielded unintended consequences when courts depart from the common methodology described in this chapter. One example is in the Chrysler bankruptcy. See MJ Roe and D Skeel, 'Assessing the Chrysler Bankruptcy' (2010) 108 *Michigan Law Review* 727. Roe and Skeel argue that the Chrysler bankruptcy was presented as a § 363 sale but operated more as a § 1129 reorganisation (ibid 741). Secured creditors received only 29 cents for every dollar of debt they held, whereas unsecured 'retiree claims were promised well over 50 cents on the dollar' (ibid 733). The bankruptcy court departed from bankruptcy norms (ibid 742–49), and the court's failure to consider this chapter's common methodology in its statutory interpretation has led to a 'significant increase in borrowing costs' for some firms, B Baylock, Bullock, A Edwards, and J Stanfield. 'The Role of Government in the Labor–Creditor Relationship' (2015) 50 *Journal of Financial and Quantitative Analysis* 325, 327.

VII. Statutes or Common Law Rules to Facilitate Contracting Save Parties' Transaction Costs, Overcome Bargaining Obstacles and Develop an Efficient Governance Form

A. Facilitating Contracts through 2-206 and Constructive Conditions of Exchange

Statutes also have another function of *facilitating contracting* by providing off-the-shelf default rules to parties' contracts that parties can use to minimise transaction costs or opt out of if they have idiosyncratic preferences that run contrary to the default rules.[87] Statutes providing such default rules lower the costs of parties who have majoritarian preferences.[88] Article 2 of the UCC provides many such default rules.[89]

When parties contract, they encounter barriers of various kinds, including bounded rationality, opportunism and uncertainty.[90] When such barriers to express contractual solutions exist, courts or legislatures might intervene in the parties' contractual arrangement by supplying terms or default rules, but only if the benefits of the default rules are greater than any offsetting costs.[91] The existence of barriers to parties reaching a private agreement justifies interventions – either through the common law or legislature – to supply default rules or implied terms to help the parties achieve their goals. Were it not for those transaction costs, the parties would have adopted those terms on their own.[92]

Section 2-206 of the UCC exemplifies a statutory default rule governing contract formation than can be justified as welfare maximising. Rather than *add a term* to a contract, 2-206 instead provides a default rule to judge contract formation. Unless the parties *unambiguously* indicate that a particular mode or manner of acceptance is required, an offer can be accepted in 'any manner and by any medium

---

[87] But see O Ben-Shahar and JAE Pottow, 'On the Stickiness of Default Rules' (2005) 33 *Florida State University Law Review* 651, 651–53 (arguing that 'parties might 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*' because of the negative costs associated with opting out of known default rules resulting in 'deviance avoidance').

[88] But see CJ Goetz and RE Scott, 'The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms' (1985) 73 *California Law Review* 261, 285 (arguing that the presumption in contract law of consistency of terms within a contract burdens 'parties who desire to opt out of the legally implied terms by trumping them with contrary express provisions').

[89] See Whitford, 'Relational Perspective' (2019). See also Ayres and Gertner, 'Filling Gaps in Incomplete Contracts' (1989).

[90] The trifecta of these obstacles hinders complete contracts. See Williamson (n 8) 57–59. See also Kostritsky (n 25) 364–69 (discussing opportunism, sunk costs and uncertainty as barriers to bargaining).

[91] See generally Coffey (n 9).

[92] See Williamson (n 8) 46 (discussing transaction costs as a hindrance to contracting solutions, explaining 'Comprehensive contracting is not a realistic organizational alternative when provision for bounded rationality is made').

reasonable in the circumstances'.[93] This rule rests on the idea that because most offerors are indifferent to the manner and mode of acceptance, the default rule should mirror that preference – lowering costs for most offerors. The law will not require sellers (acceptors) to accept by an answer in words unless the buyer (offeror) mandates such action. This lowers transaction costs by eliminating unnecessary and overly formal requirements of contract formation.

The 2-206 default rule also lowers another cost of transacting: the risk of opportunism by sellers. Without the statute, the following scenario could occur. A seller could ship non-conforming goods. If one construes the contract as calling for '*the act*' of shipment of conforming goods, then the seller could escape liability for breach of contract by claiming that the unilateral act that the buyer demanded – a shipment of conforming goods – had failed to occur.[94] Therefore, a contract would not exist and the seller could opportunistically immunise itself from a breach of contract lawsuit.[95] Section 2-206 thus prevents the seller from seizing on a formal technicality to escape liability for contract breach.[96]

The UCC prompted changes from the Restatement (First) to the Restatement (Second) of Contracts on the manner and mode of acceptance, suggesting that the common law was influenced by a statutory initiative to provide a comparable solution to opportunism and transaction cost problems of overly formal acceptance protocols.[97] The Restatement (First), in s 31, reflected the traditional view that offerors cared deeply about the manner and mode of acceptance[98] and assumed that offerors would craft their contract to request either an act or a return promise. If the offer was ambiguous, s 31 presumed that a bilateral contract was intended, and that offerors intend to permit only one type of acceptance.

The Restatement (Second) of Contracts, adopted in 1981, followed 2-206 by enacting s 30. Instead of a preference in favour of a bilateral contract, s 30(2) provides: 'Unless otherwise unambiguously indicated by the language or the circumstances, an offer invites acceptance in any manner and by any medium reasonable in the circumstances.'[99]

This sequence demonstrates how a statute may affect the course of the common law by eliminating a common law rule that added to parties' transaction costs.[100] The traditional rule, later

---

93 UCC § 2-206(1). See also UCC § 2-206 cmt. 1.

94 JJ White and RW Summers, *Uniform Commercial Code*, 6th edn (St Paul, West Publishing, 2000) § 2-6.

95 ibid.

96 ibid.

97 R Braucher, 'Offer and Acceptance in the Second Restatement' (1964) 74 *Yale Law Journal* 302, 306.

98 Restatement (First) of Contracts § 31 cmt.

99 Restatement (Second) of Contracts §30(2).

100 The common methodology described in this chapter also informs analysis of whether a statute that eliminated a common law rule should be revised. The common law 'mirror image rule', which required both acceptance and offer to match exactly in their terms, allowed opportunistic welchers to seize on technicalities to avoid responsibility. See D Baird and R Weisberg, 'Rules, Standards, and the Battle of the Forms: A Reassessment of 2-

rejected by the Restatement (Second), seemed at odds with the parties' likely indifference to the manner and mode of acceptance.

Another example of a default rule which arises not through statute but through the common law and shares the common methodology is the doctrine of constructive conditions of exchange. Until Lord Mansfield, unless a party had expressly conditioned its own performance on the performance of the other party, the law refused to imply such a term.[101] Under the prior common law rule of mutual and independent covenants, when parties entered a bilateral executory contract, they faced the risk that they would have to go forward with their own performance without the other party being required to perform.[102] Parties face uncertainty about the other party's opportunism potential and the risk of investing sunk costs that will be lost if the other party does not perform.[103] Because the risk is the same throughout all transactions, a court can intervene with an implied term, a constructive condition of exchange, that makes one party's duty to perform conditional on the other party performing. This minimises costs more than requiring every party to provide for such a contingency, and would be widely accepted by those subject to the rule. The other options of screening one's counterparty for opportunistic potential or bonding devices might be more costly than the law-supplied rule. The law can minimise transaction costs, prevent opportunism, and prevent one party from having to finance the other's performance by implying default rules that accord with the parties' intentions and prevent unexpected losses. The shared methodology of intervening when costs of intervention are outweighed by benefits thus explains implying a constructive condition of exchange into parties' private contracts.

B. Facilitating Contracts through Corporate Statutes and Common Law

Corporate statutes or common law courts provide or decline to add terms to supplement contracts in the same manner as art 2,[104] and in a manner that reflects a common methodology. They provide default terms to private parties' contracts that those furnishing resources to corporations receive in exchange for their contribution. One such term entitles the furnisher of resources with a claim against

207' (1982) 68 *Virginia Law Review* 1217. UCC § 2-207 reversed the common-law rule, providing that an expression of acceptance that states additional or different terms can still operate as an acceptance. UCC § 2-207 (1). If both parties' conduct recognises the existence of a contract for sale, such contract is established even if the writings do not 'establish a contract' – any divergent terms are replaced with UCC gap-fillers. UCC § 2-207(3). Though 2-207 was implemented to reduce transaction costs and curb opportunism, some critics have argued that the result has been inefficient – UCC-supplied terms may be 'poorly suited to the transaction': Douglas and Weisberg (ibid) 1223. Moreover, drafters may desire to intentionally form incomplete contracts. Sanga (n 24). Then again, the inefficiency of gap-filler terms may be overstated in an economy where few participants read all fine print of written contracts, which reduces the incentive to provide tailored, efficient terms.

[101] See EW Patterson, 'Constructive Conditions in Contracts' (1943) 42 *Columbia Law Review* 903, 907–10 (cited in I Ayres and G Klass, *Studies in Contract Law*, 9th edn (St Paul, West Publishing, 2017) 843.

[102] EA Farnsworth, *Farnsworth on Contracts*, 4th edn (Zachary Wolfe ed, New York, Wolters Kluwer, 2019) § 8.10.

[103] Patterson, 'Constructive Conditions' (1943) 910.

[104] FH Easterbrook and DR Fischel, 'The Corporate Contract' (1989) *89 Columbia Law Review* 1416, 1417 (discussing enabling nature of corporate statutes).

the firm.[105] Corporate statutes govern the control[106] and distribution[107] for the investor and those statutory provisions automatically become part of the investor's contract. The equity investor, a common stockholder, and the residual claimant on the assets of the firm benefit from contract terms supplied by statute. In addition, the common stockholder enters into other side agreements (contracts) including the articles of incorporation and bylaws. These contracts often provide for governance terms and the stock price of the investment share contract is affected by the market's perception of these governance provisions.[108]

The enabling statutes create default rules for equity investors' contracts. But should there be a collective intervention – either by statute or by common law – that supplies a *performance obligation* to supplement the terms of the equity investor's contract? [109] When the law supplements the parties' investor contract by supplying a performance obligation or fiduciary duty, the justification rests on a determination of whether there were obstacles to the parties' reaching an express agreement on their own to control a problem. Absent such bargaining obstacles, the parties could reach a completely contingent contract to control problems, such as agency costs, and that contract would be self-enforcing.[110]

The problem that the equity investor faces when delegating discretion to an agent is the 'natural phenomenon of what might be termed the performer's propensity to diverge caused by different preferences ...'.[111] Agent shirking is an agency cost to the principal. Because of bounded rationality,[112] the parties may have difficulty foreseeing the myriad of ways in which an agent will act opportunistically. The law intervenes by supplying an implied fiduciary obligation to supplement the investor's contract when it determines that the law-supplied fiduciary obligation will achieve a reduction in agency costs at a lesser cost than the private strategies that the parties could undertake on their own.

Fiduciary duty protects investors who have only a residual claim on the assets of the firm. The decision to protect such investors with a mandatory fiduciary duty that prevents parties from

---

105 EF Fama and MC Jensen, 'Agency Problems and Residual Claims' (1983) 26 *Journal of Law and Economics* 327.

106 Control comes in the form of the right to vote on managers. Easterbrook and Fischel, 'Corporate Contract' (1989) 1421.

107 ibid 1430.

108 Ibid 1431.

109 See, e.g, MBCA § 8.30.

110 Complete contracts are likely to be self-enforcing. See JP Kostritsky, 'Introduction – Incomplete Contracts: Judicial Responses, Transactional Planning, and Litigation Strategies, symposium' (2005) 56 *Case Western Reserve Law Review* 135, 139 fn 31 (citing JL Coleman, D. Heckathorn, and S Maser, 'A Bargaining Approach to Default Provisions and Disclosure Rules in Contract Law' (1989) 12 *Harvard Journal of Law & Public Policy* 639, 640).

111 Email from Ronald J Coffey, Professor Emeritus, Case Western Reserve University School of Law to Dean Kenneth B Davis, University of Wisconsin School of Law (2 May 1996, on file with author).

112 '[T]he capacity of the human mind for formulating and solving problems is very small compared with the size of the problems whose solution is required for objectively rational behavior in the real world ': H Simon, *Models of Man* (London, Chapman and Hall, 1957) 198 (describing bounded rationality).

contracting out of the duty of loyalty[113] – one of the prongs of fiduciary duty[114] – stems from a belief that the costs of controlling the 'propensity to diverge' through private strategies[115] are too high because the principal cannot see all of the alternative decisions that the agent will make.[116] Other private devices to control agency costs include adjusting the compensation of the agent or investigating and providing incentives for good performance. Both mechanisms are costly or infeasible because the agent will not work for a knocked-down wage[117] and investigation of incentive schemes may be difficult when the agent's actions are unobservable. The law, following the common methodology, supplies a term – fiduciary duty – as the least costly alternative to solving non-contractible agency costs.

Further, the institutional choice of whether to supply the default rule to solve a non-contractible problem of agency costs by statute or by a common law rule on fiduciary duty that intervenes in the contract may be influenced by whether there is deep expertise in the judiciary.[118] If so, and given path dependence of already existing case law, the common law solution may be most cost-effective. A

---

[113] J Velasco, 'How Many Fiduciary Duties are There in Corporate Law' (2010) 83 *Southern California Law Review* 1231.

[114] One justification for the mandatory protection of equity investors derives in part from the fact that when 'shares are widely traded, no one has the right incentive to gather the information and make optimal decisions': Easterbrook and Fischel (n 104) 1436. Another justification for the mandatory nature of the duty of loyalty rule in the corporate context is that no one would contract out of it because doing so would send a bad signal to potential investors which would affect pricing. ibid.

[115] These strategies could include monitoring and bonding. See DM Kreps, 'In Honor of Sandy Grossman, Winner of the John Bates Clark Medal' (1988) 2 *Journal of Economic Perspectives* 111, 130 (discussing monitoring devices). Screening devices can also be used but they too are costly. See HE LeLand, 'Quacks, Lemons, and Licensing, A Theory of Minimum Quality Standards', (1979) 87 *Journal of Political Economy* 1328, 1330. Bonding happens when the agent 'expend[s] resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions'. MC Jensen and WF Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 308. Bonding and monitoring are costly devices. See JP Kostritsky, 'Bargaining with Uncertainty, Moral Hazard and Sunk Costs: A Default Rule for Precontractual Negotiations' (1993) 44 *Hastings Law Journal* 621, 657.

[116] K Arrow, 'The Economics of Agency' in JW Pratt and RJ Zeckhauser (eds), *Principals and Agents: The Structure of Business* (Cambridge, Harvard Business School Press, 1985) 38–42 (discussing hidden action and hidden information problems).

[117] See JP Kostritsky, 'One Size Does Not Fit All: A Contextual Approach to Fiduciary Duties Owed to Preferred Stockholders From Venture Capital to Public Preferred to Family Business' (2017) 70 *Rutgers Law Review* 43, 57. See also B Klein, 'Contracting Costs and Residual Claims, the Separation of Ownership and Control' (1983) 26 *Journal of Law and Economics* 367, 368 (noting that cuts in wages will not solve the problem of shirking 'because the gain to the shirker and therefore his acceptable compensating wage discount is less than the cost to the firm from the shirking behavior').

[118] In this way, the common methodology of this chapter can also explain why a legislature would enact a statute to *defer* to common law judges for case-by-case adjudication. Cost considerations may weigh in favour of deferring legal intervention in the corporate arena to expert judges in Delaware, for example. Conversely, in Ohio the legislature decided to take a lighter hand, constraining judicial discretion where there is less expertise and limiting liability for business directors. See Ohio Rev Code Ann § 1701.59 (providing statutory guidelines and codifying the 'business judgment' rule).

statutory bright line rule, however, may create unintended costs. For example, '[the Model Business Corporation Act]'s Herculean attempt to create a comprehensive bright line rule approach to director-conflict transactions ... breaks down in practice and requires the use of judicial discretion in reviewing conflict transactions'.[119]

C. Declining to Intervene

Cost minimisation and the common methodology of intervening only when the benefits outweigh the costs also explains legislative and common law *refusals to intervene*. Article 2 adopts a penalty default approach to a missing quantity term in a sale of goods contract. If the parties have not specified a quantity term in the contract, the UCC refuses to supply one.[120] This refusal incentivises parties to include the quantity term themselves or risk non-enforcement of the contract.[121] The legislature, in the UCC, refuses to intervene because arriving at a quantity ex post by a court would be too costly[122] and the costs will be lower if the parties agree on the quantity term ex ante.[123] The difference in prospective costs justifies the legislature's refusal to intervene.

The cost explanation for the refusal to supply a quantity term finds further support if one considers how the law treats a missing quantity term in the context of long-term requirements contracts. There, the law intervenes with an implied term of good faith to determine the quantity.[124] The divergent approach in that context is consistent with the common methodology of intervening only if doing so increases net benefits for the parties to the exchange. If a penalty default information forcing rationale theory is subscribed to, then the court should arguably refuse to intervene and force the parties to supply the quantity even in long-term contracts.

When, however, parties face obstacles to specifying a quantity because of bounded rationality, which limits the ability to predict the quantity in a long-term contract, the law intervenes. It measures the quantity by the party with the discretion to specify a quantity, such as a buyer in a requirements contract, by an amount that may be demanded in good faith.[125] When, however, the parties face low obstacles to achieving a completely contingent contract, as in a discrete transaction, the court refuses to supply a quantity term.

---

[119] JM. Gorris, LA Hamermesh, A Lawrence, and L Strine Jr. 'Delaware Corporate Law and the Model Business Corporation Act: A Study in Symbiosis' (2011) 74 *Law & Contemp Probs* 107, 118.

[120] See UCC § 2-201(1).

[121] For a discussion of § 2-201's refusal to supply a quantity term as an example of a cost saving penalty default, see Ayres and Gertner (n 75) 95–97.

[122] ibid 96–97.

[123] ibid.

[124] UCC § 2-306.

[125] ibid.

The information-disclosing penalty default rationale that explains 2-201 does not make sense when bounded rationality prevents parties from determining the quantity. In such cases, when the 'parties can operate only in a second-best world'[126] beset by bounded rationality, when problems of opportunism might arise over a long-term contract, and when costs of devising express constraints are high, the law, through a statute such as 2-306 and the courts through case law,[127] imply a term of good faith to constrain the announced quantity. In such cases the cost-minimising solution would be the implied term of good faith, so under the common methodology the law intervenes.

When the debate about missing quantity terms is situated in the context of barriers to bargaining that exist in different degrees in discrete and long-term requirements contracts with a comparison of alternative solutions to determine which offers the greatest net benefits under a remediableness analysis,[128] a structured approach based on the common methodology of assessing barriers to bargaining and a net benefit improvement approach to gap-filling emerges as the one that underlies judicial and statutory interventions.

In other situations, the common law will decline to intervene in parties' contracts with a fiduciary duty. The law generally refuses to intervene in a preferred stockholder's investment contract and such decisions rest on the structure – the common methodology – articulated earlier: will the addition of a term to the contract minimise cost while maximising value? If implication of a term for one party – the preferred stockholders – would result in a hit to the other claimants (common stockholders) who made their investments based on risks and priced them based on a lack of fiduciary protections, rearranging those risks would be destabilising.[129] Moreover, courts should not add implied protections when the claimants, such as preferred stockholders, can easily employ a variety of other private strategies to protect themselves. In the case of venture capitalists holding preferred stock, their strategies include staged financing[130] and board control,[131] making extra-contractual protections superfluous and costly.

A comparative cost–benefit analysis underlies decisions on whether courts should intervene to grant preferred stockholders implied protections *not contracted for*. The law declines to imply a fiduciary duty to protect preferred stockholders. In such cases the intervener implicitly uses the common methodology to decide that certain parties belong to 'classes of cases where the transactors

---

[126] JP Kostritsky, 'Why Infer? What the New Institutional Economics Has to Say about Law-Supplied Default Rules' (1998) 73 *Tulane Law Review* 497, 529.

[127] See eg *NY Cent Iron Works Co v US Radiator Co*, 66 NE 967, 968 (NY 1903) (cited in Orange & *Rockland Util's v Amerada Hess Corp*, 397 NYS 2d 814, 818 (App Div 1977)).

[128] Williamson (n 11) 7.

[129] Kostritsky, 'One Size' (2017) 89.

[130] See PA Gompers, 'Optimal Investment, Monitoring, and the Staging of Venture Capital' (1995) 50 *Journal of Finance* 1461.

[131] See Kostritsky (n 117) 49.

are able to employ private strategies that control the performer's propensity to diverge'.[132] There would be no reason to intervene, especially when there are offsetting contracting around costs that might follow the intervention.

When preferred stockholders ask for additional rights or protections not included in their contracts, courts also must wrestle with whether and why to grant such protections and use a framework that assesses whether the preferred stockholders could protect themselves and whether adding implied protections would result in an overall net benefit.[133] Preferred stockholders incorporate rights, limitations and preferences in the articles or charter of the issuer.[134] A typical statute, such as that operating in Delaware, makes the legislative statement that special rights, limitations and preferences must be in the articles to be effective.[135] The statute thus begins the process of enabling other contracts that follow, including the articles or charter. These contracts or add-ons follow and include bylaws or regulations.[136] Shareholder agreements or stock purchase agreements – additional contracts – may have expanded terms that are extracted by the original purchasers.[137]

Once those rights, preferences and limitations are stated, the question arises as to whether the common law courts, or another intervenor, should intervene and afford preferred stockholders special fiduciary protections beyond those afforded all common stockholders that were not explicitly in their bargained-for contract.[138]

When deciding whether to imply such protections, common law courts must situate the question of implying a term into an overall context of bargained-for exchange and the principal/agent

[132] Coffey, email (n 43).

[133] Many of these cases arise in Delaware where the courts consider fiduciary obligation to be judicially created.

[134] If the rights are not in the Articles and printed on the back of the stock certificate, then they are not part of the contract and there is no preferred stock.

[135] See Del Code Ann § 151(a).

[136] Interview with M&A lawyer (anonymous). For example, the bylaws may say that in order to be effective, a director nomination must be filed 60 days ahead of the meeting, or might specify how many directors there are even when the statute only requires a threshold minimum of three directors.

[137] ibid. However, unlike the terms in the Articles or certificate of design which carry over to successors, these latter contracts do not extend to successors.

[138] The RJR Nabisco leveraged buyout (LBO) provides an illustrative example. *Metro Life In. Co v RJR Nabisco*, *Inc*, 716 F Supp 1504 (SDNY 1989). The plaintiffs, in the wake of an LBO, claimed that RJR had violated an 'implied covenant of good faith' by creating unsecured short-term debt, driving down the value of bonds that the plaintiffs had previously issued to the firm. *RJR Nabisco*, 716 F Supp at 1506–07. See discussion of LBOs, n 156 below. The court declined to add the implied term ex post (*RJR Nabisco*, 716 F Supp at 1508) because the plaintiffs were sophisticated financial parties (1509), with the bargaining power to protect themselves (1521). To add the requested term would be to upset the allocation of risk that the parties had bargained for; thus the intervention would not have been cost-justified under the common methodology and would not have advanced the parties' goals.

context.[139] An adjudicator must address the problem that parties face when there is a delegation issue due to the separation of ownership and control.[140] Preferred stockholders face agency costs and the danger of opportunism when they furnish resources to an agent. Will implying a fiduciary duty maximise welfare by constraining opportunism and controlling moral hazard? When there are multiple claimants or investors, including preferred and common stockholders, what is the agent's duty? Presumably the agent is 'tasked with honoring the claims of the different types of investors'.[141] The agent must assume the task of operating the firm and administering the claims possessed by the capital furnishers, including the preferred. The agent may take steps that might adversely affect one set of claimants, such as the preferred, even though there is no effect on the overall asset pool of the firm.[142]

In deciding if the preferred need protection supplied by a common law fiduciary duty, the courts could adopt an 'all or nothing approach' and deny any fiduciary protection beyond that owed to all common stockholders not to waste assets or it could extend fiduciary protection to all preferred stockholders.[143] In general, the courts deny added implied fiduciary protections to preferred stockholders. When the preferred can negotiate for contractual protection, as in the venture capital context, adding a term would bestow a gift to the preferred they did not bargain for and upset the basic risk/return profile of their investment, a cost that mitigates against adoption. Adding the term would also cause a 'hit' in terms of reduced value to other claimants such as common stockholders.

However, when substantial barriers to negotiating protections exist, as when preferred stock is issued when the holders have no direct bargaining power and the preferred are subsequent purchasers trading on relatively inefficient markets where pricing signals are attenuated,[144] and there is no underwriter helping the preferred, there may be reason for a common law court to imply fiduciary protection, at least when the market price does not correctly value weaknesses in the protections that the preferred has under its contracts with the firm.[145]

VIII. Mandatory Disclosure in Securities, Real Estate and Consumer Contexts: What Works?

The three examples discussed below demonstrate that legislative strategies of intervention that add terms to contracts through mandated disclosure depend first on a decision that parties' private

---

[139] Kostritsky (n 117).

[140] See AA Berle and GC Means, *The Modern Corporation and Private Property* (New York, Macmillan, 1932) 84–89.

[141] Kostritsky (n 117) 58.

[142] RJ Coffey, 'Firm Opportunities: Property Right Assignments, Firm Detriment, and the Agent's Performance Obligation' (1988) 13 *Canada-United States Law Journal* 155, 168–69.

[143] CR Korsmo, 'Venture Capital and Preferred Stock' (2013) 78 *Brooklyn Law Review* 1163, 1166.

[144] Kostritsky (n 117) 70.

[145] ibid 69.

strategies or common law solutions may not work to effectively control a problem, thereby laying the groundwork for intervention. The disparate success of disclosure laws, with real-estate disclosure and securities laws working more effectively than consumer disclosure laws,[146] underlines how important the comparative cost–benefit analysis is. If consumer laws add costs without enhancing consumer decision-making, then the legislature should consider other strategies that are more effective and find less costly legislative solutions.

A. Securities

In the context of contracts for the sale of securities, the legislature's decision of whether to intervene to mandate disclosure depends on whether such disclosure will not otherwise occur. By intervening to require disclosure and to forbid any material misstatements, the law can control an agency problem that would otherwise be uncontrolled. The law constantly assesses whether the benefits of intervention outweigh the costs. The benefits of the Exchange Act of 1934 disclosures are thought to outweigh the costs because the disclosures promote accurate pricing of securities, fostering allocative efficiency.[147]

When investors buy stocks and enter into contracts as equity investors, questions will arise as to whether managers in the firm will make all the material information available to the investors or whether a collective intervention to force the disclosure of information is needed either in the form of a common law rule or a statute.

The management and the shareholders have a conflict of interest – an agency cost that will sometimes cause the manager to act opportunistically at the expense of shareholders. If shareholders fear the non-disclosure of material information, the manager will be 'the primary loser'.[148] To convince prospective shareholders that all relevant information is being disclosed, management may try to signal that disclosures are accurate using auditors.[149] Management may also invest in stock options, signaling that the information has been disclosed. The manager could suffer losses if it bought stock at a high price that did not reflect negative material information. The manager's own investment is a self-regulating device against material non-disclosures to investors. This illustrates how voluntary disclosure may occur without legal intervention.

Moreover, if managers of companies or promoters acquiring new businesses and selling their services to investors all must compete for investments, and investors are rational, self-interested

[146] But see CR Korsmo, 'The Audience for Corporate Disclosure' (2006) 102 *Iowa Law Review* 1581, 1632 (suggesting current inefficiencies in the approach of securities laws and arguing that securities disclosures should be narrowly tailored to 'minimize the costs sophisticated investors face').

[147] Professor Coffee explains why mandated disclosure and its effect as pricing is so important for efficiency: 'Depending on a firm's share price, its cost of obtaining capital will be too high or low as compared to a cost that would prevail in a perfectly competitive market'. JC Coffee Jr, 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717, 734.

[148] ibid 737.

[149] ibid 738. The use of auditors reflects a private strategy to overcome an information failure that prevents efficient investment.

failures to disclose will have negative consequences and result in losses for managers and promoters because rational investors will invest elsewhere.[150] Thus, such managers will be incentivised to voluntarily disclose information to investors or will face the possibility of losing investors.

Another means of equalising information between buyers and sellers of securities is for the buyers to contract for disclosure. However, significant bargaining obstacles may hinder such contractual agreements including the lack of equal bargaining power, lack of expertise and lack of sophistication. Buyers will not know what questions to ask to secure disclosure, and when buyers do ask, sellers will selectively contract with buyers to whom there is no duty to disclose a strategy which keeps the information hidden.[151] The same obstacles that prevent a buyer from formulating the right questions to ask may also render common law fraud actions ineffective. Without the questions being asked, holding the seller accountable for misleading answers may be difficult under common law fraud. Moreover, rescission as a remedy in common law fraud actions may be an ineffective institutional response.

Because obstacles to self-induced disclosure exist,[152] the law intervenes through statute by requiring disclosure of information to investors both through the initial registration statement and though subsequent regular periodic filings. The intervener – the legislature – implements a law affecting a private contract/sale between a broker and a buyer if intervention in the form of mandated disclosure is justified using a net-benefit or welfare-improvement methodology. Disclosure can avoid the inefficiencies that would occur if investors tried to self-protect by gathering the information on their own.[153] The disclosure of the information affects the pricing of the underlying securities and contractual behaviour. Investors enter contracts with their broker on the basis of information about a company released in a report or prospectus. The investor 'can effectively free ride on the accurate pricing generated by the buying and selling of sophisticated investors'.[154]

The Exchange Act of 1934 requires disclosure on an ongoing basis of information about the dealings between the management and the company.[155] Why would federal law require such disclosure? One answer, consistent with the thesis in this chapter, is that requiring disclosure economises on transaction costs that investors would otherwise face in controlling agency costs.[156]

---

[150] ibid 737.

[151] PG Mahoney, 'Mandatory Disclosure as a Solution to Agency Problems' (1995) 62 *University of Chicago Law Review* 1047, 1091 fn 186.

[152] See, eg, discussion on LBOs, n 156 below.

[153] Mahoney, 'Mandatory Disclosure' (1995) 1092.

[154] Korsmo, 'Audience' (2006) 1581. Korsmo has argued that SEC disclosures should focus on disclosure to the professional – rather than the ordinary – investor (ibid 1581). Efficient pricing of the securities and diversification adequately protect the ordinary investor (ibid 1607–09 fn.133). The question in Professor Korsmo's article is what intervention will best achieve the protection of investors in the most efficient manner.

[155] Securities Exchange Act of 1934, 48 Stat 881.

[156] Another reason, also consistent with the thesis herein, is to curb adverse incentives for non-disclosure, as in the context of management engaging in an LBO to resist a hostile takeover. Because the manager wants to keep the price of the firm low, there is an incentive to 'underplay positive information [or] to release false information

Investors face an agency cost when they buy stock because often the promotor or the manager may have purchased property or other businesses and may therefore have conflicting interests. The securities laws force the disclosure of such self-interested dealings.

Mandatory disclosure may therefore be justified in efficiency terms. It may be more cost-effective to mandate disclosure of a uniform variety than to have all promoters or managers negotiate individually for disclosure 'where the outcome is not likely to vary among firms and thus the costs of complying with a one size fits all rule are less than the costs of negotiating individual levels of disclosure'.[157] Because investors would want managers to disclose information on matters such as conflicts of interest as a means of controlling agency costs, and managers would be willing to disclose as a way of encouraging transactions and overcoming investors' disinclination to invest without such disclosure, the mandatory rule is efficient. Both investors and managers would want disclosure of such information and a one-size-fits-all rule lowers the cost of controlling the agency problem.[158]

B. Real Estate Disclosure

Mandated seller disclosure laws in real-estate transactions offer another instance when statutes intervene in private contracts and displace common law rules. Seller disclosure laws help to clarify the seller's obligations. Under the common law, those obligations remained unclear as courts struggled with differentiating between patent and latent defects.

The question is whether voluntary disclosure obligations under the common law would be effective in solving a problem of asymmetry of information between buyers and sellers and, if not, would mandated statutory disclosures solve that problem more effectively. If so, then intervention would yield overall net benefits and maximise welfare.

Prior to 1984, many states followed the doctrine of caveat emptor in real-estate transactions. Ohio is illustrative, and precluded a purchaser's recovery for a structural defect when the defect was discoverable, the buyer had the opportunity to examine the premises and the seller did not engage in fraud.[159] Courts presumed that the 'duty falls upon the purchaser to make inquiry and examination'.[160] This approach effectively precluded rescission for patent defects unless the seller was guilty of common law fraud, such as concealment.

---

of adverse developments': Coffee (n 147) 741. Legally mandated disclosure makes information available to third party bidders, ensuring that management cannot buy the firm for a 'depressed price': ibid 742.

[157] Mahoney (n 151) 1092.

[158] ibid. But see RJ Coffey, 'Comment: The Significance of Non-Publicness for Securities Interventions' (2001) 51 *Case Western Reserve Law Review* 473, 476.

[159] *Layman v Binns*, 519 NE 2d 642, 645 (1988).

[160] ibid . at 644.

In 1984, the California Supreme Court set forth the principles for a seller's duty to disclose red flags in contracts for the sale of residential real-estate property.[161] By the early 2000s, a majority of states mandated seller disclosure, often in the form of a statute.[162]

The asymmetry-of-information problem explains why states adopted statutes. Absent disclosure statutes, the seller will often fail to disclose information to the buyer. Sellers with high-quality real estate will then withdraw from the market.[163] Subsequently, buyers will assign only an average price for the real estate and sellers will not be able to charge a premium for higher-quality real estate.[164] This process continues, resulting in what economists called the 'lemons' problem.[165]

If mandatory seller disclosure laws can solve this 'lemons' problem, sellers can release higher-quality properties to the market and receive a higher price. As one author studying the effect of these laws predicted: 'housing prices should rise'.[166] Empirical data confirms such a rise in prices following the adoption of seller disclosure statutes and a lowered risk premium for real estate. Mandated disclosure laws permit buyers to identify higher-quality real estate and allow sellers to realise the full value of such property.

The success of such disclosure statutes in solving asymmetries of information and the 'lemons' problem more effectively than the common law may be explained, in part, by a phenomenon in which people cheat less when forced to sign a form pledging not to cheat (as on an exam).[167] Although cheaters are omnipresent in society, and although some people will always cheat, others 'want to be honest' and when furnished with an ethical reminder that requires their pledge, will cheat less.[168] Having the seller sign a form that mandates disclosure of information may reduce the tendency to withhold information in a way that was not present under the common law rules, which only prohibited fraud when there was uncertainty about what was material and what was a patent or latent defect in the premises. Statutory interventions in sale contracts increased wealth and offered a comparative advantage over the common law in solving the 'lemons' problem, thereby justifying intervention under the shared methodology.

---

[161] A Nanda and SL Ross, 'The Impact of Property Condition Disclosure Laws on Housing Prices: Evidence from An Event Study Using Propensity Scores' (2012) 45 *Journal of Real Estate Finance and Economics* 88, 89.

[162] Ibid. See, eg, Ohio Rev Code Ann § 15302.30.

[163] GA Akerlof, 'The Market for "Lemons": Quality Uncertainty and the Market Mechanism' (1970) 84 *Quarterly Journal of Economics* 488, 495.

[164] Nanda and Ross, 'Property Condition Disclosure Laws' (2012) 90.

[165] ibid 89. See also Akerlof, 'The Market for "Lemons"' (1970).

[166] Nanda and Ross (n 161) 89.

[167] See D Ariely, *The (Honest) Truth About Dishonesty* (New York, HarperCollins, 2012) 42.

[168] ibid.

C. Consumer Disclosure

The rise of standardised contracts has prompted legislative intervention for more disclosure. Legislatures and courts have intervened in consumer contracts by mandating the disclosure of certain terms[169] and by regulating the process by which the terms of the contract are disclosed. In certain instances, the seller must make the term conspicuous to a buyer.[170] Other disclosure laws require insurers to disclose that buyers can buy different types of insurance without bundling the insurance in a single policy.[171]

The goals of legislative intervention included increased consumer awareness of the terms of a contract by making them more accessible and less hidden. At the same time, the legislature hoped that such disclosure would increase competition among providers or sellers[172] and improve decision-making by consumers.[173]

Lawmakers find disclosure an appealing method of regulating contracts because it avoids direct legislative regulation or modification of a contract's terms – thereby preserving autonomy for the parties. Yet, the failures of mandated disclosure as a method of improving decision-making underline the importance of using the common methodology for assessing whether the net benefits of additional disclosure legislation outweigh the costs of such intervention. An assessment should include the efficacy of the mandated disclosure and the negative 'unintended consequences' of such disclosure,[174] and other harms.

The success of disclosure mandates depends on parties actually reading, analysing, and understanding the disclosed terms. Recent empirical studies of licence agreements show that despite

---

[169] See WC Whitford, 'The Functions of Disclosure Regulation in Consumer Transactions' [1973] *Wisconsin Law Review* 400. Disclosure of terms today include overdraft fees on ATM withdrawals, 12 CFR § 1030.11(a)(1)(i) (2019), and APR under the Truth in Lending Act, ibid § 1026.60 (b)(1).

[170] See, eg, UCC § 2-316 (warranty disclaimers).

[171] WE Wagner with W Wagner, *Comprehension Asymmetries and Consumer Protection Law*, in *Incomprehensible*! : A Study of How Our Legal System Encourages Incomprehensibility, Why It Matters, and What We Can Do About It

70 (Cambridge University Press (2019))

See also Ben-Shahar and Schneider, 'Mandated Disclosure' (2011) 659 (discussing bundling problem).

[172] Wagner and Wagner (ibid) (discussion effect of overly complex contracts on competition).

[173] Ben-Shahar and Schneider (n 22) 667. See also Whitford, 'Disclosure Regulation' [1973] 404. This article does not address the failures that result from consumer protection laws deriving from the fact that the legislation is a political compromise that may be influenced by parties who are resisting the statutory goals. 'So a statutory expert might say, "no wonder disclosures don't work when they arise from legislation – they were designed to fail or at least to provide lots of wiggle room for creative compliance".' Email from Professor Wendy E Wagner, Professor of Law, University of Texas School of Law to Juliet P Kostritsky, Professor of Law, Case Western Reserve University School of Law (17 December 2018, on file with author).

[174] Ben-Shahar and Schneider (n 22) 647.

the disclosure requirements and increased accessibility of contract terms, parties fail to read the contracts.[175] That failure initially made common-law solutions ineffective as many common-law doctrines are premised on parties having a duty to read. Today, the difficulties that the common law faces in solving assent in standardised contracts is reflected in the failure of courts to utilise s 211 of the Restatement (Second) of Contracts.[176]

Yet, disclosure by statutory mandates also results in overload and accumulation problems that interfere with the ability of disclosees to 'understand, assimilate and analyse the avalanche of information'.[177] The mountain of information also results in fewer consumers reading contracts. As disclosures increase and disclosees face an accumulation of disclosures, consumers are less inclined to read the disclosures.[178]

Moreover, problems such as illiteracy, innumeracy and a lack of comprehensibility persist, which, when coupled with a failure to read, render the required disclosures meaningless. In some instances, the benefits may be slight compared to the burdens. Even if the disclosures would improve decision-making, those subject to the mandates often devise strategies to undermine the effectiveness of the disclosures. One such strategy is to 'bury the lede' and highlight other unimportant provisions.[179]

When legislatures intervene to achieve broad social goals (that differ from the parties' private goals) and to improve private decisions, the decision-maker must still consider whether there are other costs on future contracting parties that would more than offset the benefits obtained by the statutory intervention. The failures with mandated disclosure and the ever-cascading disclosures of more information[180] underline the importance of devising legislative strategies that account for how those subject to the laws will react (including both the disclosers and the disclosees). To achieve legislative goals of fostering better decision-making by consumers, legislators may need to adopt targeted strategies demonstrated to be effective. These could include requiring disclosers to use pretested language that consumers understand, rely on alternative strategies that forbid certain terms (balloon payments) if consumers will not react to mere disclosures, or nudge consumers to better outcomes by devising default rules (opting out of savings for a 401k). Another approach is embedded in the Consumer Financial Protection Bureau regulation of home mortgage contracts. The goal is to adopt 'newly simplified mortgage disclosures ... tested in labs for readability and efficacy'.[181]

---

[175] See F Marotta-Wurgler, 'Even More than you Wanted to Know About the Failures of Disclosure' (2015) 11 *Jerusalem Review of Legal Studies* 63.

[176] Restatement (Second) of Contracts § 211. See also EA Zacks, 'Restatement (Second) Section 211: Unfulfilled Expectations and the Future of Modern Standardized Contracts' (2016) 7 *William & Mary Law Review* 733.

[177] Ben-Shahar and Schneider (n 22) 687.

[178] See Wagner (n 171). See also Marotta-Wurgler, 'Failures of Disclosure' (2015).

[179] See Wagner and Wagner 68 (n 171).

[180] Id. at 13 (focusing oncomprehensibility of the information disclosed).

[181] O Ben-Shahar and CE Schneider, *More Than You Wanted to Know: The Failure of Mandated Disclosure* (Princeton, Princeton University Press, 2014) 122.

To address the failure of disclosure informational strategies to achieve readership, two authors have suggested a new approach to consumer protection laws tailored to the problem that arises when consumers have an overly optimistic understanding of terms in the contract that does not match the reality of the meaning of the terms.

The approach championed by Ayres and Schwartz diverges from efforts to improve the readability and intelligibility of the content of all terms, seeking instead to ascertain through testing whether 'consumers held accurate beliefs about the terms'.[182] If so, the terms could be buried in the contract because, in those cases, the consumers would expect those terms even if they had not read them. Where, however, the consumer's expectation about a term relied on by one party is more optimistic than the reality, special precautions would need to be taken – warning boxes – to highlight such terms. Without such boxes, the terms would not be enforceable.[183] The advantage of the Ayres and Schwartz approach is that it would limit 'consumers' scarce attention'[184] to terms that consumers falsely understand to be more protective than the reality.[185] Disclosure would focus on terms likely to surprise the consumer, and would save on the costly and often pyrrhic approach of mandating readability and conspicuousness when most consumers simply do not read contracts even when they are accessible through legislative or judicial mandates. Their approach would be consistent with the shared methodology suggested earlier – opting for an intervention when costs and burdens do not outweigh the benefits of enhancing decision-making and overall welfare.

IX. Terms Forbidden by Legislature: Regulatory Intervention and its Limits

Sometimes the legislature takes a different interventional stance. Instead of trying to facilitate contracting by providing off-the-shelf default rules or gap-fillers when barriers to bargaining prevent the parties from reaching an optimal agreement, the legislature sometimes chooses to forbid the parties from enacting a term in their contract – or provides that if such a term is included, the law will withhold enforcement. These statutory interventions require a different analytical framework for justifying interventions than when law intervenes to facilitate bargains.

Legislatures regulate contracts by passing laws that modify or limit the private contractual choices parties can make. For example, the law might forbid the parties from entering into contracts that contain covenants not to compete.[186] When the legislature intervenes in this manner, it withholds

---

[182] I Ayres and A Schwartz, 'The No-Reading Problem in Consumer Contract Law' (2014) 66 *Stanford Law Review* 545, 545.

[183] ibid 582.

[184] ibid 545.

[185] ibid 552.

[186] See, eg, Cal Bus & Professions Code § 16600 (2008).

enforcement of private contracts to achieve certain broad social objectives, or to conform to social norms, even though the parties themselves benefited from the contract.

Examining how private parties respond to one particular statutory intervention can facilitate an understanding of the reverberative effects of statutory interventions in private contracting and the need to account for such effects whenever there is an intervention in order to determine if intervention will lead to welfare improvement.

California's statutory prohibition of covenants not to compete provides one example.[187] Such covenants are 'ubiquitous' in employment contracts,[188] both for high-level management employees and, more recently, for lower-level non-managerial employees.[189]

Prohibiting covenants not to compete raises the question of when and why such intervention is required. How does the intervention affect the achievement of the employer's goals in including such covenants, such as the deterrence of poaching valuable employees? Further, how can firms be incentivised to invest in training for employees given the potential for poaching if such covenants are not enforced?[190]

When jurisdictions forbid such clauses, do parties devise ways to circumvent the legislative prohibitions in unexpected ways, drawing on informal relational enforcement of otherwise unenforceable clauses? If so, what does this reveal about the limits of legislative interventions in private contracts and the need to account for private bargaining when statutes affect such contracts?

Legislatures that sanction non-compete clauses are acting to serve broad public goals, responding to concerns that without the protection of a non-compete, employers who invest in employee training will be victimised by other employers hiring away those highly trained employees. Empirical data show that jurisdictions that enforce such clauses 'increase … firm-sponsored training for primarily high skill and high earnings occupations'.[191] A firm's willingness to invest in training and protection against post-firm employment are linked. The enforcement of covenants not to compete also affects worker mobility, with enforcement of such covenants reducing worker mobility and the non-

---

[187] See ibid.

[188] See N Bishara, 'Covenants Not to Compete in a Knowledge Economy: Balancing Innovation from Employee Mobility Against Legal Protection for Human Capital Investment' (2006) 27 *Berkeley Journal of Employment**:***

287, 305.

[189] ibid.

[190] See N Bishara, 'Fifty Ways to Leave Your Employer: Relative Enforcement of Covenants Not to Compete' (2011) 13 *University of Pennsylvania Journal of Business Law* 751, 767.

[191] E Starr, 'Consider This: Training, Wages, and the Enforceability of Covenants Not to Compete' (2019) 72 *Industrial and Labor Relations Review* 783.

enforcement of such clauses increasing mobility and promoting innovation.[192] Variation in enforcement may also affect hiring with reduced enforcement of such clauses leading to a decreased willingness to hire employees without experience. This follows logically because, without the protection of the non-compete, firms may decrease training investment and rely instead on other firms to train employees.[193] The enforcement of non-competes may have positive effects on wages, at least among physicians.[194]

To determine whether the legislature should deny enforcement of such clauses by modulating enforcement according to the level of managerial expertise, or by operating under the common law to enforce to such clauses as long as they are reasonable, the effects – both positive and negative – on worker mobility, wages and hiring are all relevant. California's decision to adopt a bright line prohibition on covenants not to compete demonstrates a legislative determination that the benefits of a strict statutory rule outweigh the costs of a common law rule assessing the reasonableness of the restriction.

However, the presence of the statutory ban on covenants not to compete only blocks *public* enforcement of such covenants. Denying public enforcement cannot suppress efficient bargaining between parties. If there is an efficient exchange, barring one form of exchange, such as a contract with a covenant not to compete, it will not prevent parties from reaching their goals in a cost-effective manner that protects the employer and the employee.

Such bargaining has been ignored when legislatures absolutely prohibit non-compete covenants. Parties faced with such a prohibition appear to deliberately enter into unenforceable contracts. These contracts contain both covenants not to compete and post-employment severance payments to be furnished in installments – with both the non-compete and the installments being legally unenforceable.[195] The employer is incentivised to make the severance payments as long as the employee refrains from competing. Similarly, the employee will refrain from competing in order to secure the unenforceable severance payment. In effect, the parties informally enforce a contract covenant that is unenforceable by statute.

Thus, one cost of the California intervention is that many parties contract around the prohibition and rely on informal enforcement of unenforceable contracts.[196] This cost needs to be weighed against the benefits of the statute. It is possible that the private informal arrangements that parties enter into may be a less costly result than public enforcement of a covenant not to compete. The parties institute a relationship built on trust in which each monitors the performance of the other. The statute banning covenants works in tandem with informal private arrangements to achieve the goals of the common law

---

[192] See R Gilson, 'The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete' (1999) 74 *New York University Law Review* 575, 578–80.

[193] See Starr (n 190) 785.

[194] Medical practice groups will 'allocate … more clients' to physicians who sign such covenants, presumably because the practice would be willing to invest in such doctors because they will be less likely to leave. K Lavetti, C Simon and WD White, 'Buying Loyalty: Theory and Evidence from Physicians' 14 (1 February 2014) (unpublished manuscript, on file with author).

[195] Sanga (n 24) 654.

[196] ibid.

in balancing the interests of the employer in preserving an incentive to invest with the employee's interest in worker mobility.

The non-compete example demonstrates the importance of understanding bargained-for exchange in evaluating statutory and common law interventions outlawing certain contracts. That bargained-for exchange model demonstrates that parties will find a way to achieve their private goals even when public statutory law blocks one way of achieving those goals; efficient bargaining cannot be suppressed.

The question should be whether the reverberative effects of the statute are more costly and whether they exceed the welfare benefits from adoption of the statute. Those benefits could be considered in the narrow social sense looking only at the two contracting parties or more broadly.

Legislative prohibition can take a different form of blocking an exchange when the legislature outlaws a certain type of transaction. Such prohibitions may cause unintended costs and demonstrate the limits of legislation that contravenes parties' private preferences. One such prohibition is contained in the Sarbanes-Oxley ('SOX') legislation.[197] Responding to Enron abuses, s 402 outlawed loans to executives.[198] Prior to SOX, companies could, for example, lend money to an executive to buy a house. One problem with the SOX prohibition is that 'because if one form of compensation is restricted, managers can renegotiate their contracts to make up for the loss'.[199] The legislation has had limited effect and may have led to more inefficient compensation arrangements.[200] After SOX, instead of loaning money to executives, the company will simply give the executive a one-time bonus. The company will swallow the cost to recruit the executive and the company will not be reimbursed as it would have under a conventional loan. The prohibition on loans may also have the undesirable effect of prohibiting loans to facilitate stock purchases, thereby depriving companies of a key mechanism for 'aligning managerial incentives with shareholder interests'.[201] Those costs of intervention may outweigh the benefits. Only by taking the private exchange into account can those costs be factored into the costs of legislative intervention.

X. Conclusion

[197] Sarbanes-Oxley Act of 2002, Pub . No 107-204, 116 Stat 745 (2002) (codified in sections of 15, 18, 28 and 29 USC).

[198] 'Section 402(a) of SOX prohibits corporations from arranging or extending credit to executive officers or directors (unless the corporation is a financial institution offering credit in the ordinary course of business and the terms of credit are the same as those offered to the public).' R Romano, 'The Sarbanes Oxley Act and the Making of Quack Corporate Governance' (2005) 114 *Yale Law Journal* 1521, 1538 (2005). See 15 USC § 78m(k).

[199] Romano (ibid) 1538.

[200] ibid

[201] ibid 1539. These undesirable effects have led some scholars to suggest an alternative approach of disclosing the loans but not prohibiting them. ibid 1540.

Although statutes have sometimes been neglected in contract law, it is palpably clear that statutes play an ever-expanding role in contracts. Traditionally, these statutory adoptions have been regarded as intrusions into the private world of contract. This chapter argues that to assess the significance of these statutory developments, one must situate them in the context of bargained-for exchange. When so situated, legislation, like the common law, is an institution for minimising the costs of exchange. Legislation shares a common methodology with the common law when it formulates decisions about whether and how to add terms to contract. Intervention must depend on whether adding terms will increase welfare. That analysis depends on whether the parties can achieve their goals without any intervention and whether intervention will reduce the costs of exchange without introducing offsetting costs that outweigh the benefits. The framework is useful in explaining why and when courts or statutes intervene to facilitate contracting with rules or implied terms when obstacles prevent parties from contracting to solve a problem. It also sheds light on when and why courts or legislatures should decline to intervene, and on when and why disclosure mandated by statutes works or fails. The framework also illuminates the limits and offsetting costs of statutory intervention when parties devise mechanisms to circumvent statutes that forbid terms in contracts.