Fairness and Freedom in Contract Law

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Abstract

Parties may choose their contract's substantive terms but courts regulate party choices of remedy, interpretive, fiduciary and modification terms, which we characterize as "procedural." We claim that parties should also be free to choose the procedural terms. We make three arguments. First, mandatory contract law rules bear unfairly and arbitrarily on contracting parties: the rules bind unsophisticated or occasional players while sophisticated parties can use clever contracting strategies to avoid the rules' affect. Second, there is a divide in the contracts literature, and increasingly among courts, between economic and moral views of contract law. Economic theorists tend to support greater party control over procedural terms; moral theorists tend to support the current constraints. We attempt to dissolve this divide, arguing that nonconsequential moral theories actually support the same freer contract law that the economic theory supports. Third, we offer novel arguments in support of the economic view. Finally, we attempt to show what the commercial world would be like if parties could create their own contracting regimes in lieu of the current state regime.

Our claim that parties should be free to choose procedural terms has wide implications. Parties can contract away from contract law's substantive default rules but the law's mandatory rules bind parties everywhere. Reducing these rules to defaults thus would increase commercial agents' freedom to contract about property, corporations, finance, bankruptcy, and so on. American business law would be fairer and more efficient.

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Substantive contract law rules -- (i.e., Restatement sections) -- function as implied terms in contracts. Parties are free to delete such terms or substitute others for them. The law also contains mandatory rules, which are inescapable contract terms. For example, the liquidated damage rules prevent parties from choosing their own remedies for breach, the modification rules prevent parties from tying their hands with no modification clauses, the interpretation rules prevent parties from choosing the evidentiary base on which a court would interpret their agreement, the good faith duty rules prevent parties from deleting such duties from their contracts, and so forth.

Economic and moral theorists divide over the wisdom of these constraints but *assume* that the constraints, at the least, effectively and fairly implement the policies that animated their adoption. This foundational assumption is false: a contract law with inescapable -- that is, "mandatory" -- rules functions unfairly, arbitrarily and incoherently. Discussions of contract law's morality or efficiency should consider these effects.

Consider this example. A "lawgiver" (a court or legislature) wants to implement a policy X that would require sellers to agree to rescind sales contracts when they cannot repair the goods. The lawgiver chooses a mandatory rule R that requires the seller to refund the price (or down payment) if a reasonable number of repairs fail. The typical sales contract, in contrast, contains a set of terms, denoted "z", that obligate the seller only to make a good faith effort to repair; the risk of failure is on the buyer. The rule R, which shifts the risk, would increase a seller's cost per sale because each sale would be attended with a risk of rescission and product return. There exists an alternate set of terms "q" that would permit the seller to avoid rule R's effect. For example, the q terms define a successful confirming product loosely so that many repair efforts would satisfy the contract, or would require a down payment, identified as only for the seller's expenses in taking back the product, which the seller could retain. The cost of writing contract terms is positive and varies across seller firms. The q terms would cost each firm $c_j(q)$ to adopt, where i indexes contracting cost per firm from low to high. The marginal selling cost of the rule differs by the nature of a seller's business; some firms can absorb returns better than others. Denote the marginal selling cost s_j, where j also indexes costs from low to high.

Terms such as the q terms that define product quality or that specify down payments are substantive, and so would be enforceable under the freedom of contract principle. Therefore, mandatory rule R will bear most heavily on parties for whom $s - c(q) < 0$. These parties would let rule R stand because the marginal cost increase the new policy would impose on them is less than their contracting cost of adopting the q terms. These parties thus would raise their prices by $\$s_j$ -- the cost of the liberal product return policy. The parties whose contracting costs are low relatively to the avoidance gain would use the q terms effectively to retain the effect of their no return policy; their prices would be below $\$s_j$.

The "incidence" of a contract law rule -- that is, the parties whom it affects -- is a function of a party's gain from avoiding the rule compared to the party's contracting cost of avoiding it. The mandatory rule R affects the high contracting cost sellers because they would have to raise their prices to reflect the rule's full cost, which would reduce buyer demand at those firms. In contrast, R would not affect (or affect less) the low contracting cost firms, who would not raise their prices, and thus would take buyers away from the other firms. For the converse, buyers for whom it is most convenient to purchase from high contracting cost firms would pay the full price for the right to return while buyers who could purchase from low contracting cost firms would pay less.

Pursuing policy X with a mandatory rule R thus treats like cases unlike. The rule disproportionately burdens high contracting cost firms, and their buyers, more than it burdens low contracting cost firms and their buyers. We show below that contracting costs are lower and the gains from avoiding mandatory contract law rules higher, for repeat players, who tend to be large, sophisticated firms. Rule R is more likely to bind the occasional player — usually a small firm. Mandatory rule R thus reduces the contracting autonomy of smaller firms (and their economic gains), who must accept it, more than it reduces the autonomy (and the economic gains) of large firms, who can escape it. This is *unfair*.

In addition, the lawgiver cannot affect the variables — contracting and mandatory rule costs that determine rule R's incidence. In a large economy, the lawgiver cannot know for most markets what that incidence would be. Thus, from the lawgiver's viewpoint, compliance with rule R is random. Put another way, it is *arbitrary* to pursue a substantive policy with a mandatory contract law rule.

The lawgiver could increase compliance with rule R by banning the avoiding q terms. But to do that would be to abandon the freedom of contract principle that permits parties to write whatever substantive terms they like. Contract law today, however, is committed to implementing substantive policies with mandatory rules *and also* is committed to substantive freedom of contract. Thus, contract law is i*ncoherent.* In sum, contractual fairness *is increasing* in contractual freedom.

Introduction

A. Contract Law's Unity

Common law courts make rules in the course of deciding cases. Contracts is a common law field[1] but bankruptcy and corporations are thought not to be. On the definition here, this consensus is incorrect. Insolvency and corporate codes either give courts no guidance or contain abstract standards. Therefore, bankruptcy and corporate courts also make the rules in the course of adjudicating bankruptcies or corporate disputes.[2]

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[1] Much of the doctrine and principles of contract law have been developed over centuries by judges in the course of deciding individual cases. *See* Alan Schwartz & Robert E. Scott, *The Common Law of Contract and the Default Rule Project*, 102 VA. L. REV. 1523, 1533-35 (2016).

[2] For example, section 363 of the Bankruptcy Code authorizes a debtor in possession to sell assets "out of the ordinary course" if the bankruptcy court, "after a hearing", permits the sale. Section 363, however, does not say what the court is supposed to find or which findings would justify or bar a sale. Thus, in the area of asset sales, and many others, bankruptcy is a common law field. *See, e.g.,* Mark J. Roe, *Three Ages of Bankruptcy*, 7 HARV. BUS. L. REV. 187, 189 (2017) (explaining how the § 363 sale has become the "prime system of industrial restructuring in the

A legal substructure unifies thes seemingly disparate transaction fields: contract law's defaults and mandatory rules, which govern everywhere. Thus, every merchant seller must make an implied warranty;[3] a party to a preliminary agreement cannot recover reliance costs unless its counterparty made a promise that would, if accepted, create an enforceable contract;[4] a creditor cannot impose a penalty for late payment;[5] a merger agreement cannot contain penalties and must be sufficiently definite to enforce;[6] and so on.

We claim that courts (or other lawgivers) should change particular mandatory contract law rules to defaults. This reform would have two consequences: (i) contract law would become a fairer, a more coherent and a more transaction facilitating legal field; and relatedly (ii) because contract law applies everywhere, these improvements would liberate parties to make more efficient bankruptcy, corporate, property and other commercial contracts.

Though contract law is unified at the level of application, there exists a theoretical divide between contract scholars and, increasingly, among courts regarding what contract law should be. On one side are the philosophers (and other moralists): on the other, the economists (and lawyer economists).[7] The moralists' paradigm contract is between two individual persons. Philosophical analyses of contract law use non-consequentialist theories to explain or justify the freedom these agents have to make binding contracts; the freedom they should have;[8] and which

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United States" despite the fact that it "derives its authority from two broad, open-ended sentences in the Code that lack texture, standards, specifics, and instructions."). In Delaware, a corporation is managed by its board of directors, but the Delaware Code does not say how boards should act and constrains them only with the broad fiduciary duties of loyalty and care. Delaware Chancery makes most of Delaware corporate law in the course of adjudicating corporate disputes. *See, e.g.,* Jack B. Jacobs, *The Uneasy Truce Between Law and Equity in Modern Business Enterprise Jurisprudence*, 8 DEL. L. REV. 1, 5 (2005).

[3] U.C.C. § 2-314 (AM. L. INST. & UNIF. L. COMM'N 1977).

[4] Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 673 (2007).

[5] *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L. J. 541, 616-17 (2003); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554, 568-76 (1977).

[6] See, e.g., *Genuine Parts Company v. Essendant Inc., C.A. No. 2018-0730-JRS* (restating consolidated jurisprudence that Delaware courts will enforce the clear and unambiguous terms of a merger agreement.)

[7] For an illuminating description of the theoretical divide between deontic and consequentialist moral theories, *see* Jody S. Kraus, *Philosophy of Contract Law*, *in* THE OXFORD HANDBOOK OF JURISPRUDENCE AND PHILOSOPHY OF LAW 687 (Jules L. Coleman, Kenneth Einar Himma & Scott J. Shapiro eds., 2004).

[8] *See, e.g.,* CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION 13 (2d ed. 2015) (arguing that the ability to commit oneself to a promise through contract is necessary for maximizing freedom).

contracting restrictions would prevent the exploitation of weaker parties by stronger ones.[9] The philosophers, generally speaking, are not interested in economics, and seldom justify their conclusions in welfare economic terms. Rather, they apply normative criteria, largely drawn from deontic theories, to contract law rules.[10]

The economists' paradigm is the contract between two companies. Economic analyses of contract law use economic methods, primarily mechanism design and contract theory,[11] to explain or justify the freedom companies have and should have to make contracts and normatively appropriate restrictions on those freedoms. Because commercial parties' contracts attempt to maximize the expected surplus their deals could create, economists evaluate contract law rules with the welfare criterion: the rules should facilitate parties' ability to make maximizing contracts.[12]

These scholarly traditions function largely independently of each other. According to the economists, it would be a category mistake to evaluate contract law rules with agent-centered

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[9] *See, e.g.,* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 378 (1980) (arguing that the doctrine of good faith in performance is aimed at regulating the discretionary behavior of parties when they try to recapture forgone opportunities).

[10] *See generally* FRIED, *supra* note 8, at 1-3, 17-21 (pioneering a Kantian approach to contract law); PETER BENSON, JUSTICE IN TRANSACTIONS: A THEORY OF CONTRACT LAW (2019) (articulating a Kantian approach to contract law that focuses on justice implications); Seana Valentine Shiffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 708 (2007) (challenging the view of contracts merely as economic instruments for regulating transactions and arguing that this divergence undercuts the moral foundation of contract law and adversely affects our moral relationships).

[11] For a discussion of the difference between mechanism design and contract theory tailored to a law review audience, see Alan Schwartz & Simone M. Sepe, *Economic Challenges for the Law of Contract*, 37 YALE J. REG. 678, 691 (2021). In particular,

> Contract theory and mechanism design are often used as synonyms. This, however, is an oversimplification. As one commentator observed, 'In contract theory, we study the optimal design of incentives for a single agent. In mechanism design, we study the optimal design of incentives for a group of agents. . . . Contract theory therefore, unlike the theory of mechanism design, does not have to deal with strategic interaction.

See id. (quoting TILMAN BÖRGERS, AN INTRODUCTION TO THE THEORY OF MECHANISM DESIGN 2 (2015)).

[12] The welfarist approach to contract law presupposes a commitment to utilitarianism, which, as a normative ethics conception, implies that the morality of contract law depends on the economic consequences the law brings about. *See, e.g.*, Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEG. STUD. 103-140 (1979); Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487, 488 (1980; Guido Calabresi, *An Exchange: About Law and Economics: A Letter to Ronald Dworkin* 8 HOFSTRA L. REV. 553, 562 (1980). For a critique of the welfarist perspective, see Ronald Dworkin, *Why Efficiency? - A Response to Professors Calabresi and Posner*, 8 HOFSTRA L. REV. 563, 563 (1980) (criticizing the legitimacy of efficiency as the Grund principle for welfarists); Duncan Kennedy & Frank Michelman, *Are Property and Contract Efficient?* 8 HOFSTRA L. REV. 711, 711 (1980) (offering a radical criticism to the traditional welfarist approach -- in particular as applied in law and economics to property and contracts); Jules Coleman*, Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 509 (1980).

ethical theories. Corporations are artificial persons who cannot have second order preferences[13] or desires for fully flourishing lives.[14] According to the moralists, welfare economics is a reductive moral theory that ignores important ethical considerations.[15] The contract law articles of both schools pass by each other largely unnoticed.[16]

We show, in contrast, that contract law's unity is *both* practical *and* theoretical: Practical in the sense that the rules are the same everywhere and should be less constraining than they are now; theoretical in the sense that both theoretical traditions, on a deeper view, support the increased freedom of contract that we urge.

B. Premises and Claims

Contract law rules are in four categories. *Substantive rules* govern what the parties can trade; *structural (or bargaining) rules* identify the bargaining conditions that must obtain -- absence of coercion or fraud, a rough equality of sophistication -- for a court to enforce the substantive terms;[17] *interpretive rules* specify the evidence that a court may consider when determining what the substantive terms intend;[18] and *remedy rules* specify what a party must pay, or do, if the party breached a substantive term.[19] Under American contract law, parties can choose the contract's substantive terms subject to two constraints: (a) the terms do not create a negative externality; (b) the terms do not violate widely accepted moral principles, such as those prohibiting the sale of organs[20] or (in many states) the use of a womb.[21] Courts and

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[13] In economics, an individual's (first-order) preferences form the basis for their utility function: if I prefer x over y, I assign a higher personal utility to x than to y. By observing market transactions, we can then infer the first-order preferences of market participants. Second-order preferences are an individual's preferences for certain preferences: if I prefer to prefer x over y, I am making what might be understood as a moral choice. For a more complete discussion of second-order preferences tailored to a legal audience, see Saura Masconale & Simone M. Sepe, *Citizen Corp. - Corporate Activism and Democracy*, 100 WASH. U. L. REV. 257, 290 n. 157 (2022).

[14] One of us has taken this position in prior work. *See* Schwartz & Scott, *supra* note 5, at 556.

[15] *See* sources quoted *supra* at notes 10. *See also* sources quoted *supra* at note 12 criticizing the welfarist approach to contarct law.

[16] Parallel to this indifference, some courts award "gain based damages" for putative moral reasons but many courts do not. *See* Daniel Markovits & Alan Schwartz, *The Expectation Remedy and the Promissory Basis of Contract*, 45 SUFFOLK U. L. REV. 799, 806 (2012).

[17] *See infra* Part II.A.1.

[18] *See infra* Part II.A.2.

[19] *See infra* Part II.A.3.

[20] The sale of human organs for transplantation is illegal in many jurisdictions, including in the United States, as specified by the National Organ Transplant Act (NOTA) of 1984, section 301.

[21] *See, e.g.*, Matter of Baby M, 537 A.2d 1227 (N.J. 1988) (holding a surrogacy agreement invalid).

statutes adopt, and courts apply, the interpretive, remedy and structural rules. The freedom of contract principle in American contract law thus means that parties can create the substantive content of their agreements subject only to the two constraints. Otherwise, parties cannot freely choose the interpretive methods, remedies or structural restrictions that apply to their agreements.[22]

We make a legal and a theoretical claim, both of which apply only to the contracts sophisticated contracting agents make. Our *legal claim* is that contract law should generalize freedom of contract. This claim comes in a weak and a strong form. The weak form holds that courts (or other private lawgivers) should convert the law's interpretive, remedy and structural rules -- "the triad" of mandatory procedural rules -- into defaults (or repeal them). The claim is weak because it leaves ultimate authority over contracting behavior with the state.

The stronger version of our legal claim is that the locus of control over contracting should shift in favor of private parties.[23] Contracting freedom falls on a continuum. At one end is an economy resembling the former USSR, where major contracting activity was between state ministries. Individuals could trade small items for small sums but the state could regulate or ban any contract.[24] Today's economies, regarding contract law, are "mixed": parties choose substance; courts choose procedure. We ask what a contract law that permits parties to choose everything would look like. And would such a legal regime be desirable?

Consider a business sector populated by sophisticated agents. The agents organize themselves in contracting groups we call "islands." The smallest island is a dyad: two parties who trade. In much of the sector, the islands are larger. They would be related commercial groups, such as farmers and grain elevators; auto parts makers and automobile manufactures; chip producers and computer makers. Each such island would create the rules -- the contract law -- that regulates intragroup transactions; and specify the criteria governing intergroup trade. Members, organized as panels, would adjudicate disputes; their rulings would be enforced, initially, by private sanctions, such as the withdrawal of trading privileges. Each island would set

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[22] It is customary for commentators to analyze the three restrictions independently. For a general treatment, *see* Schwartz & Scott, *supra* note 5, at 594-609. *See also infra* note 133 (discussing differences between the three sets of mandatory restrictions).

[23] *See infra* Part VI (examining the strong form of GFC in detail).

[24] *See* PHILIP HANSON, THE RISE AND FALL OF THE SOVIET ECONOMY 9-10 (2003) ("The fundamental difference from a market economy was that decisions about what should be produced and in what quantities, and at what prices that output should be sold, were the result of a hierarchical, top-down process culminating in instructions 'from above' to all producers"); *see also* Oskar Lange, *On the Economic Theory of Socialism: Part One*, 4 REV. ECON. STUD. 53, 62 (1936) (providing the classic account of market socialism).

its own criteria for membership. There would be free but necessarily conditioned exit. For example, a member could not leave with trade secrets.

What would the role of the state be in an economy of independent contractual islands: a "commercial archipelago"? The state would perform five basic functions: (a) to ensure that island members are commercially sophisticated; (b) in cases of noncompliance, to reinforce local judgments by applying *the law of the island*, not the law of the state; (c) to enforce inter-island contracts according to the law an inter-island contract itself specified; (d) to ensure that no island gets so large as to upset the archipelago ecosystem (there would an antitrust law of islands); and (e) to require islands to internalize negative externalities. In this imagined commercial world, contracting would be democratic and free: democratic in the sense that private commercial groups would create their own law; free in the sense that commercial contractors would be bound as they chose.

In this Article, we primarily argue that contract law should change important mandatory contract law rules, such as the rules regulating interpretation and remedies, to defaults. These reforms, we claim, would make contract law fairer and more efficient. In the last part, however, we attempt to make concrete the thought experiment just sketched, showing in more detail what a decentralized contract law would look like.[25] Our legal aim is to make more salient to scholars and decision makers the consequences of the constraints that characterize current law, and to bring to their attention a view of a largely constraint free contracting world.

Our *theoretical claim* is that a normatively unified contract law actually exists. We support this claim by showing that philosophic and economic theories both support the case for generalizing freedom of contract.[26] A variety of deontological theories (including principle-based[27] and right-based theories[28]) as well as consequentialism (including in the form of welfarism[29]) are compatible with such freedom. We can put this conclusion in Rawlesian terms:

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[25] *See infra* Part VI.

[26] Our argument is consistent with Jody Kraus and Robert Scott's argument that the triad rules and others are not part of a correctly interpreted contract law; rather the rules were illegal importations from equity into the common law. When these rules are excluded, contract law, they claim, is a unified set of rules that facilitate parties' ability to make maximizing contracts. *See* Jody P. Kraus & Robert E. Scott, *The Case Against Equity in American Contract Law*, 93 S. CAL. L. REV. 1323 (2020). Our argument is more normative than interpretive. Kraus and Scott claim that the triad rules (and others) never belonged to contract law properly understood; we claim that, however illegal the triad rules' origin was, the rules have no place in a fair and efficient contract law.

[27] *See infra* Part IV.A.

[28] *See infra* Part IV.B.

[29] *See infra* Part V.

there is an overlapping, though largely unrecognized, moral consensus for expanding the freedom of contract sphere.[30]

Generalizing the freedom of contract principle would yield three payoffs. First, contracting freedom has intrinsic moral value. It enhances agents' autonomy by introducing symmetry in the legal system's treatment of substantive and procedural contract terms: parties would have equal freedom to adopt either.[31] Reducing the triad's rules to defaults also would expand parties' commercial rights, consistent with the view that parties' rights -- and their power to transfer them -- should be constrained only when parties acquired their rights illegitimately.[32] Second, a generalized freedom of contract would permit parties' to make more efficient contracts.[33] Third, such freedom would increase contractual fairness because it would facilitate the ability of all commercial parties -- from weak to strong -- to design their own exchange mechanisms.[34] Today, only sophisticated commercial agents enjoy this freedom because they can escape the effect of many mandatory rules by adroit (but expensive) contracting. [35]

C. A Roadmap

Part I clarifies the scope of our analysis: we focus on contractual governance terms that sophisticated parties agree upon in the exercise of their "interactive agency" – the parties' moral power to shape their interactions with others.[36] This focus requires us predominantly to consider non-market transactions. The competitive market mechanism constrains individual agency because the mechanism determines prices and many terms.[37] In non-market transactions, by contrast, agents (subject to the law) potentially possess full freedom of contract: the freedom to exercise their interactive agency to determine contract content.

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[30] Broadly speaking, there are two main intermediate positions: a right-based contract law subject to cost constraints and an efficient contract law subject to rights constraints. We claim that generalizing freedom of contract is supportable under either position.

[31] *See infra* Part IV.A.

[32] *See infra* Part IV.B.

[33] *See infra* Part V.A.

[34] *See infra* Part III.B.

[35] *See infra* Part II.B.

[36] *See infra* note 55 and accompanying text.

[37] *See infra* note 53-54 and accompanying text.

Part II shows how mandatory rules actually affect contracting agents. These rules have an arbitrary and unfair incidence, their real-world impact turning largely on factors unrelated to the policies that animated the rules. The most important such factor is the parties' relative contracting costs; these largely determine which parties a mandatory rule constrains and which parties remain free.

Parts III and IV consider agent centered moral theories, focusing respectively on equality and freedom as core values. Many moralists believe that courts should (i) control remedies because otherwise the strong could impose remedy terms that exploit the weak;[38] (ii) control interpretation because otherwise the strong could impose duties (or disclaim them) that the weak could not understand;[39] and (iii) control bargaining protocols because otherwise the strong could impose one-sided deals.[40] We show that when sophisticated agents contract, these beliefs are false.

More particularly, these beliefs sustain the current distinction between how the law regulates substance (lightly) and how it regulates procedure (heavily). Because a deal *is* its substance, party freedom over substance should also imply party freedom over procedure. To the contrary, courts control procedure. This is an error because the moral justifications for substantive liberty, we show, *also support* procedural liberty.[41] Recognizing this makes the case for a theoretically unified contract law that would permit party freedom over substantive terms *and* over procedural terms.

Part V consider welfare theories. Our argument links to Parts III and IV in two ways. First, we show that welfare analyses also support giving parties control over the triad terms. To understand the second aspect of our argument, realize that normative ethical approaches do not provide criteria for deciding concrete cases.[42] Rather, to decide a case requires an instantiation

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[38] See BENSON, *supra* note 10, at 212-13; *see also* Seana V. Shriffin, *Paternalism, Unconscionability Doctrine, and Accommodation*, 29 PHIL. & PUB. AFF. 205 (2000).

[39] *See, e.g.,* STEVEN J. BURTON, ELEMENTS OF CONTRACT INTERPRETATION 60 (2008) (arguing that in every contract, there is an implied covenant of good faith and fair dealing to protect the weaker parties).

[40] *See, e.g.,* Ian R. Macneil, *Relational Contract Theory: Challenges and Queries*," 94 NW. L. REV. 877, 877 (2000) (examining how contract interpretation can be used to safeguard the interests of the less powerful party in contract negotiations).

[41] *See infra* Part IV.A.1.

[42] Consider the Kantian deontological approach. Without more specific instantiations of the theory, this normative ethics approach can lead to vastly different conclusions. For example, Fried concludes that a promise is a sufficient condition for an enforceable contract. *See* FRIED, *supra* note 8, at 38. Conversely, Benson asserts that for a contract

of the general moral conception. Perhaps put more clearly, there must be an intermediate moral premise that links the theory to the case. Non-consequentialist approaches illuminate basic features of the system, such as how agents have the moral power to create externally enforceable obligations to perform their promises. These approaches do not bridge to the case, however.

An apt instantiation should be derivable from every ethical approach but, as Richard Craswell has shown, only welfare consequentialism has done so.[43] Economic analysis supplies intermediate moral premises because it applies at the micro level, asking whether particular rules (or their application) are efficient or not. An efficient rule that is consistent with, or implied by, a moral theory is instrumentally *and* intrinsically valuable.

Part VI develops our conception of a stronger form of freedom of contract, which would transfer the locus of control over contracting behavior from the state to the parties. Such a transfer would entail, among other things, authorizing private associations to create their own substantive and procedural contract law. Part 7 concludes.

I. The Domain of Our Argument

A. Sophisticated Parties

We study a commercial world of sophisticated agents. These can exercise means/ends rationality.[44] The agents seldom are at the same economic scale, but are "epistemic peers":[45]

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to be enforceable, it must be supported by consideration and satisfy the requirements of contractual doctrines. Benson, *supra* note 10, at 40, 192.

[43] Richard Craswell argues that:

> *certain* philosophical theories may have implications for the proper content of contract law's background rules. For example, theories that justify the enforceability of promises on grounds of economic efficiency . . . may imply that the law should adopt those background rules that are most efficient . . . . Other philosophical theories, however — including the one endorsed by Fried — have no such implications for the content of the law's background rules.

Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 490 (1989) (emphasis in original).

[44] We use rationality in this context in its epistemological rather than its economic sense. Our concern is with the agent's reasoning process and the criteria for what would be a rational change in the agent's beliefs. *See generally* GILBERT HARMAN, CHANGE IN VIEW: PRINCIPLES OF REASONING (1986).

[45] An important exception is the framework agreements that structure what we call elsewhere "new collaborations": agreements that regulate multi-year arrangements between firms to produce new products, drugs or platforms. *See* Alan Schwartz and Simone M. Sepe, *Contract Remedies for New-Economy Collaborations*, 101 TEX. L. REV. 749, 749 (2023). Because these agreements govern process rather than the sale of products or services, they are often only

that is, they have similar abilities to access and process information.[46] When both parties possess these abilities, they can share knowledge about the commercial environment; are good predictors of future outcomes; and can solve the economic problems their transaction poses.[47] A good example is a company that pursues complex projects.[48] These companies possess an organizational structure that can process information and manage project and legal risk. Such companies also have rational expectations about their environments that are correct on average because the companies observe multiple realizations; hence, they can learn by correlating past predictions with past outcomes. Another candidate is the experienced smaller company, including established sole proprietorships.[49]

Commercial agents have limited cognitive abilities, however, because bounded rationality characterizes all economic actors. Bounded rationality is a limited ability to process information.[50] Sophisticated boundedly rational agents are aware of their cognitive limitations, however. As such, they have an incentive to pursue protective strategies. A less informed or less rational, but self-aware, party will attempt to bargain for a contractual mechanism that would induce the more informed party to reveal her private information, or terms that

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partially spelled out in writing or fully definite at the outset of the parties' commercial relationship. *See id.* at 754-55, 757-58. On the new collaboration contracts, *see also* Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Text and Context: Contract Interpretation as Contract Design*, 100 CORNELL L. REV. 23, 29–30 (2014) (discussing implications of "new forms of contracting among legally sophisticated parties unanticipated in earlier discussions"); Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine,* 110 COLUM. L. REV. 1377, 1382–83 (2010) (explaining that contemporary contracts build trust by combining formal and informal methods of enforcement); Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 COLUM. L. REV. 431, 433–35 (2009). For a discussion of the implications of GFC for the efficiency of new collaboration contracts, *see infra* Part V. A.

[46] When we refer to parties as "epistemic peers," we are not suggesting they possess identical capabilities for processing and analyzing information. It would be error to assert, for example, that a large corporation and a small company have the same information-processing abilities. Rather, in the world we analyze, contracting parties satisfy certain minimum standards that qualify them as "sophisticated.".

[47] See MICHAEL MASCHLER, EILON SOLAN & SHMUEL ZAMIR GAME THEORY 321 (2013) (formally showing that with common knowledge parties can predict future outcomes, that is, conjecture equilibria, through their rationality).

[48] *See id*. at 551.

[49] For example, a bookstore that just started business yesterday might not be considered a sophisticated party, but a bookstore operating for the past twenty years would be. We address the domain objection that deontic moral theories do not apply to corporations or other sophisticated commercial parties as defined in this article in Part III. *See infra* text accompanying notes ---.

[50] *See generally* Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q. J. ECON. 99, 103-04 (1955) (formally analyzing how individual rationality is inherently restricted by available information, cognitive limitations, and time constraints). *See also* GERD GIGERENZER & REINHARD SELTEN, BOUNDED RATIONALITY: THE ADAPTIVE TOOLBOX 43 (2002) (arguing that the human mind is not an "optimizer" but rather an "adaptive toolbox," deploying heuristics to make satisfactory decisions under the imposed constraints).

constrain the informed party's ability to exploit its private information.[51] We acknowledge, however, that the "rationality gap" for a transaction can be so wide as to justify a court in viewing the transaction through a different frame. But every theory has difficult boundary cases and our domain is wide enough to support the relevance of the treatment below.

Courts usually can identify sophisticated parties. Sometimes it is possible to infer sophistication from the contract alone: only sophisticated parties could make certain agreements. Also, verifiable factors exist that plausibly proxy for sophistication such as corporate or professional status.[52]

B. Freedom to Exchange and Freedom to Contract

There is a distinction between parties' freedom to exchange and their freedom to contract. In a general equilibrium framework, parties can exchange a commodity (where any right is a commodity) against a price.[53] The competitive behavior of consumers and producers determines the prices and other terms. Agents thus are free only to transact under contracts the market creates .[54] *Freedom to contract*, by contrast, is the ability to exercise interactive agency: the agent's moral power to shape her relations with others.[55]

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[51] One can predict how parties will behave at the equilibrium, when they assume that agents behave rationally. *See generally* DREW FUDENBERG & JEAN TIROLE, GAME THEORY 11 (1991)). We also remark here about two basic features of commercial contracting. First, there is a difference between being informed about the nature of a transaction and being informed about the values of the payoff relevant variables that characterize it. Thus, a party can know and understand that she is trading widgets but not know the value her counterparty places on widgets. Second, it is difficult for a party to profit from private information when her counterparty knows she possesses it.

[52] Alan Schwartz & Simone M. Sepe, *Commercial Rationality* (working paper, 2023) (on file with authors) (introducing the concept of commercial rationality as a theoretical normative definition of party sophistication.) In particular, sufficient conditions for commercial rationality include: (i) capacity for learning; (ii) memory; (iii) an updating belief mechanism; (iv) sensitivity to payoffs; and (v) weak consistency with probability and logic rules. *Id.* These conditions are less stringent than those assumed by the rational choice model used in economic theory. Because merchants usually meet these rationality conditions, we argue that courts should presume merchants to be sophisticated. *See id.*

[53] The commodities are state-contingent rights to receive a unit of a physical good if and only if a particular state of the world occurs. The state of the world is the realization of one of the possible worlds that could have occurred when the parties contracted. *See* ANDREU MAS-COLELL ET AL., MICROECONOMIC THEORY 704 (1995).

[54] Scholars sometimes claim that competitive markets are the domain in which individual agency is fully realized. *See, e.g.,* MILTON FRIEDMAN, CAPITALISM AND FREEDOM (1962); FRIEDRICH A. HAYEK, THE MIRAGE OF SOCIAL JUSTICE (1976); JOHN TOMASI, FREE MARKET FAIRNESS (2012). One of us has argued that there is a deep tension between agency and efficient markets. *See* Thomas Christiano & Simone M. Sepe, *Agency and Markets* (working paper, 2023) (on file with authors).

[55] Christiano & Sepe *supra*, manuscript at 5.

Freedom to exchange *and* freedom to contract are necessary for efficiency in the real world of incomplete markets because the price system imperfectly coordinates economic actors.[56] Therefore, parties must create contracts that mitigate market imperfections. For example, when buyers face adverse selection, they are reluctant to trade.[57] Warranties help to overcome this reluctance. Contract law thus has two roles to play in imperfect markets: as a form of centralized planning that can promote efficiency,[58] and as a facilitator of agents' ability to exercise their moral power to improve their own welfare.[59]

Parties' ability to exercise interactive agency even in incomplete markets is limited, however. The automatism of competitive exchanges under the price mechanism continues to constrain individual choices. Indeed, in general equilibrium models with incomplete markets, the canonical representation of the economy still supposes an "auctioneer" [60] who somehow coordinates market agents' actions.[61] Freedom of contract, in the sense of an agent's ability to exercise interactive agency, thus can fully flower only when parties interact in bilateral monopoly conditions.[62] In these non-market cases, parties can specify contract terms, including prices, through bargaining. But while agents' moral power is potentially maximal in out-of-market

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[56] *See* John Geanakoplos, *Arrow–Debreu Model of General Equilibrium*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS 451 (3d ed. 2018).

[57] *See* Schwartz & Sepe, *supra* note 11, at 694-96 (examining adverse selection problems in contract law).

[58] When the strong assumptions of the Arrow-Debreu general equilibrium model are relaxed, the corrective role of contract law is not carried out against the benchmark of an efficient market equilibrium but rather performs as a substitute for an inefficient (or non-existent) equilibrium. *See id.* at 680, 684-85 (quoting Kenneth J. Arrow & Gerard J. Debreu, *Existence of an Equilibrium for a Competitive Economy*, 22 ECONOMETRICA 265 (1964).

[59] *See* DAVID GAUTHIER, MORALS BY AGREEMENT 84 (1984). Under these imperfections, Gauthier argues, the rational self-interest that typically guides market behavior is insufficient to guarantee fair outcomes. *See id.* at 113. Hence, individuals should consider the impacts of their actions on others, out of a rational understanding of long-term self-interest. *See id.* at 128.

[60] The 'Walrasian auctioneer' is a theoretical mechanism of market equilibrium adjustment, a fictional concept that helps illustrate the dynamics of general equilibrium theory. *See* MAS-COLELL, *supra* note 53, at 578.

[61] Parties, however, can instruct the auctioneer to implement contracts that solve market failures. Edward C. Prescott & Robert M. Townsend, *Pareto Optima and Competitive Equilibria with Adverse Selection and Moral Hazard*, 52 ECONOMETRICA 21, 21 (1984). Apart from this ability, in imperfectly competitive markets, agents are largely price and contract takers—at best able to choose bundles of state-contingent contracts rather than determine the content of individual agreements.

[62] A bilateral monopoly exists when there is a single buyer (as in a monopsony) and a single seller (as in a monopoly) for a product or service. In these cases, which are common. the l competitive forces that determine price and quantity are absent. Each party thus has significant market power, and their behaviors, particularly in terms of negotiating prices and quantities, become strategic and interdependent. *See generally* OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 32, 43, 63 (1985.

transactions, it has not led to maximal legal freedom of contract. Rather, the mandatory triad rules, as we next see, arbitrarily and unfairly restrict how agents' can shape their transactions.[63]

II. The Arbitrary Incidence of Mandatory Rules

There are two drawbacks to pursuing public policies with mandatory contract law rules. First, the lawgiver cannot accurately predict the extent to which a rule would implement the policy. Second, to the extent that the lawgiver can predict anything, it should expect two unfortunate effects. First, the rule probably would constrain the contracting behavior of episodic or weak players, not frequent, substantial contractors, who could escape the rule's impact by adroit contracting. Second, and relatedly, the rule might actually subvert the policy that animated its adoption. These results imply that a contract law with mandatory rules that are not restricted to internalizing externalities is self-defeating.

To pursue this implication, recall that a rule's incidence is the affect the rule has on its addressees and possibly others. For contract law the question would be whether the rule causes parties to contract such that the lawgiver realizes its animating policy. The incidence of a legal rule is "arbitrary" if the factors that determine its actual effect are unrelated to the policy. Another way to put this criterion is that, from the viewpoint of the lawgiver, incidence is arbitrary when compliance is random.

Mandatory contract law rules have an arbitrary incidence, for two reasons. To understand them, let the lawgiver enact rule ω to implement policy X, though many parties prefer ω not to bind. In this case, the extent to which the state achieves X partially turn on the parties' costs of escaping ω. In a highly diverse economy, contracting costs differ materially across parties. Parties whose contracting costs are high relative to ω may obey ω while parties whose contracting costs are low may escape it. Parties' contracting costs partly are a function of the rule ω itself -- some rules are easier to escape than other rules - but also partly are a function of the parties' contracting capacities. Contracting capacities differ across parties and exist independently of the substantive policies that may animate contract lawgivers. Therefore, the degree to which the rule ω effectively implements policy X importantly turns on a factor -- contracting capacity -- that is unrelated to policy X. The incidence of ω also turns on the increase in the cost of selling goods the rule would impose on the parties. This cost, however, is a function of the nature of the parties' business and so also is beyond the lawgiver's ability to affect.

[63] Two final observations are helpful. First, while the standard law and economics approach to contract law uses market transactions and the efficient market equilibrium as a benchmark, most transactions between commercial parties reflect bilateral Coaesean features (with the exception of transactions taking place in financial markets). Second, competitive forces influence non-market choices so that a continuum exists from pure freedom of exchange to pure freedom of contract, with parties' moral power to determine contract content decreasing as the background competitive forces increase.

Now consider a lawgiver deciding whether to implement policy X by enacting the contract law rule ω. The lawgiver knows that ω's incidence -- i.e., its affect -- is a function of three factors: (a) the nature of the rule ω itself; (b) the capacity of particular parties to create contract terms that would avoid or ameliorate ω's affect; (c) the selling costs ω imposes on the parties. The lawgiver could only affect factor (a). Further, because contracting costs and selling costs often are private information, the lawgiver seldom could predict what the rule's incidence would be. These drawbacks exist because it is difficult effectively to implement a policy X by passing a contract law rule ω when ω *only regulates one term.* Some parties could use the unregulated substantive terms to escape rule ω's reach. Nevertheless, it is practice, and we assume, that the lawgiver enacts rule ω *without* proscribing likely contractual responses.

The lawgiver can choose among four ω versions when pursuing policy X:

(1) Parties must comply with rule ω unless they choose not to.

(2) Parties can choose not to comply with rule ω, but they may only avoid ω in a legally prescribed way.

(3) Parties must comply with rule ω. Other possible contract terms would enable parties to offset ω's impact.

(4) Rule ω prevents parties from achieving their contracting goal in a specified way. Contracting strategies exist that would enable parties to circumvent ω.

A. Transformation Operator

The four rule versions are on a spectrum: rule $\omega_{(1)}$ is a "simple" default; rule $\omega_{(2)}$ is a "sticky" default because it is nontrivially more costly than $\omega_{(1)}$ to contract away from; and rules $\omega_{(3)}$ and $\omega_{(4)}$, which commonly are called mandatory, are increasingly and significantly more costly to escape. To demonstrate more precisely how contracting costs affect parties, let T be a "transformation operator" that maps a legal rule ω to the parties' contracting response k: formally, T: $\omega_{(1)} \mapsto k_{(1)}$ where the term to the left of the double arrow indexes the four rule versions: $\{i \; \varepsilon \; \omega_1 \; \ldots \; \omega_4\}$ and the term to the right indexes the corresponding party responses.

T: $\omega_{(1)} \mapsto k_{(1)}$. Example: Rule $\omega_{(1)}$ requires the seller to warrant its product: $k_{(1)}$ is a warranty disclaimer.

T: $\omega_{(2)} \mapsto k_{(2)}$. Example: Rule $\omega_{(2)}$ requires the seller to warrant: $k_{(2)}$ is a warranty disclaimer that must be cast in legally required words and be conspicuous.[64]

[64] *See* U.C.C. § 2-316(2) (AM. L. INST. & UNIF. L. COMM'N 1977).

T: $\omega_{(3)} \mapsto k_{(3)}$. Example: Rule $\omega_{(3)}$ requires the seller to warrant. The seller cannot disclaim the ω warranty but may use response $k_{(3)}$, which would be to raise the price, or alter other terms, to offset the warranty's effect.

T: $\omega_{(4)} \mapsto k_{(4)}$. Example: Rule $\omega_{(4)}$ prevents parties from contracting out of the duty to act in good faith. The response $k_{(4)}$ would specify the standards a court is to apply when adjudicating alleged breaches of the duty.[65] Parties thus can control how the duty affects them.[66]

Transformation operators therefore permit parties to convert regulated procedural terms -- the mandatory rules -- into unregulated substantive terms.

The lawgiver can rank transformation operators ordinally. To see how, define a "contracting capacity." A firm's contracting capacity is composed of an administrative apparatus to create and administer terms, such as a warranty department; a legal department (or routine access to lawyers); experience with the contract type at issue; and so forth. Contracting capacities differ across firms. The contracting capacity of a small firm that makes important contracts infrequently may consist of the experience of its owner (such as it is). The contracting capacity of a large firm that makes numerous significant contracts will also consist of contract administration and legal departments.[67] There is an inverse relation between the fixed and variable costs of using transformation operators: the larger the fixed cost of implementing a contracting capacity the lower the variable cost. Put more concretely, the more extensive a party's contracting capacity is the lower is its cost of escaping a particular rule.[68] This is because the fixed set up costs for a capacity are high relative to the variable costs of using the capacity to escape single mandatory rules. Firms with different contracting capacities therefore would incur different variable costs to escape the same rule.

Holding fixed costs constant, it is cheap -- the variable cost is low -- for parties to disclaim rule $\omega_{(1)}$; more costly for parties to disclaim $\omega_{(2)}$ as the law requires; more costly still for parties to raise the price or adjust other terms to offset the effect of $\omega_{(3)}$; most costly of all for parties to

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[65] *See* U.C.C. § 1-302((AM. L. INST. & UNIF. L. COMM'N 1977)

[66] As another example, parties cannot use a penalty term, but a buyer may "lend" $y to the seller, which is the buyer's expectation; the seller must pay $y + $r -- where r is "interest" -- to the buyer unless the seller delivers the contract goods. If so, the buyer "forgives" the loan of y. For additional illustrations of how parties can contract away from the penalty rule, see Kraus and Scott, *supra* note 26, at 1368-69.

[67] *See* Schwartz & Sepe, *supra* note **Error! Bookmark not defined.**, at 766-767 (describing in detail the "contracting t echnology" of big firms such as Cisco System Inc.).

[68] Also note that the more extensive a party's contracting technology is the more sophisticated the party is at making contracts.

replicate the effect of using an $\omega_{(4)}$ prohibited term by changing contracting strategies.[69] Denoting variable cost as C and assuming that C is decreasing in the fixed cost F,[70] we have:

$$C(k_1) < C(k_2) < C(k_3) < C(k_4)$$

To illustrate the effect of differing response costs across firms, let the law enact an $\omega_{(2)}$ procedurally demanding disclaimer: the disclaimer must be conspicuous, use specified words, be explained to buyers individually and so forth. A small firm -- an individual proprietorship, say -- is likely to have a modest contracting capacity. Thus, this firm would have to incur startup costs: to learn about disclaimers, to consult lawyers, to adopt a form contract. The already existing contracting and legal departments of a large firm could comply more cheaply with the procedural demands such a sticky disclaimer requires. Thus, the large firm is less likely to warrant than the small firm is.

The lawgiver can affect the parties' transformation operator response by its rule choice. For example, parties can escape rule ω_2 only by usin T: $\omega_2 \leftrightarrow K_2$. Because transformation operators are costly to use, it is more accurate to say that the law creates an incentive for parties to use the appropriate transformation operator. Parties in our example for whom this incentive is insufficient let rule $\omega_{(2)}$ "stand." The lawgiver thus can know two things: (a) rule $\omega_{(1)}$ is less likely to stand than rule $\omega_{(2)}$ because T:$\omega_{(1)}$ is less costly to use than T:$\omega_{(2}$, and so forth; *but* (b) firms with limited contracting capacities are more likely to let the same rule $\omega_{(2)}$ stand than more sophisticated firms are. The lawgiver, however, *cannot influence* the proportion of the party universe that would let a particular mandatory rule stand.

We note the normative significance of this result. The more extensive an agent's contracting capacity is the more likely the agent is to escape the impact of rules regulating contracting behavior. More precisely, parties will compare the cost the rule imposes on them to the cost of contracting to escape the rule. Large firms, other things equal, have lower escape costs than small firms because large firms have more sophisticated contracting capacities. In our example, the large firm thus is more likely to disclaim rule $\omega_{(2)}$ effectively than the small firm is. Note also that rule $\omega_{(4)}$, prohibiting the use of a particular contracting strategy, is the costliest rule to escape, but some parties will escape it as well if the strategy would generate sufficient gains.

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[69] Remedy rules tend to belong to either $\omega_{(3)}$ or $\omega_{(4)}$ provisions which are the most costly to escape.

[70] This is a reasonable assumption, under which the inequality in the text is likely satisfied for any fixed cost.

We make four clarifying remarks. First, whether a mandatory contract law rule effectively implements a public policy turns on how mandatory the rule is *as applied*, which is largely a function of factors -- the cost the rule imposes and the parties' contracting capacities -- that are unrelated to any rule's animating policy. Thus, mandatory contract law rules have an arbitrary incidence. Second, contract law does not contain weapons that would permit the lawgiver to affect contracting capacities or selling costs. Further, the lawgiver cannot accurately predict the effect of a mandatory rule because the lawgiver cannot observe even a small fraction of the economy's contracting capacities and potential selling costs. Third, mandatory rules disproportionally bind small, occasional players. Because mandatory rules often are meant to constrain the large players -- the big firm imposing a contractual penalty on the small firm -- a rule's real-world effect can be perverse.[71]

Regarding our fourth remark, contract theorists argue that when asymmetric information materially reduces the efficiency of market contracting, parties' best response often is to vertically integrate.[72] The cost to agents of monitoring each other usually are lower within firms and information flows are more efficient there.[73] Consider this possibility:

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[71] Because contracting capacities differ across parties, some firms not only are more likely to escape the effect of a rule than other firms are; the former firms may even subvert the rule entirely. Suppose that the lawgiver enacts the broad version of rule $\omega_{(2)}$ in order to discourage disclaimers and so spread expected accident costs widely across buyers. Sellers, the lawgiver believes, would raise prices to reflect these costs; every buyer thus would pay an additional small amount rather than having some buyers bear their entire accident costs. The buyers from large firms, however, are more likely to face a disclaimer than the buyers from small firms because it is less costly for large firms to disclaim rule $\omega_{(2)}$. This outcome subverts the lawgiver's policy goal because usually there are more buyers from large firms than from small firms. The large firm sellers thus would disclaim and not raise prices while the small firm sellers may warrant and raise prices significantly. Losses would be spread, but over a small and arbitrarily selected buyer universe.

[72] *See generally* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 692-93 (1986); Benjamin Klein, Robert G. Crawford & Armen A. Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 298–99 (1978). Vertical integration often serves as a response to the challenges of incomplete contracts. The standard informational assumption underpinning vertical integration posits that while the involved parties are perfectly informed, external observers -- such as courts -- are not. Therefore, while parties can observe each other's actions, these actions are not readily verifiable by third parties. *See* Grossman & Hart, , at 691-719 (modeling the firm as a set of contracts and discussing how vertical integration can mitigate issues related to incomplete contracting); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm,* 98 J. POL. ECON. 1119 (1990). (expanding upon Grossman and Hart's framework and further exploring how integration decisions can be influenced by the incomplete nature of contracts); Oliver E. Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. REV. 112-123 (1997) (providing a discussion of vertical integration as a response to market failure, including information problems).

[73] Firms can implement mechanisms to monitor agents that are typically more challenging to execute in markets. However, as firms become exceedingly large, the associated organizational costs may surpass the transaction costs found within markets. See Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386-405 (1937). *See also* Armen A.

T: $\omega_{(I)} \mapsto k_{(I)}$ Example: Rule ω_I is a mandatory rule that would be very costly for firms to escape with contractual responses: possible response k_I is to vertically integrate.

It is more costly for parties to create a new business structure than it would be to contract around any particular rule, however.[74] Therefore, when the cost to parties of contracting around rule $\omega_{(I)}$ would exceed the gain, the cost to parties of integrating vertically to escape rule ω_I also would exceed the gain. Vertical integration thus may be a plausible response to asymmetric information contracting constraints, but it is not a plausible response to mandatory rule contracting constraints. Hence, it is *theoretically possible* for the lawgiver to structure a mandatory rule $\omega_{(I)}$ such that no parties could escape it. As far as we know, no such rule exists.

There is this conclusion: a business contract law's basic function is to facilitate the ability of parties to make transactions that are in the parties' best interests. The lawgiver sometimes may want to implement a policy that, in its view, overrides this function. Our positive argument is that implementing such a policy with a mandatory contract law rule usually would be both arbitrary and ineffective. Our normative argument, as we shall see in Part III and Part IV, is that because transformation operators -- the mechanisms that map from a legal rule to a contractual response -- are more accessible by some parties than by others, mandatory rules reduce equality, fairness and trespass on rights. We end this analysis by remarking that a contract law that is committed to substantive freedom *and* to the triad mandatory rules is self-defeating. This is because the triad rules do not affect a contract's substantive terms.

We have not argued here that mandatory contract law rules are normatively undesirable in and of themselves. Rather, we argued that mandatory rules are an ineffective, self-contradictory and unfair way to implement substantive policies. We next argue that mandatory rules also cannot withstand a deontological and a consequentialist critique. Both perspectives thus support our claim for generalizing freedom of contract.

III. The Equality Case for Generalizing Freedom of Contract

Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization,* 62 AM. ECON. REV. 777-795) (1972) (introducing the idea that monitoring and information costs significantly shape the economic organization of firms); Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74-91 (1979) (discussing the issue of moral hazard within firms, which relates to monitoring costs and the flow of information); Patrick Aghion & Jean Tirole, *Formal and Real Authority in Organizations,* 105 J. POL. ECON. 105, 1-29 (1997) (discussing how formal and real authority within organizations can affect monitoring costs and the flow of information).

[74] Using our notation, $T\omega_{(4)} < T\omega_{(I)}$.

We develop the case for a generalized freedom of contract as a normatively unified theory.**75** This unity is "external" and "internal": the former in the sense that our theory of GFC spans the traditional disciplinary divide between the philosophical and the economic approaches to freedom of contract: the latter because one can hold different moral premises only to learn that they support GFC in the end.

We begin with the internal approach, arguing that GFC is compatible with moralist theories that rest on equality of opportunity. In Part IV, we show that GFC also is compatible with moralist approaches that rest on freedom, whether freedom is meant as enhanced autonomy[76] or as a quasi-libertarian expansion of parties' commercial rights.[77]

Before moving forward with this discussion, we address a preliminary domain objection. Contract law primarily regulates companies -- the usual litigated contract is business to business -- and deontic moral theories, it is sometimes said, do not apply to corporate actions. Corporations are artificial persons, created by the law for economic reasons,[78] and cannot have a moral identity.[79] Deontic and welfare theories therefore must exist in distinct moral spheres. As such, a unified critique is impossible. This objection is unpersuasive.

To see why, let X be a 100% owner of a corporation (X owns all the stock). Then X has complete decisional authority over the firm's actions. It would be anomalous for moral considerations to apply to every action X commits (or fails to commit) except for her commercial actions, as to which only welfare considerations are apt. The distinction between the corporation and the person collapses when the corporation is one person. But there is no good argument for making the distinction absolute when X and Y have joint authority to manage the firm. Rather, in this case the firm's actions would be the resultant of X and Y's actions: as these actions themselves are the justifiable object of moral considerations, so must their firm's acts be the justifiable

[75] For conscision, we sometimes represent our claim that contract law should generalize contractual freedom (i.e., relax mandatory rules) as a claim for "GFC".

[76] *See infra* Part IV.A.

[77] *See infra* Part IV.B.

[78] *See* Trustees of Dartmouth Coll. v. Woodward, 17 U.S. 518, 636 (1819).

[79] In the past ten years there has been a shift in the mainstream approach to the relationship between corporations and morality. Traditionally, corporate law scholars have shared a common view that preferences of *homo economicus* and *homo moralis* are largely irreconcilable. However, following the rise of the Enviromental, Social and Governance (ESG) trend in corporate governance, scholars emphasize that today's corporations select sustainable projects in response to a "moral demand" of their stakeholders, including consumers, workers, and, with increasing frequency, also shareholders. We would thus may be witnessing the rise of a new, sustainable corporate model—or, more briefly, "moral capitalism." *See* Saura Masconale & Simone M. Sepe, *Moral Capitalism, Ethical Shareholderism and Social Cohesion*, SOC. PHIL. & POL. (forthcoming 2023).

object. This argument scales to the corporate board and firm management.[80] And because the firm's acts are the resultant of its directors' acts, the firm too is the justifiable object of moral concern. [81]

A. The Distributive Argument for GFC

Generalizing freedom of contract is justifiable under an equality-based approach, though this approach deviates from the traditional understanding of equality as a fair distribution of resources. Commentators often use that understanding to support contracting restrictions.[82] The duress doctrine and the duty of good faith, for example, supposedly redress power imbalances between contracting parties, thereby promoting equality within contracts. This interpretation of contract law is incompatible with the principle of the division of institutional labor, however[83] r.

This principle holds that the state's function of protecting and promoting citizens' core interests requires specialized institutional structures. Different institutions effectively serve different social functions.[84] When the state wants to promote distributive goals, it assigns the task to institutions other than contract law. For example, antitrust law reduces bargaining disparities more effectively than contract law because antitrust law curbs agents' market power while contract law leaves market power unaffected. More broadly, the welfare state apparatus

[80] For example, let a board have ten members. Then if X is a moral agent, and to be evaluated as such in connection with her corporate acts when her stake is 1 or .5, she is no less a moral agent when her stake is .1.

[81] In the context of collective agency, individual autonomy signifies the ability of members to act independently while participating in group actions. Indeed, individuals, even as part of a collective, maintain their unique perspectives, intentions, and decision-making capabilities. *See* MICHAEL E. BRATMAN, SHARED AND INSTITUTIONAL AGENCY 9-10 (2022). There is a distinction between moral and legal responsibility, however. Each of the ten board members is morally responsible for her acts, but each board member's legal responsibility should fall in her decisional authority. Thus, X is morally and potentially legally responsible for the company's actions when X owns 100% of the company. Board member Y is morally responsible for her acts when she owns 10%, but her legal responsibility for those acts should be less because her decisional authority is materially less. The *firm's* acts, however, are the resultant of the board's acts; and because the corporation is reducible to the agents who run it, the firm is fully subject to moral and legal considerations.

[82] *See* Anthony Kronman, *Contract Law and Distributive Justice*, 89 YALE L. J. 472, 472 (1980) (examining the relationships between the law of contracts and distributive justice goals).

[83] *See* JOHN RAWLS, A THEORY OF JUSTICE 244 (rev. ed. 1999) (postulating that different institutions should have varying roles and responsibilities in implementing the principles of justice.)

[84] While Rawls does not make explicit the exact roles of these institutions, we argue that private law and contract law fit within this framework, though not for distributive reasons. *But see* David Blankfein-Tabachnick & Kevin A. Kordana, *On Rawlsian Contractualism and the Private Law*, 108 VA. L. REV. 265, 278-285 (2022) (defending a distributive view of private law in Rawlsian terms).

is meant to ensure a fair distribution of wealth through grants and progressive taxation, methods unavailable to a common law court.

The division of labor principle might be relaxed for non-sophisticated parties. Their reduced ability to manage risk and other sources of distributive concern might justify a redistributive intervention as between two parties to a contract even under a system that otherwise provides for a division of labor. But sophisticated parties are by definition not subject to similar inequality concerns.[85] Hence, the division of labor principle requires no exceptions or modifications for them. In sum, the principle of the division of labor elides, for sophisticated parties, the distributive justice concerns that might otherwise justify the triad rules. It follows that contract law should reject these constraints on freedom of contract.

The Equality of Opportunity Argument

Because parties' have different access to transformation operators, mandatory terms undermine equality *across* contracting parties. Suppose the lawgiver enacts rule ω (i.e., any of the mandatory procedural rules in the triad). Next consider two contracting dyads: A/B and C/D. The lawgiver would place the A/B dyad at an economic disadvantage relative to the C/D dyad if only the latter could use a transformation operator to overcome the contractual constraints imposed by rule ω. GFC permits weaker parties to overcome this disadvantage, which would increase equality of opportunity in the commercial domain.

We use Rawls to illustrate this argument.[86] When some parties can escape rules in the current mandatory rule set, the set itself violates Rawls' second principle of justice.[87] This principle comes in two parts: Social and economic inequalities should be arranged such that they are (a) to the greatest benefit of the least advantaged consistent with the just savings principle (the *Difference Principle*);[88] and (b) attached to offices and positions open to all under conditions of fair equality of opportunity (the *Equality of Opportunity Principle*).[89]

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[85] *See supra* Part I.A.

[86] *See* RAWLS, *supra* note 83, at 52-53 (introducing the concept of justice as fairness, and his two fundamental principles of justice); JOHN RAWLS, JUSTICE AS FAIRNESS: A RESTATEMENT 39, 50, 79 (1971) (discussing the principles of justice and their interactions). *See also* SAMUEL FREEMAN, RAWLS (2007) (providing an exhaustive overview of Rawls's work); Leif Wenar, *John Rawls*, STAN. ENC. PHIL. (2021), https://plato.stanford.edu/entries/rawls/ (same); GERALD A. COHEN, RESCUING JUSTICE AND EQUALITY (providing a comprehensive analysis and Marxist critique of Rawls's principles).

[87] *See* RAWLS, *supra* note 83, at 57-65 (discussing the interpretation of the second principle of justice).

[88] *See id.* at 65-70 (discussing the *Difference Principle*).

[89] *See id.* at 73-78 (discussing the *Equality of Opportunity Principle*)

Mandatory rules that only some can escape, because they possess contracting capacities unrelated to the rules, violate the *Equality of Opportunity Principle* in the commercial domain. As shown above, mandatory rules purport to bind everyone but commonly bind only parties whom contract law occasionally (but importantly) affects, and who possess limited contracting capacities.[90] These parties lack the opportunity the large, sophisticated parties have to construct their own contracting path. By extending this opportunity to all sophisticated parties, GFC would remedy this violation. Mandatory contract law rules also violate the *Difference Principle*: the rules disadvantage the worst-off commercial parties by restricting the ability of these parties to pursue their contracting goals.[91] GFC would *increase* equality under the *Difference Principle* because GFC would empower the worst-off commercial parties to make contracts that otherwise would be unfeasible for them.[92]

IV. The Freedom Case for Generalizing Freedom of Contract

The claim for GFC also is supported by moralist theories that focus on freedom, whether freedom is the agent's exercise of her autonomy or the exercise of her rights.[93]

A. The Autonomy Argument

1. Autonomy and moral parity

The value of autonomy consists in enhancing the agent's ability to realize self-authorship.[94] An autonomous agent's freely chosen acts necessarily reflect her self-authorship

[90] *See supra* Part II.B.

[91] The lawgiver may prefer to continue with a rule ω because the lawgiver believes that it is better for some persons to be constrained to pursue policy X rather than none but this preference cannot control. The principles of justice are fundamental and so trump ordinary policy choices.

[92] Both the *Equality of Opportunity Principle* and the *Difference Principle* have a similar operational structure. The *Equality of Opportunity Principle* has components of the *Difference Principle*, and vice versa.

[93] "Autonomy" is a term of art which characterizes a common moral, political, and social ideal. The ideal holds that there exists a "notion of the self which is to be respected, left unmanipulated, and which is, in certain ways, independent and self-determining." GERALD DWORKIN, THE THEORY AND PRACTICE OF AUTONOMY 11-12 (1988). More particularly, Raz identifies three basic conditions for agents to exercise autonomy: they must possess sufficient mental capacities, have an adequate range of options among which to choose, and be free from coercion. JOSEPH RAZ, THE MORALITY OF FREEDOM 372-73 (1986). Regarding the relation between the availability of relevant options and autonomy, *see also* HANOCH DAGAN & MICHAEL HELLER, THE CHOICE THEORY OF CONTRACTS (2017). This view of autonomy implies that autonomy is increasing in the relevant options available to the agent (until bounded rationality becomes a constraint).

[94] While a discussion of the metaphysical conditions distinguishing autonomy from agency is beyond the scope of this article, some clarification is helpful. Agency is the capacity to act. Autonomy is self-government. An autonomous agent is thus one who acts on her own motives. It is possible, however, that autonomous persons choose not to

because acts implement preferences and these are the outcome of the agent's own considerations.[95] Relevant here, contracting parties have preferences over a contract's procedural rules. Because the mandatory triad rules restrict agents' moral power to implement those prefereces, they necessarily reduce party autonomy. This restriction is arbitrary for two reasons. First, most contracting actions are permitted under substantive freedom of contract. These actions should also be subject to procedural freedom of contract because their performance in either freedom domain would exhibit the same deontic power. Call this the *similarity argument*.[96] Second, the transformation operator permits parties to make contracts that are equivalent to the contracts the triad rules prohibit, though at higher contracting costs. Call this the *equivalence argument*.

a. The similarity argument

The similarity argument is a moral parity argument, holding that mandatory triad rules arbitrarily reduce parties' autonomy whether transformation operators are feasible for a party or not. This argument rests on two premises:

i. Contracts that are valid under substantive freedom are on a moral parity with contracts that include terms which could only exist if parties enjoyed procedural freedom.

ii. The state should enforce contracts that are valid under substantive freedom.

These premises imply that:

iii. The state should enforce contracts that would be valid if the relevant terms were allowable under procedural freedom in consequence of the contracts' moral parity.

Premise (i) rejects a common moralist concern about expanding freedom of contract: its potential to allow people to put themselves in disadvantageous positions as a result of insufficient reflection or unequal bargaining power.[97] For example, a party might agree to ruinous penalty damages because they are temporally myopic or in a weak bargaining position. Parties, however, can use substantive terms to ruin themselves through shortsightedness or desperation

realize their capacities. RAZ, *supra*, at 372-73. A person might also act without her actions exemplifying morally relevant types of self-government. For example, in complete markets, individuals have capacity but when they choose under the constraints of price coordination the extent to which they are acting autonomously is unclear. *See supra* text accompanying notes 53-54.

[95] *See generally* Gerald Dworkin, *The Concept of Autonomy*, in THE INNER CITADEL: ESSAYS ON INDIVIDUAL AUTONOMY 54–62, 60 (John Christman ed., 1989).

[96] We thank Lisa Bernstein for providing the intuition behind this argument.

[97] Similar concerns are especially relevant to the "new equity" school of contracts. *See* sources cited *infra* at Part IV.A.4.

for a deal. One can spend her life savings in one night by making massive bets in a casino, on terms that everyone knows are biased against winning. Or if one is desperate, she could pawn a priceless family heirloom for a pittance. Absent mistake or coercion, courts will enforce these contracts. But such cases are morally similar to the myopic and desperate variations, respectively, on the procedural cases this paragraph notes. The moral power that parties could exercise in order to create enforceable obligations under either set of cases is the same.

The second premise states that substantive terms should be enforced. The state would disrespect the autonomy of its citizens were it to shield them from the consequences of agreements that they effectively consented to undertake. But then, under these premises, there is no legitimate justification to restrict party autonomy regarding procedural terms.[98]

b. The equivalence argument

The existence of the transformation operator strengthens the moral parity argument that restricting the parties' control over procedure arbitrarily prevents some parties from fully realizing their autonomy (i.e., their contractual preferences). The transformation operator permits parties to make enforceable transactions that are equivalent to those prohibited by the triad mandatory rules. Exercising the transformation operator is costly, however. Thus, while every party has the moral power to enter into an enforceable contract that is equivalent to the contract restricted by the triad rules, only some parties actually can do so. As a consequence, the restrictions that mandatory rules create unfairly reduce autonomy.

Reprising our introductory example, parties with the appropriate contracting technology could effectively preserve their deal, originally implemented with "z" terms, by adopting q terms. But given that z terms and q terms are equivalent, there is an inconsistency in the state's respect for the deontic power of contracting parties: that is, some parties possess actual deontic power while other parties possess it only in theory.

[98] It is also worth noting here that so long as premise (i) is true, there is a deep normative symmetry between the substantive and procedural terms of contracts that is independent of whether premise (ii) is true or false. If premise 2 is true, then both types of term should be (allowed to be) enforced, and if it is false then forbidding enforcement of either term is permissible (and probably obligatory). Either way, given the existing legal system's asymmetric treatment of party autonomy under substantive and procedural terms, even without premise (ii) the similarity argument still reveals a serious gap between current contract law and what is normatively required. Unsophisticated parties, however, may not competently reason in risk-oriented ways. Hence, there might be an autonomy-dependent reason to keep procedural terms mandatory for unsophisticated parties.

This inconsistency challenges the view that party autonomy in the commercial domain is preserved as long as the state provides a wide range of contract "types" for parties to choose from, even if some contract types are sticky defaults or mandatory terms. This "choice theory approach" fails to acknowledge the existence of the transformation operator, under which an agent's choices are constrained by contracting costs. [99] Autonomy shrinks as these costs increase. [100]

It would be a mistake, however, to conclude that a mandatory rule does not reduce the autonomy of parties who could preserve their deal by adopting the equivalent q terms. A mandatory procedural rule *always* restricts the exercise of an agent's first order autonomy -- to achieve her goal with z terms. The rule also increases the agent's cost of exercising her second order autonomy -- to achieve her goal with the more costly q terms. Procedural constraints thus reduce autonomy over-all: for parties that have to forego their goal altogether -- for example because they are occasional contractors; and for parties that can pursue their goal, though only at the increased cost of exercising their second order autonomy.[101]

A novel illustration might make the equivalence argument more vivid. Consider two agents considering whether to pursue a project with a joint venture or to merge into one firm and pursue the project "in house". Contract law, including its procedural constraints, would apply

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[99] *See* DAGAN & HELLER, *supra* note 93, at 72 (arguing that agent autonomy is preserved if agents have a choice of relevant contract terms.) Their argument does not fully take into account the cost of exercising this choice, however.

[100] In his book, The Liberal Archipelago, Kukathas emphasizes the importance of granting individuals and groups the autonomy to shape their own values and norms, without undue interference from external authorities. *See generally* CHANDRAN KUKATHAS, THE LIBERAL ARCHIPELAGO: A THEORY OF DIVERSITY AND FREEDOM (2007). To realize this interest, a society must be based on tolerance and permit freedom of association. The freedom to exit is essential for realizing full freedom of association because the right permits the agent to escape authorities that would require her to act contrary to her beliefs. *See id.* at 96. However, in his book review of the Liberal Archipelago, Donald Moon observes that an exit option is effective only if the agent has the knowledge and means to exercise it. *See* J. Donald Moon, *The Liberal Archipelago: A Theory of Diversity and Freedom by Chandran Kukathas*, 115 ETHICS 422, 424. Many agents lack these prerequisites. Kukathas rejects Moon's objection, arguing that exit costs do not negate the voluntariness of an action (whether to exit or not). See KUKATHAS, *supra*, at 37. But Kukathas does not consider extreme situations, where the exit cost is so high as to preclude anyone from exercising it. As applied to our analysis of the relationship between the transformation operator and party autonomy, because the transformation operator enables exit from mandatory rules, Kukathas' argument seemingly implies that mandatory rules are ethically ok. This conclusion, however, overlooks that Kukathas requires exit to be available to *all* agents while access to the transformation operator is restricted to parties that can afford to exercise it. For parties that cannot afford the exercise cost, the theoretical availability of exit does not translate into the actual ability to exit. This cost concern is similar to the case of parties having a right to emigrate but who lack the means to do so.

[101] The higher transaction costs parties incur through the transformation operator could serve as a screening device to sort parties. Under this view, those who can shoulder higher transaction costs would require less protection. However, neither a contract's surplus nor the parties' contracting technology are determinative of the parties' moral power to enter into enforceable contracts.

to the agreements that constitute the joint venture. Contract law would not apply to the practices that that the merged firm follows. For example, the Board of Directors could penalize a division for a late or unsatisfactory performance or make directives non-modifiable for a prescribed period. Our illustrative agents may prefer a joint venture because, they believe, it is the more effective way to pursue their project. But there is no first order reason for this choice to trigger the entire apparatus of contract law while the other feasible choice would not. That contract law applies to one commercial form rather than the other is not a function of contract law's merits but is a second order implication of the difficulty courts have policing "internal" corporate acts. It is similarly arbitrary for the law to prevent two contracting parties from pursuing their project with a penalty or no-modification term rather than with less effective but enforceable substantive terms.

To conclude, we argue that autonomy "on the ground" increases in the degree of *cost-justified control* the agent can exercise over her contracting affairs. Our argument that contract law unjustifiability restricts the agent's control should meet two objections and address an important qualification. The first objection is that the conditions for truly autonomous choice seldom exist in a modern economy. The second objection is that parties cannot effectively exercise autonomy without the assistance of the state, and the state should not lend its assistance unless the exercise of private power conforms to the state's moral norms. The important qualification is that an agent's choice is autonomous only insofar as the agent can foresee its likely effects. Hence, the agent does not consent to a disadvantaging action of its counterparty taken in a state the agent could not have foreseen, *even if* the contract read literally permits the counterparty to take that action. A court that exercises its equitable powers to rescue the harmed agent thus is not overruling the agent's ex ante contractual autonomy.

2. The relational egalitarianism objection

The first objection is that parties' choices are truly autonomous only when made under "relational egalitarianism," a condition that requires equality to exist among the members of a political community.[102] It follows that true autonomy is absent for agents who face hierarchies of power, esteem and standing. Strong actors can exploit such agents by putting them in "inferior positions."

[102] *See* Elizabeth Anderson, *What is the Point of Equality*, 109 ETHICS 308, 308 (1999); ELIZABETH ANDERSON, PRIVATE GOVERNMENT: HOW EMPLOYERS RULE OUR LIVES (AND WHY WE DON'T TALK ABUT IT) (2017); Samuel Scheffler, *What is Egalitarianism*, 31 PHIL. & PUB. AFFAIRS 211, 211 (2003); Shanna V. Schiffrin, *Paternalism, Doctrine and Accomodation*, 29 PHIL. & PUB. AFFAIRS 205 (2000); Hanoch Dagan & Avihay Dorfman, *Justice in Private: Beyond the Rawlsian Framework*, 37 LAW & PHILOSOPHY 171, 171 (2017).

The domain of our claim that the law should generalize freedom of contract is the transaction between sophisticated commercial agents. Each such agent apparently has standing to deal, and commercial parties ordinarily bracket self-esteem issues when buying contract terms. All commercial agents transact in markets, however. Can some market agents exploit free contracting to put other agents in inferior positions? In the formal sense, the answer is no because inferior positions do not exist in markets: every market actor has the same right to enter into transactions and to make and enforce contracts. This answer may seem too simple, however, because in markets, "positions" often are associated with bargaining power: an agent has the higher position in a transaction if she has more bargaining power than her counterparty.[103] Because bargaining power can be hierarchical in this sense, so also are positions. Some agents are less equal, and therefore less autonomous, than others are.

This egalitarian objection rests on an incorrect view of the relation between bargaining power and the power to choose. In the commercial world, bargaining power often is unequal but the power to choose is not. Bargaining power is the ability to command a particular share of a transaction's surplus: the party who can command the greater share has the greater bargaining power. But the power of parties to command shares is exogenous. Power in a transaction is a function of the parties' relative discount rates and disagreement points. The more patient party, or the party with the best outside option, can capture the larger share of a deal's surplus. A party, however, seldom could affect her counterparty's discount rate or disagreement point. Therefore, neither party is responsible for the other's position, but both parties' consent is necessary to make the maximizing deal. Put another way, parties choose deals but do not choose shares.

Autonomy, however, is about choice, not wealth. Therefore, the agent who can command the smaller share is exercising her autonomy in the same way as her counterparty is exercising his: both parties, that is, *will prefer the same contract*.[104] Therefore, relational egalitarianism in a commercial economy requires only the existence of sophisticated agents who can choose

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[103] We have in mind bargaining power disparities other than the existence of a monopoly, which is regulated by antitrust law under the principle of the division of labor. *See supra* Part III.A.

[104] We state this argument formally here. Define a contract as a set of terms K. Suppose that contract K_m would yield a surplus $\$S_m$ for the parties to share, and the contract K_n would yield the surplus S_n. Each party's utility is increasing in its monetary payoff. Party A can capture α ($0 < \alpha < 1$) of any S and Party B can capture $(1 - \alpha)$ of S. Party A's possible utilities are $U_A(K_m) = \alpha S_m$ and $U_A(K_n) = \alpha S_n$. Thus, $U_A(K_m) > U_A(K_n)$ if $S_N > S_M$. Similarly, party B's possible utilities are $U_B(K_M) = (1-\alpha)S_M$ and $U_B(K_N) = (1 - \alpha)S_N$ with $U_B(K_M) > U(K_N)$ if $(1 - \alpha)S_N > (1 - \alpha)S_M$. Hence, both parties would agree to make contract K_M if $S_M > S_N$. This result holds for *any* value of α. Suppose then that $\alpha = .9$. Party B nevertheless would prefer contract K_M because $.1(S_m) > .1(S_N)$. The weaker party, that is, prefers the maximizing contract even when its share of the gain is only one-ninth the share of the stronger party. If autonomy requires the law to respect the choices of sophisticated, informed parties, relational egalitarianism cannot be violated when one party has much more power (nine times in our example) than the other, if "power" means bargaining power.

among the deals the market offers, *unless* power in a market setting is not bargaining power. No other conception of power seems apt, however.[105]

3. The state's moral agency objection

The second major objection to our argument regarding autonomy rests on two premises. The first is that parties require the service of the state to enforce contracts; the state and private parties are partners in pursuing the practice of commercial contracting.[106] The second premise is that the state is an independent moral agent, and as such has a say in how the state/parties' partnership functions.[107] These premises together imply that the state's morally justified (in its view) refusal to enforce a particular procedural term does not override the parties' autonomy. Rather, the refusal would be among the conditions the state has the right to set in order for it to agree to become a commercial partner.[108]

This objection contradicts the ordinary language meaning of what it means to provide a service. Under that meaning, the service provider typically has no say in how the service buyer uses the service, except for uses that affect the provision of the service itself. Thus, the cable company can regulate a person's use of the modem or prevent the person from accessing entertainment for which they have not paid, but the company has no say in what the person watches. Similarly, the public utility can regulate a person's use during peak periods or the number of hookups in their home, but the company has no say in which appliances they use or how they use them. Thus, the state, as an independent provider of contract enforcement services, can prevent me from contracting to impose costs on third parties or to further immoral purposes, but the state otherwise should have no say in what my contracts contain, if providing a service is given its ordinary language meaning.

The claim that the state can leverage its enforcement power to veto contract terms distorts the meaning of "to provide" because the claim rests on a conceptual mistake. The state cannot enforce a contract without taking a position on what the essential elements of the entity "contract" are. There must be free consent, parties must be able to understand the terms, there must be a minimum remedy and so forth. But there is a countably infinite set of terms that are

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[105] Mandatory rules actually reduce relational egalitarianism because the rules arbitrarily restrict the ability of some parties but not others to pursue their commercial goals. *See supra* Part II.B.

[106] *See* Shiffrin, *supra* note 38, at 221 ("[T] he institution of contract is an institution in which the community assists people who make agreements by providing a measure of security in those agreements.").

[107] *See id.* at 223-25.

[108] *See id.* at 224 ("the [state's] motive [to refuse enforcement] may reasonably be a self-regarding concern not to facilitate or assist harmful, exploitative, or immoral action.").

consistent with, or fit within, this conception of a contract. Similarly, the state must define what "property in rem" is before deciding whether to protect property. There must be a right to exclude, a clear definition of boundaries, and so forth. But there is a countably infinite set of uses that are consistent with, or fit within, this conception of property. The state's power to *define* what it wants to enforce or protect, however, does not itself imply the further power to *regulate uses*, except for uses relating to the enforcement or protective functions themselves. The ordinary language meaning of what it means to provide a service thus is consistent with the conceptual meaning of what it means to enforce a contract: the state can ensure the efficacy, and prevent the distortion, of what it provides, but it cannot otherwise control the uses to which private parties put their freedom. For such control, an additional justification is needed. Any such justification, however, likely would not rest on the state's necessary role of contract enforcer.[109]

4. The new equity qualification

The "new equity" school of contract scholarship supposes that an agent -- the promisor -- cannot foresee every possible future state in which its counterparty -- the promisee -- would enforce the contract just in order to shift wealth to it. Courts, it is argued, should use their equitable powers to rescue promisors from such promisee "opportunism."[110] These rescues do not restrict a promisor's freedom to contract because a promisor cannot be taken to consent to counterparty actions taken in circumstances the promisor did not anticipate, even when the contract permits those actions. A historically important illustration is the Jacob & Youngs case.[111] There the contract permitted the owner to withhold the entire last payment due under a

[109] To illustrate this claim, define two grounds for not enforcing a contract that affects the third parties who constitute "the state." (a) The contract directs a result that contradicts the third parties' moral views. For example, a person borrows from a payday lender to finance the purchase of a television set. (b) The contract directs a result that imposes tangible costs on some third parties. For example, party A pays Party B to dump A's chemical waste into a stream. These are normatively different cases. To allow the community's moral judgment to dictate the validity of a contract between two consenting parties would undermine the contracting parties' autonomy. Rather, autonomy implies the agent's right to pursue her moral goals through the contracts the agent makes, even if other persons hold different moral views. Thus, the state should enforce the case (a) contract. On the other hand, the agent should not exercise her autonomy to impose tangible costs on third parties. The state could legitimately protect the interests of these parties with regulation external to contract law, such as financial regulation, environmental law, bankruptcy, and so on. Thus, the state should not enforce the contract in case (b).

[110] *See*, *e.g.,* Kenneth Ayotte, Ezra Friedman & Henry E. Smith, *A Safety Valve Model of Equity as Anti-Opportunism*, Elements in Law, Politics and Economics (2023) (arguing that the goal of preventing opportunism can explain and justify the exercise of ex post equity); Juliet P. Kostritsky, *Plain Meaning vs. Broad Interpretation: How the Risk of Opportunism Defeats a Unitary Default Rule for Interpretation*, 96 KY. L.J. 43 (2007); George M. Cohen, *The Negligence-Opportunism Tradeoff in Contract Law*, 20 HOFSTRA L. REV. 941, 957 (1992); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts,* 65 MINN. L. REV. 521 (1981).

[111] Jacob & Youngs v. Kent, 129 N.E. 889, 891 (N.Y. 1921).

construction contract for errors that only trivially affected the property's value. The court did not permit the "forfeiture," holding that the contractor need only substantially perform.[112]

The new equity qualification of the autonomy case for freedom of contract rests on a confusion between a low probability state and an unincluded case. It is one thing for, say, a court to hold that an agent was not negligent in failing to take extensive precautions against a highly improbable accident risk. It is another to hold that the agent did not consent to its counterparty's exercise of a power the contract clearly permitted the counterparty to take, even if the circumstances that triggered the exercise of the power were difficult for the agent to predict. A contracting power, we will argue, authorizes *every* action the words literally permit. Or the obverse: the sophisticated agent consents to the exercise of every contractual power it does not bargain to qualify.[113] Therefore, a court that uses its equitable power to prevent a party from enforcing its contractual rights against the agent does in fact reduce the agent's autonomy.

To make this claim out, suppose that when parties contract there exist Θ possible future states of the world. Define two actions a promisee could take in a realized state: an action the contract does not explicitly prohibit, denoted a_{-k}, and an action the contract explicitly permits, denoted a_k. In the set of future states $(1 - \theta)$, the promisee prefers to perform the contract, and performance would protect the promisor's expectation. In states θ, (a) taking the *not-prohibited* action a_{-k} would advantage the promisee at the promisor's expense. For example, the promisee threatens to delay payment for goods unless the promisor extends the warranty period; *or* (b) taking the *permitted* action a_k would advantage the promisee at the promisor's expense. For example, the promisee enforces a liquidated damage clause in circumstances in which the promisee unexpectedly suffered little harm from breach.

The promisee would violate the duty of good faith in case (a). The question for a court would be whether the promisor would have consented to the not-prohibited action a_{-k} if the promisor had foreseen that the promisee would take that action when the parties contracted. In the posited case, the answer would be no. Therefore, there would be a need for an equitable intervention only in case (b), when the promisee is enforcing *the contract* to the promisee's allegedly unanticipated disadvantage. Enforcement in case (b) would be "opportunistic."

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[112] Justice Cardozo famously adopted the rule of substantial performance in construction cases on the grounds that "intention not otherwise revealed may be presumed to hold in contemplation the reasonable and probable." *Id.*

[113] Here we attempt to expand Kraus and Scott's argument that parties consent to the complete extension of every term in their contract. *See* Kraus and Scott, *supra* note 26, at 1323.

When sophisticated parties contract, they know that there always exist Θ possible future states, and that their contract would be profitable to perform only in a subset of those states (the (1 - θ) states). It follows that parties know their contract could linguistically apply to, but would be unprofitable to perform in, the complementary subset of states θ. A party would enforce the contract in such a state only if enforcement would permit it to shift wealth from the counterparty to itself. A party -- here the promisor -- does not have to identify every state in θ, or attach probabilities to each of those states, to know that it faces a risk when it lets an unqualified contractual power stand. The risk exists because a party -- here the promisee -- has an incentive to enforce the literal contract whenever enforcement would benefit it; and the states that constitute Θ occur with positive probability. *But* because risks are priced, the promisor would remain silent -- not contract over the strategic enforcement risk -- because the promisor has been paid, in the form of a lower price, to bear the risk. In contracting contexts, silence in face of a risk constitutes purchased consent to bear it.

In contract law this is the general assumption. For example, courts enforce a contractual index even when the index fails: that is, generates prices, costs or quantities that fall outside their expected ranges.[114] Courts that do not enforce the contract in our posited case (b) therefore are overruling the parties' autonomous contracting choices. Another way to put this conclusion is that, in sophisticated contracting situations, the set of cases in which equity is required to intervene to prevent "opportunism" is empty.

To summarize, we show that a contract law committed to autonomy would demote the mandatory rules in the triad to defaults (or repeal them). We considered two objections to this conclusion: sophisticated parties are relationally unequal in markets (they aren't); and the state is a full partner of the parties regarding enforcement (it isn't). We also considered a qualification to our claim: parties opportunistically exploit counterparties by enforcing contracts literally in low probability states (they are allowed to enforce them then).

B. The Rights Argument

Rights moral theories also support the case for GFC. We illustrate this claim through the lens of Nozick's entitlement theory of justice.[115] At the core of his theory is the view that

[114] *See* Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEG. STUD. 271, 285 (1992).

[115] *See* ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 150-53 (1974).

individuals have inherent rights that are independent of social and political institutions.[116] These are "prior rights," that individuals possess before the formation of the state. These rights include the right to life, liberty, property and, importantly, the right to control one's own life. [117] The right to control, we argue, implies the right to contract because contracts facilitate the agent's ability to direct her life and property.

More particularly, Nozick's theory of justice rests on two basic principles. The first principle is the *Principle of Justice in Acquisition*, which holds that agents are entitled to acquire property through legitimate means such as production.[118] The second is the *Principle of Justice in Transfer*, which holds that agents are entitled to transfer their property rights to others through voluntary exchange or gifting.[119] The second principle assumes the satisfaction of the first because agents are free only to trade property they have justly acquired.[120] For an agent's trades to be legitimate, three conditions must be satisfied: (i) the transfer is voluntary: each party to a trade must have the opportunity to participate or not; (ii) the transfer is of an item (or money) each party has justly acquired; and (iii) the transfers that constitute a trade do not violate the rights of others. [121] When these conditions are satisfied, restricting the right to transfer would be unjust.

Mandatory restrictions of procedural terms are illegitimate when contract is a prior right because they restrict the right to transfer. Because a contract comprises both substantive and procedural terms, parties necessarily -- and it is essential to emphasize "necessarily" as a modal operator -- have the right to determine the procedural terms that govern their transfers.[122]

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[116] *See id.* at 10-12 (arguing that individual rights are foundational and not contingent on social or political institutions.)

[117] *See id.* at 11, 28-35 (discussing the rights to life and liberty as fundamental individual rights); 171-172; 177; 228-229 (discussing the rights to property as a fundamental individual right).

[118] *See id.* at 151.

[119] *See id.*

[120] The contract laws of advanced economies suppose that the *Principle of Justice in Acquisition* is satisfied because these laws regulate *trades* between rights holders: they do not regulate how parties came to own what they are trading. However, there is an argument that helps to justify contract law's restrictive premise. Suppose a pattern of entitlements and consider a person who inherited a special musical talent. She cannot sing for everyone, however, and so rations appearances partly by price. Many persons much prefer hearing her sing to the price of a ticket. As a result, the singer becomes wealthier than most of her customers. This distributive result is just, in Nozick's view, because no affected agent prefers an outcome other than the one that occurred. *See id*. at 160 (discussing the now classic Wilt Chamberlain's example to show that no principle patterned distribution is compatible with liberty).

[121] *See id.* at 152.

[122] *See infra* text accompanying notes 184-192 (examining the metaphysical grounds of the parties' power of form creation beyond a libertarian framework).

Restated, the legitimate right to contract in a pre-political state implies the right to adopt every "term type" that would appear in a contract.

However, because Nozick derives his theory from a state of nature, its derivations are at best partial: parties make contracts in civil society and these require legal enforcement. When parties invoke the power of the state, it is legitimate for the state to set the rules regarding how its power is used. Those rules could then legitimately restrict the parties' procedural freedom to contract.[123]

But this objection is overstated because Nozick envisions a minimal state, which emerges organically from an anarchic society when individuals form "protective associations" to safeguard their rights.[124] Over time, these associations merge and grow into a "dominant protective association,"[125] where the state-association's role is restricted to protecting individuals from force, theft and fraud, and to enforce contracts. [126] Most importantly, when Nozick refers to contract enforcement, he seems only to have in mind the ex ante power of ensuring that parties make contracts voluntarily, and the ex post power of contempt -- the power to use force for enforcement purposes.[127] When parties are sophisticated, the principle of voluntariness is inherently satisfied.[128] And the power of contempt cannot include the mandatory determination of procedural rules or other restrictions of parties' individual rights. Hence, from a Nozickian viewpoint the formation of the state does not impinge on the parties' freedom to define procedural terms in contracts.

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[123] This objection has been made to the autonomy justification for GFC and we have answered supra at Part IV.A.3. We reconsider the objection here in the context of a right-based justification for GFC.

[124] *See* NOZICK, *supra* note 115, at 12.

[125] Nozick argues that the threat of potential conflicts among private protective associations would naturally result in a dominant association to emerge by consent and have features (e.g., fair and transparent procedures acceptable to rational individuals) that would help settle inter-associational disputes. *See id.* at 15.

[126] *Id.*

[127] In Nozick's view, the monopolization of the use of force by the state isn't unjust, because it arises from voluntary processes and respects individuals' rights. *See id.* at 23-24 (stating that a monopoly on force is a condition for the existence of the state.)

[128]According to Nozick, if the parties involved in a contract are not sophisticated or have different levels of sophistication, additional doctrines may be necessary (i.e., mandatory) to ensure that the transaction is voluntary and fair. *See id.* at 73. These doctrines are designed to ensure that parties enter into the contract voluntarily. However, when the parties are sophisticated, there is a strong presumption of voluntariness because of the parties' level of knowledge and understanding of the transaction.

This account may beg an important question, however. Right-based morality rests on the *No Harm Principle*.[129] Under this principle, if the exercise of one's liberty would harm others, state-mandated restrictions on contracting behavior would be legitimate. Nozick elaborates the connection between actions that impose risks on others and the potential violation of their rights, a connection that also applies to actions that impose legal risk on others.[130] Thus, if giving some parties greater freedom of contract could harm others, there would be a right-based justification against the decentralization we advocate. But this concern is also overstated, for two reasons. First, we do not advocate extending the freedom to contract to terms whose enforcement would create harms to third parties.[131] Second, the sophisticated contracting parties we consider would not make contracts that could harm themselves.[132]

To summarize, our non-consequentialist argument begins with the status quo, in which agents have freedom to choose the substantive terms of their agreements subject to two constraints: the terms are not intrinsically immoral and do not create negative externalities. Because procedural contract terms are in the service of substance, it apparently should follow that parties are as free to choose procedure as substance. But it does not follow for the law and for many commentators. We thus argue that the obvious inference is the correct inference: greater procedural freedom is consistent with, and usually advances, the goals that ethical theories pursue, whether they focus on freedom or equality.

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[129] *See id.* at 78-79.

[130] *See id.* at 80-82 (examining the concept of risk in relation to rights violation).

[131] For instance, bankruptcy law or financial regulation that renders some contracts unenforceable are consistent with Nozick's theory because they protect property rights and third-party interests. In transactions between sophisticated parties, there could thus be legitimate limitations on freedom of contract. These limitations should not come from the law of contract, but from other legal institutions whose aim is to safeguard the interests of non-contracting parties. Criminal violations such as fraud and duress are independent of the law of contract. Therefore, the law of contract should not interfere with the operation of these rules.

[132] We note that GFC also is consistent with a principle-based (i.e., non-libertarian) approach to freedom of contract. In particular, Rawls is authoritative in the (apparently rare) case when the lawgiver has enacted a mandatory rule $\omega_{(\#)}$ that no party could escape. This rule would not violate the *Equality of Opportunity Principle* because the rule would constrain every party. *See supra* text accompanying notes 86-90. The rule, however, may violate Rawls' first principle of justice, that each person has an equal right to the most extensive basic liberties compatible with similar liberties for others (the *Equal Liberty Principle*). See RAWLS, *supra* note 83, at 53. Although contracts, particularly those involving the means of production, are not considered a basic liberty by Rawls, freedom of association is a basic liberty and is thus governed by the first principle of justice. *See* RAWLS, *supra*, at 44. This is because associations, when constructed appropriately, can eliminate discrimination, and ensure equal opportunities for agents to pursue shared goals regardless of the agents' personal characteristics. Associations also encourage agents to engage in cooperative goal directed activities.

This conclusion raises the question whether there is an economic justification for the triad procedural restrictions that can overcome the non-consequentialist case for relaxing them. To the contrary, Part V below shows that GFC actually increases economic efficiency.

V. The Welfare Case for Generalizing Freedom of Contract

We introduce the economic case for GFC in two parts. First, we show how extending GFC could remedy the inefficiencies created by mandatory rules that restrict parties' ability to design bargaining protocols, regulate interpretation and create tailored remedies.[133] As we shall discuss below, GFC permits parties to use some of the corrective mechanisms identified by the economics of contract. In the second part, we show that GFC is also compatible with an alternative consequentialist, but non-welfarist, argument.

The analysis in Part V thus will support the case for contract law changing the triad rules from $\omega_{(3)}$ and $\omega_{(4)}$ mandatory rules to $\omega_{(1)}$ simple defaults (at most).[134] Part VI then makes a tentative argument for extending parties' freedom of contract by authorizing them to form associations that the parties' own laws of contract would govern.

A. Increasing Welfare

GFC is consistent with the new economics of contracts and can facilitate some of the efficient protocols the theory has identified.

1. Optimization and incentive theory

[133] The constraints on the parties' freedom of contract arising under each set of procedural rules might be more or less severe to escape. Put differently, parties will bear different costs for devising and implementing a transformation operator under different sets of rules. *See supra* Part II.B. For example, as we saw above, it is relatively easy – and inexpensive – for sophisticated parties to include a choice of law clause in their contracts and choose a specific interpretative regime (i.e., a formalist rather than contextualist jurisdiction). *See supra* note **Error! Bookmark not d efined.** and accompanying text. The same is true for no-modification clauses affecting the bargaining process. *See supra* text accompanying notes **Error! Bookmark not defined.**-**Error! Bookmark not defined.**. On the contrary, es caping the mandatory rules that limit the remedial choices of parties is likely to be much more expensive. *See supra* note 69. However, this is not a sufficient reason to limit the extension of parties' procedural freedom to the domain of remedies. Although parties have the freedom to choose a given jurisdiction to escape mandatory rules on interpretation or bargaining, they cannot selectively opt for some rules while excluding others. *See supra* note **Error! Bookmark not defined.**. Therefore, escaping mandatory rules on interpretation and bargaining may involve substantial opportunity costs. We accordingly advocate for an application of GFC to *any* set of procedural rules. We thank Bob Scott for prompting us to think harder about the relationship between different sets of procedural rules.

[134] *See supra* Part II.B.

The triad rules constitute constraints on parties' ability to maximize contract surplus.[135] A basic canon of optimization theory holds that the optimizing function cannot have a higher value under a given constraint than it would have if that constraint were removed.[136] Sophisticated parties therefore would do as well from a welfare standpoint if mandatory $\omega_{(3)}$ (a particular term is required) and $\omega_{(4)}$ (prohibiting a contracting strategy) rules were changed to $\omega_{(1)}$ or $\omega_{(2)}$ defaults (or less). We show here that, for plausible economic parameters, parties can do better.

We illustrate with two basic contract theory constraints. The "participation constraint" holds that a necessary condition for entering into a contract is that the agent would be at least as well off as she would have been under her next best opportunity.[137] The triad rules increase the difficulty of satisfying the participation constraint. For example, the interpretation rules can make it difficult for parties to choose the optimal tradeoff between accuracy and costs[138] or make it difficult for parties to learn the type of court the parties may face.[139] These constraints can reduce a contract's expected return and so make the participation constraint more likely to bind. A similar result exists for restrictions on remedies, which can also reduce a contract's expected return.[140] By better enabling parties to devise contractual solutions that satisfy their participation constraints, parties could make more ex ante efficient contracts than they can make today.

A contract satisfies the "incentive compatibility constraint" when the contract induces a party who possesses private information about the transaction to choose the optimal action.[141] For example, consider a contract that requires a seller to invest in product safety when the buyer

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[135] For example, the ban on anti-modification clauses is inefficient because parties only use anti-modification clauses when a renegotiation would upset the contract's incentive scheme. Such schemes put risk on a risk averse agent in order to induce optimal effort. After the agent invests there usually is a Pareto improving deal to shift risk to the risk neutral principle. Anticipating the renegotiation, however, the agent knows that he will not bear risk and so underinvests. *See supra* note **Error! Bookmark not defined.**.

[136] *See generally* RANGARAJAN K. SUNDARAM, A FIST COURSE IN OPTIMIZATION THEORY (1996); ALPHA C. CHIANG & KEVIN WAINWRIGHT, FUNDAMENTAL METHODS OF MATHEMATICAL ECONOMICS (2005) (introducing the concepts of optimization, including the effect of constraints on the optimal solution).

[137] BERNARD SALANIÉ, THE ECONOMICS OF CONTRACTS: A PRIMER 122 (2d Ed. 2005).)

[138] *See supra* note **Error! Bookmark not defined.**.

[139] A court's type is determined based on "(i) the evidence a court will admit (and the weight the court will give to the evidence), (ii) the factual inferences a court will draw from the evidence, and (iii) how a court will apply contract law to the evidence." Alan Schwartz & Simone M. Sepe, Midstream Contract Interpretation (manuscript at 3) (forthcoming Notre Dame L. Rev. (2023), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4410961.

[140] *See supra* Part II.A.3.

[141] *See* SALANIÉ, *supra* note 137, at 122.

cannot observe the seller's actions. The seller thus has an incentive to stint. A contract would satisfy the seller's incentive compatibility constraint if its pricing terms would induce the seller to invest optimally rather than stint. Put more directly, in the absence of externalities, satisfying the incentive compatibility constraint makes the parties' private interest coextensive with the social interest.

For a concrete example, consider the hold-up problem that arises when parties are required to make bilateral specific investments.[142] Because parties cannot verify payoff relevant information to courts in a world of incomplete contracts, each party will anticipate that they will neither be compensated for their sunk costs nor fully realize the contract surplus in a renegotiation (but will instead have to share surplus with their counterparty according to their relative bargaining powers).[143] As a result, each party will underinvest in the contract. A solution to this problem is to give one party (say the buyer) full bargaining power at the renegotiation stage, making her a residual claimant.[144] As such, the buyer will invest optimally because she can realize the entire surplus. The contract makes the seller a fixed claimant by guaranteeing the seller's sunk costs if renegotiation fails. Therefore, the seller also will invest optimally.[145]

However, this contracting protocol cannot work unless parties can design the rules governing the renegotiation process. In particular, the residual claimant must be able make a "take-it-or-leave-it" offer to the counterparty to acquire the full surplus for itself.[146] Under procedural constraints on parties' contractual freedom, such a take-it-or-leave-it offer is arguably

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[142] For a technical overview of the holdup problem, *see* PATRICK BOLTON & NMATHIAS DEWATRIPONT, CONTRACT THEORY 560–78 (2005); SALANIÉ, supra note, at 195–200; Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, in 1 HANDBOOK OF LAW AND ECONOMICS 3, 84–86 (A. MITCHELL POLINSKY & STEVEN SHAVELL EDS., 2007) (discussing the holdup problem and renegotiation); Benjamin Klein, *Why Hold-Ups Occur: The Self-Enforcing Range Of Contractual Relationships*, 34 ECON. INQUIRY 444, 444–47 (1996) (explaining that holdup occurs because the contract form provides a place for opportunism).

[143] *See* Schwartz & Sepe, *supra* note 11, at 696-97 (providing a treatment of the implications of the hold-up problem for contract law tailored for a law review audience).

[144] *See* Philippe Aghion, Mathias Dewatripont & Patrick Rey, *Renegotiation Design with Unverifiable Information,* 62 ECONOMETRICA 257, 257 (1994) (articulating this solution through a formal model).

[145] *See id.* at 258*.*

[146] More specifically, parties must be able to use default options (i.e., for when renegotiation fails) and specify either initial transfers ("hostages") refundable without interest upon agreement or per diem penalties to be paid by one party to the other until an agreement is reached. *See id.* at 258. Penalties influence the parties' relative degree of impatience, and thus their bargaining powers in the renegotiation stage. Sufficiently large hostages or penalties upon the seller would make it too costly for the seller to delay the renegotiation outcome. *See id.* at 268. Knowing this, at the equilibrium, the buyer can make the seller a take-it-or-leave-it offer, which the seller will accept.

precluded by the no penalty rule and the obligation to behave in good faith in a renegotiation.[147] By making these rules defaults, GFC would permit parties to use this contracting protocol and thereby induce efficient investment.

2. Mechanism design

Mechanism design (MD) theory studies the optimal design of incentives for a group of agents.[148] Because contract law governs interactions between parties and between parties and courts, MD theory provides an essential economic tool for contract analysis.[149] Today, many mechanism design protocols are too abstract and complex for practical use. More importantly, they assign roles to courts that courts will not play.[150] Current conceptions of the appropriate role of courts create difficulties for MD solutions because courts enforce the parties' will only to the extent they deem it consistent with the public interest. This approach is incompatible with the implementation of optimal MD protocols; those protocols require courts to obey party instructions regarding remedies and enlist courts in the parties' information revelation schemes.[151]

Consider again the mechanism discussed above for mitigating the hold-up problem that bilateral specific investments create.[152] In addition to possibly being precluded by contract law, the mechanism cannot function in a legal system that assigns courts exclusive authority over contractual remedies. Party control over the mechanisms that govern the parties' transactionis essential to ensure that parties stay on the efficient equilibrium path. These mechanisms necessarily include interpretation and remedial protocols that provide for plans of action should parties move *off* the efficient equilibrium path.

For example, parties now enter into "collaborations" under which they attempt to create new products, drugs, vaccines or platforms in multi-stage transactions.[153] A feature of these

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[147] *See supra* Part II.A.

[148] *See supra* note 11.

[149] When parties are sophisticated, both of them participate in the contract's design. In the long-term contracts that tend to characterize many current commercial relationships, both parties take actions during the course of the contractual relationship and, typically, these actions are sequential. Therefore, incentives matter for both parties rather than for a single agent. This observation suggests that MD theory adds value to contracting analysis that cannot come from incentive theory alone. *See* Schwartz & Sepe, *supra* note 11, at 690-92

[150] *See, e.g.,* Eric A. Posner, *Fault in Contract Law*, 107 MICH. L. REV. 1431, 1436–37 (2009).

[151] See Schwartz & Sepe, *supra* note 11, at 692-97 (discussing some of these protocols and their limitations).

[152] *See supra* text accompanying notes 142-147.

[153] *See supra* sources quoted at note **Error! Bookmark not defined.**.

collaborations that distinguishes them from traditional contracts – where parties exchange goods and services in a one-stage transaction: the seller tenders (or not) and the buyer accepts (or not) -- is the development of new information as the parties continue to invest in their project.[154] This information may outmode the parties' original agreement, so that a revision could maximize expected surplus. The parties are free to renegotiate to a new arrangement but bargaining can fail in the asymmetric information environments that characterize the new collaborations. Sophisticated commercial parties need new remedies for the new collaboration contracts.[155] There is no finished product until the final stage of a multistage collaboration, but party defections from a framework arrangement often occur before then. When there is no product, there is neither value, cost nor quantity on which the expectation remedy could condition, nor would there be a subject for specific performance.[156] Rather, "breach" tends to consist of actions such as not performing assigned tasks or otherwise withholding or wrongfully exploiting private information, or just exiting before the end. Contract law remedies do not compensate disappointed parties for such breaches.

From a consequentialist perspective, making court intervention a contractible element of the parties' incentive protocol would increase parties' ability to implement optimal contracting plans.[157] For example, parties to new collaborations may want a form of specific performance under which a party is required to comply with the procedural terms of a contract, such as cooperating in R&D, rather than performing the contract's substantive obligation. And viable forms of specific performance in new collaboration contracts may provide for the assignment of the defecting party's stake in the project, as developed at the time of breach, to the counterparty or prevent the defector from exploiting information the collaboration developed.[158]

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[154] *See* Schwartz & Sepe, *supra* note **Error! Bookmark not defined.**, at 754-55.

[155] *Id.* at 759-61.

[156] *Id.* at 757-59.

[157] We have previously explored this claim in Schwartz & Sepe, supra note 11, at 691–92; Schwartz & Sepe, *supra* note **Error! Bookmark not defined.**, at 762-763 (proposing way in which courts could play an active, but delegated, r ole in facilitating efficient collaboration contracts). For an accessible description of how to involve courts, see Schwartz & Watson, *supra note,* at 26 (2004).

[158] Importantly, the parties' control over remedies should extend to equitable remedies. Similar to the interpretation domain, contract remedies should be $\omega_{(1)}$ default rules because that would increase parties' freedom to create modern solutions to the modern problems they face. And because every made contract between sophisticated parties is a Pareto improvement, a GFC regime would increase social efficiency.

We can now also explain the value of midstream interpretations under which parties could obtain a pre-breach interpretation. [159] This mechanism would make courts active players along the equilibrium path of the game, rather than being constrained to the role of payoff adjudicator after a deal breaks up. In particular, the availability of midstream interpretation would help mitigate the inefficiencies arising in contracting environments characterized by high transactional uncertainty and informational asymmetry – such as the new collaboration contracts. In these circumstances, parties may come to have different beliefs regarding the efficient path forward.[160] Midstream interpretation would facilitate the disclosure of information, through the process of discovery and by court hearings, and thus facilitate the efficient path forward.[161]

Shifting decision-making authority from courts to parties also helps ensure that contracts will contain optimal bargaining mechanisms in addition to optimal enforcement mechanisms. Consider again anti-modification clauses. MD theory explains this preference: as we have seen, parties sometimes must commit to an ex post inefficient outcome in order to preserve their ex ante incentive scheme.[162] But allowing anti-modification clauses might not be enough to implement a renegotiation-proof mechanism because parties can always voluntarily rescind a contract and write a new one. The protocol can overcome the parties' commitment problem only if the anti-modification clause is enforceable against the parties' ex-post desire to rescind their contract.[163]

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[159] Under current interpretation rules, parties can ask for a declaratory judgement to determine question of construction or validity arising under a contract before a breach has occurred. A party may also bring an action for contract reformation if the parties' contract rested on a material mistake of fact. Both forms of pre-breach interpretation, however, are only actionable in circumscribed cases. For example, a declaratory judgement must involve an issue of law on relatively undisputed facts. And a reformation action will correct only mistakes that related to the situation that existed when parties contracted. A court would make a midstream interpretation on new facts as well as old ones. *See id.* (manuscript at 25-27).

[160] *See* Schwartz & Sepe, *supra* note **Error! Bookmark not defined.**, at 771-72; Schwartz & Sepe, *supra* note **Error! Bo okmark not defined.**, (manuscript at 3-4, 41-47).

[161] Schwartz & Sepe, *supra* note **Error! Bookmark not defined.**, (manuscript at 41-47). Further, the availability of m idstream interpretation would give parties a credible threat to induce a counterparty to renegotiate the contract; in contrast, because classic contract interpretation requires contract breach, if a party insists on its interpretation of the contract rather than engaging in renegotiation, the deal may break up. *Id.*

[162] *See supra* note **Error! Bookmark not defined.** and accompanying text.

[163] As in the case of the too little trade problem (i.e., when no trade takes place even though it would be efficient), parties must be assured that the forced execution of the anti-modification clause will not be challenged. *see* Schwartz & Sepe, *supra* note 11, at 692-94 (providing a discussion of the too little trade problem . This explains why providing for a third-party arbitrator may be insufficient to ensure the viability of the mechanism. *See* Schwartz & Sepe, *supra,* at 699-700.

B. Commercial Experimentation

The prior discussion suggests another consequentialist, but non-welfarist, reason in favor of GFC: an increased possibility of experimenting with new commercial practices. Experimenting with social improvements when the effects of reforms is uncertain has a long history in political philosophy.[164] And even when experiments produce little themselves, excluding some alternatives and suggesting new ones can have value.[165] A similar argument exists in favor of commercial experimentation. The development of new commercial practices naturally involves uncertainty. Some practices will fail to achieve their desired effects. And even when practices do work out as planned, standards of evaluation might later be revised. But the process of trial and error is more likely to lead parties to discover what the margins for improvement are and eventually stumble upon better options.[166]

An enlarged contracting sphere complements and extends state experimentation. Centralized experimentation is necessarily more limited than decentralized experimentation. The state can introduce new rules, change others, reinstate old ones, but it has limited ability to induce localized experimentation. Unlike private order experimentation, state-mandated experimentation is never the result of a horizontal dialectal process, which may limit experimentation's capacity for innovation and marginal improvements. Centralized experimentation also tends to become less frequent as democracies become more mature, which might help explain why the common law contract project may be approaching an end.[167]

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[164] *See generally* JOHN STUART MILL, *On Liberty,* in THE COLLECTED WORKS OF JOHN STUART MILL VOL. 18. (J. M. ROBSON ed., 1977); KARL POPPER, THE OPEN SOCIETY AND ITS ENEMIES (2013); JOHN DEWEY, THE PUBLIC AND ITS PROBLEMS (1927); Charles F. Sabel & Jonathan Zeitlin, *Experimentalist Governance*, in THE OXFORD HANDBOOK OF GOVERNANCE (LEVI FAUR ed., 2012).

[165] *See* Jacob Barrett & Allen Buchanan, *Social Experimentation in an Unjust World*, OXFORD STUDIES IN POLITICAL PHILOSOPHY 130 (David Sobel & Steven Wall ed. 2022).

[166] This conclusion is also consistent with a virtue ethics defense of GFC. Unlike consequentialism and deontology, which are theories of the "good" action, virtue ethics is a theory of the "good" person, emphasizing virtue or moral character rather than the consequences or essences of actions or principles. *See* JULIA ANNAS, THE MORALITY OF HAPPINESS 8 (1993) [hereinafter, ANNAS, THE MORALITY]. The virtuous person -- one who exercises certain excellent, and persistent, traits of character -- sets the evaluative benchmark for human conduct. *See* Julia Annas, *Why Virtue Ethics Does Not Have a Problem with Right Action*, in OXFORD STUD. IN NORMATIVE ETHICS 4 (MARC TIMMONS ED. 2014). Two defining attributes characterize the actions of the virtuous person. The first is "habituation": the repeated performance of virtuous acts. ANNAS, THE MORALITY, *supra*, at 49, 54. The second is practical wisdom (or "phronesis"): excellence in deliberation characterized by rational choices that follow from a good disposition. *See* ANNAS, THE MORALITY, *supra*, at 60. By promoting commercial experimentation, we suggest that GFC would accord agents more opportunities for habituation to virtue and the exercise of practical wisdom in the commercial domain, along the lines suggested by the *doux-commerce* thesis of the French and Scottish Enlightenment. *See* Masconale & Sepe, *supra* note 79, (manuscript at 5-6) (examining the relationship between the *doux-commerce* thesis and the recfent rise of moral capitalism).

[167] *See* Schwartz & Scott, *supra* note 1, at 1524-25.

Nineteenth and twentieth century courts created today's contract law in the course of deciding cases.[168] This process produced a restricted set of general contract law rules, which necessarily apply independently of context.[169] Under this transcontextual constraint, there is small room for more common law rules or even just the updating of existing ones, which reflects the limited capacity of courts to address specific commercial practices adequately.[170]

This account of state experimentation apparently overlooks the contribution of a federalist system because, as famously remarked by Justice Brandeis, states can serve as "laboratories" to test new policies.[171] Competitive pressure would also give each state incentives to devise better commercial practices so as attract more business. In practice, however, there is a convergence of state common law on a few fundamental contract doctrines, with little variation.[172] This convergence might be the result of transcontextual constraints and/or the constraints that arise because state common law rules apply to both sophisticated and non-sophisticated commercial parties.

VI. Generalized Freedom of Contract in the Liberal Society

We have argued, on deontological and consequentialist grounds, that contract law should turn the mandatory rules governing three contract law areas -- interpretation, bargaining and remedies -- into defaults. Contract law would remain a court-centered system if it enacted only these reforms. The state would retain conditional authority over the law (subject to party opt out) and exclusive authority over contract enforcement and the law's procedural rules (including rules regulating court intervention and policing powers).

In this Part, we consider what a world that shifted the locus of control over contract law from courts to parties would look like. We also begin to address the question whether a more decentralized contract law would be desirable. A more decentralized law would expand the sphere in which autonomous agents can make commercial choices and would increase equality and welfare, both relative to the legal system we now have. The economy we visualize would authorize parties to create private "associations" whose substantive and procedural rules courts

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[168] *See* Schwartz & Scott, *supra* note 1, at 1540.

[169] *See id.* at 1570-77.

[170] Id.

[171] New State Ice Co. v. Liebmann, 285 U.S. 262 (1932).

[172] *See* Schwartz & Scott, *supra* note 1, at 1570-77.

would enforce; and would authorize parties to make courts players in party designed mechanisms for increasing contractual efficiency.[173]

We address an important objection at the outset: that expanding the court's role in these ways would make excessive demands on the state's enforcement apparatus. This concern is misplaced. Contracts have a temporal dimension: A and B exchange promises to take future actions. A contract law needs an enforcement arm because a party may become reluctant to perform if circumstances change. Recognizing that enforcement requires coercion dissolves the argument that increasing the courts' role in a freer contract law would make excessive demands on the state. This is because the state has a monopoly of coercion. If force is necessary, the state must apply force. The state thus enforces contracts because enforcement makes real the parties' authority to choose a contract's substantive terms. It follows that the state must make its enforcement apparatus available to parties who could choose the triad terms and enlist the courts in their commercial plans. The issue, that is, is not whether broadening the court's role would make excessive demands on the state: the issue is whether the state should expand the court's role.[174]

We conclude this introductory section with three additional remarks. First, we sometimes refer to the stronger conception of freedom of contract set out below as "commercial anarchism" because there would be many loci of private contract law creation rather than one state system. Put directly, commercial anarchism would make parties sovereigns of their affairs, vested with the power to shape their own laws of contract. Second, the state's role in such an anarchic world should become fully clear only *after* the introduction of commercial anarchism because one of its justifying features is to encourage parties to experiment with new commercial practices.[175] Third, we repeat a caution from the Introduction: this is an early attempt to pursue the extended implications of taking freedom of contract for sophisticated agents seriously.

A. The Broader Domain

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[173] *See supra* notes **Error! Bookmark not defined.**-158 and accompanying text (discussing how this reform of the role of courts in contract law would increase efficiency).

[174] Expanding the court system would benefit sophisticated contractors but be paid for by all. We are not concerned with this cross-subsidization for two reasons. First, the tax system is generally progressive and sophisticated contractors usually are relatively well off. Second, our interest is the domain in which sophisticated parties usually make complex contracts. Court costs are increasing in litigation complexity, so the parties we study would internalize much of the cost a freer contracting system would create.

[175] *See supra* Part V.C.

The implications of commercial anarchism are close in spirit to the implications of right-based ethics and Nozick's idea of "private protective associations."[176] Under both ethical schemes, parties become rulers of their local commercial domain (i.e., the associational agreements they voluntarily conclude).[177] The parties could choose the contract's adjudicator and the rules of adjudication. The adjudicator could be private, but the rules of adjudication need not comply with state-accepted standards, as is required with current arbitration procedures. Parties could also choose to "appoint" state courts (likely expert courts like Delaware or New York) as adjudicators; such a court would act as an agent of the parties and abide by the adjudication rules established in their contract. To this extent, the choice between the GFC considered above and commercial anarchism involves a continuum of options, rather than a binary one, depending on the relative moral power of parties and courts over adjudication and enforcement.

There are, however, major difference between our approach and libertarian positions. In Nozick's treatment, the power of enforcement -- albeit restricted to the power of contempt --[178] lies with the state, which possesses a monopoly on legitimate force and holds the final authority for dispute resolution. We suggest that this monopoly power could be supplemented and sometimes replaced by private enforcement power[179] We suggest that procedural rules should be determined and enforced by the parties themselves. However, we do not defend the view that parties should be free to exercise coercive power independently from the state, as in more radical libertarian accounts. [180] More modestly, we argue that parties should be able to invoke the state's coercive power to enforce contractual governance mechanisms that the parties

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[176] *See supra* text accompanying notes 124-128.

[177] We consider the contract dimension of commercial transactions. We do not discuss other important legal areas, such as property, because these raise issues of third party rights.

[178] *See supra* note 127 and accompanying text.

[179] Like more radical libertarian approaches, Nozick also defends the legitimacy of private coercive power in some circumstances. However, we take the existence of the state as given. Therefore, the parties of an association (as a principal) have the option to use the adjudication function or the state's enforcement power (as an agent).

[180] *See* JASON BRENNAN, WHEN ALL ELSE FAILS: THE ETHICS OF RESISTANCE TO STATE INJUSTICE (2018) (arguing that when governments violate our rights, citizens may not just resist but may have a moral duty to do so); MURRAY N. ROTHBARD, FOR A NEW LIBERTY; THE LIBERTARIAN MANIFESTO (2020) (proposing an anarcho-capitalist society where voluntarily funded competitors, rather than taxation, would provide law enforcement, courts, and other security services); DAVID D. FRIEDMAN, THE MACHINERY OF FREEDOM: GUIDE TO A RADICAL CAPITALISM (2015) (defending an anarcho-capitalist society where competition among private firms in a free market would provide protection and defense services.); BRUCE L. BENSON, THE ENTERPRISE OF LAW: JUSTICE WITHOUT THE STATE (1990) (outlining a model where a modern legal system operates without state involvement, relying on private arbitration and other non-state dispute resolution mechanisms).

themselves chose. In this collaboration between private and state power, the parties would become the principal and the court (or other state institution) would become the agent.

To see what this role reversal would imply, we begin with the more radical libertarian aspect of a strong GFC. This aspect would return commercial parties to the Lockean "state of nature" so that parties control their transactions much as they would have in the pre-political state.[181] But individuals in the state of nature may fail to settle their disputes because each individual is tempted to be biased in their own favor. Yielding to this temptation would cause individuals to overestimate their strength and attempt to punish others disproportionately by seeking excessive compensation. The state of nature might become a "state of war."[182]

In the classic Lockean formulation, this risk motivates agents to form a social contract and establish state power in their own interests.[183] Indeed, when individuals' natural rights are broadly construed, rather than limited to the commercial domain, their relinquishment in favor of pervasive state power is required in order for civil society to function. But when individuals' natural rights are limited to the commercial domain (and sophisticated parties), there is room for a less enveloping associational solution. With a strong GFC individuals could form "associations," charged with acting as impartial "umpires" to create a law for themselves and to settle disputes among themselves State power would remain in the picture just to facilitate private protective functions.

We conclude this section with a final remark. Our discussion of the strong form of GFC has not yet addressed the important issue of the parties' metaphysical power to create a mechanism -- a form -- that makes an exchange possible.[184] In the case of legal contracts, parties create moral and legal obligations by referring to an existing form -- state contract law -- that provides a structure for their transaction. This form is an ontological entity separate from the individuals. Under a weak GFC regime, individuals can modify state-provided forms , but there is a pre-existing form (or "metaform") the state supplies as a reference. Under a strong GFC regime, however, parties have the power to create moral and legal obligations ex nihilo -- that is, without any state-provided reference form. Can he parties create a form for themselves?

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[181] In Locke's words, parties "could order their [commercial] actions and dispose of their persons and possessions as they think fit, …, without asking leave or depending upon the will of any other man." *See* PETER LASLETT: LOCKE : TWO TREATISES OF GOVERNMENT 269.

[182] *See id.*, at 269; Nozick, *supra* note 115, at 10.

[183] *See* LASKETT, *supra* note 181, at 350.

[184] We thank Daniel Markovits for raising this question.

From a strict libertarian perspective, the answer to this question is relatively straightforward: if parties can transact β before the existence of a political state, they must also have the capability to generate the mechanism enabling this exchange.[185] But given the differences between our approach and the libertarian one, the problem of the parties' power of form creation requires further investigation,[186] though a full discussion of the matter remains beyond the scope of this Article. Our tentative argument is that the same normative power that parties employ to create moral obligations also enables their metaphysical power to generate the forms from which these obligations spring.

We deploy this argument in three steps. First, drawing on action theory,[187] we assume that individuals have agency collectively to intend and consent to a specific form of action or interaction. The act of shaking hands -- a mutually agreed form of action symbolizing greeting or agreement -- provides a prime example of this agentic power. [188] More broadly, by virtue of their agency and through mutual agreement, individuals are capable of defining and consenting to specific forms of action or interaction. Second, this agentic power of form creation fosters shared expectations among individuals. According to convention theory,[189] conventions arise from repeated patterns of action due to mutual expectations.[190] Thus, when individuals mutually consent to a specific form of action, their agreement will trigger the formation of shared expectations for future actions based on that specific form . Third, obligations are generated when a collective agreement is reached regarding certain forms of interaction or action, which in turn leads to the development of common expectations.. Exercising one's agency to participate in collective actions or interactions carries an implicit acceptance of moral responsibility towards fellow participants and the agreed-upon practice. This act of engagement (i.e., a metaphysical condition) is what transforms mutual expectations into obligations.[191] In sum, agents actually can create their own forms.

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[185] *See supra* text accompanying note 122.

[186] Although the libertarian approach hinges on the necessity of form creation for effectuating an exchange, it is worth emphasizing that Nozick does not go into the details of the metaphysical mechanism of form creation.

[187] *See generally* ALFRED R. MELE, THE PHILOSOPHY OF ACTION (1997).

[188] Shaking hands is not merely a physical movement, but a collectively agreed form of action that conveys meaning, designed and agreed upon by those participating in it.

[189] *See generally* DAVID K. LEWIS, CONVENTION: A PHILOSOPHICAL STUDY (2013 ed.).

[190] *Id.* at 60-1 (stating that there is a convention when it is common knowledge in a population *P* that some state of affairs *B* holds. Then everyone in *P* has reason to expect it to be common knowledge in *P* that *B* holds).

[191] This progression aligns with Searle's theory of institutional facts, in which obligations arise from mutually acknowledged expectations. *See generally* JHON R. SEARLE, THE CONSTRUCTION OF SOCIAL REALITY (1997). Note, however, that the view that participation grounds a duty to conform goes beyond a single ethical doctrine. It resonates with

Under these combined assumptions, individuals can generate obligations through their collective actions and intentions in a metaphysical sense. That is, the power of form creation derives from individuals' ability to shape their social reality through shared forms of action, shared expectations, and shared recognition of obligations.[192]

B. A Commercial Archipelago

We can now make concrete the though experiment about a truly decentralized contract law that we presented in this Article's introduction. A "liberal commercial archipelago" would be composed of numerous associations, each with its own rules and contractual mechanisms for governing parties' trades. Thus, it would resemble a federal society in its commercial domain. Similar to an ordinary federal system, rule creation and adjudication would occur at the local level (i.e., the level of the associations). The state would perform tasks that an association could not perform, such as legal enforcement. Similar to states in a federal system, the associations could create their own commercial law, which the state should enforce.[193]

Each association therefore could be a site in which agents would realize the moral and economic benefits of decentralization. Associations would likely be homogenous commercially, so members would participate in conditions of relative economic equality.[194] The small size and

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consequentialist views, where breaching a practice could lead to adverse outcomes. But it is also consistent with deontological ethics involving a duty that arises from the collective commitment to the practice, not from one party's reliance on another's expected behavior. For example, this duty could arise from the Kantian principle of "universalizability," entailing a moral obligation to act in ways that could be universally adopted without contradiction.

[192] This conclusion might be subject to objections due to its grounding in specific metaphysical perspectives. First, one could argue that collective intentionality does not exist since intentions fundamentally belong to individuals. But what we perceive as collective intentionality can be reduced to a complex interaction of individual intentions. *See* BRATMAN, *supra* note 81. Second, one could argue that not all social conventions inherently involve obligations. This is true, but while not all conventions possess normative characteristics, those explicitly recognized and accepted as binding by participants do take on a normative dimension. Third, our argument could potentially lead to some form of relativism, where anything can become an obligation if it is socially recognized as such. This criticism, however, can be addressed by introducing criteria or constraints on the process of obligation-creation. Under these constraints, only those practices that respect certain fundamental rights or ethical principles would generate legitimate obligations. In particular, the requirement of mutual consent would ensure that not just any convention can evolve into a source of obligation, thereby providing a safeguard against relativism.

[193] Under a federal system, the federal government does not lose its moral agency when enforcement is governed by lower level, local laws because the federal government retains the power to check whether certain conditions are met. For instance, a federal court may be required to apply state law. Federal courts will generally respect and enforce the parties' choice of law, as long as there is a connection between the chosen jurisdiction and the contract.

[194] *See supra* Part IV.A.2.

similar goals of associations would also permit members to exercise an effective autonomy over their commercial affairs. Further, associations could ameliorate asymmetric information problems. Members would have similar economic interests and would come to know each other over time. As a result, members' types would be more public, and their intra-association trades consequently more efficient.

A review of contract law's basic remedy, expectation damages, may illustrate an association's economic value.[195] The remedy is exchange efficient because it authorizes the promisor to perform under the contract, or to reallocate her resources to another use if she transfers to the promisee a sum that equals the gain the promisee expected to make.[196] Because the promisor will choose the least costly option, the remedy would make her better off without reducing the promisee's payoff. This result suggests that agents in a Rawlsian original position would have chosen expectation damages were their goal to identify the "right" remedy.[197] The result, however, requires the promisor to know either a buyer's value or a seller's costs (depending on which is the breacher). Members of an association would be more likely to know these parameters than market contracting strangers would know them.

The expectation remedy is an $\omega_{(3)}$ mandatory rule: that is, the remedy is a required term in *every* contract.[198] Parties, however, sometimes may prefer other remedies depending on the economic parameters and their own values. As examples, parties may contract for specific performance when a party could not verify its expectation to a court, or contract for a penalty for breach, despite its exchange inefficiency, if performance has particular value to the promisee.[199] A unitary ideal (in the Rawlsian sense) law of remedies, and by extension the institutions governing contracts, is not required as a matter of morality, however.[200] The parties' moral power legitimates their choice of contractual governance mechanisms if the parties agree under ideal contracting conditions and their agreement creates no externalities or violates any

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[195] *See supra* text accompanying notes **Error! Bookmark not defined.**-**Error! Bookmark not defined.**.

[196] *See supra* Part II.A.3.

[197] Put another way, if society were including contract remedies in the social contract, expectation damages would be the equilibrium outcome of an ideal deliberation.

[198] Parties can contract for a liquidated damage clause, but the clause would be unenforceable unless it approximated what expectation damages would be.

[199] *See supra* text accompanying note **Error! Bookmark not defined.**.

[200] *Cf.* GERALD GAUS, THE TYRANNY OF THE IDEAL: JUSTICE IN A DIVERSE SOCIETY XIX (2016) ("Only those in a morally heterogeneous society have a reasonable hope of actually understanding what an ideal society would be like, but in such a society we will never be collectively devoted to any single ideal.")

deontological constraints. Therefore, contract laws with various moral standards could coexist in the liberal commercial archipelago.

To sum up, current contract law subjects the parties' exercise of their moral power to its own moral commitments.[201] A commercial "anarchical" regime would permit parties to make legally enforceable contracts in accordance with their own moral commitments. GFC, in the form of commercial anarchism, thus corresponds to the ideal of an open society, in which citizens accommodate their different needs and values in the commercial domain.[202] Such a society would be characterized by sets of contractual governance mechanisms, whose legitimacy would be determined by a basic principle: if a contracting party is seeking to bring about some new action type Γ (say a remedy) for which there is no current legal permission, she may Γ if and only if she can justify Γ to her counterparty. When both parties agree to Γ, Γ-ing is justified by consent.[203]

C. The Archipelago in Practice

The commercial archipelago would consist of dyadic, industry (or trade) wide and inter-industry associations. A perfect correspondence would exist between the association and the contractual relationship when the association is dyadic. The parties' contract would be the "associative contract," specifying the local contract law. Larger associations, especially industry-wide associations, would govern themselves with associative contracts. These would specify the local contract law; regulate contracts between the association members; and adjudicate infra-industry disputes. [204]

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[201] *See* KUKATHAS, *supra* note 123, at 4, 17 (emphasizing the importance of granting individuals and groups the autonomy to shape their own values and norms .)

[202] *Id.* (proposing a "minimal moral conception" rooted in fundamental human interests, which all individuals have sufficient reason to accept in spite of their conflicting views on justice and morality.)

[203] *See* Gaus, *supra* note 200, at 187-90 (discussing the principle of natural liberty).

[204] See Bernstein, *supra* note **Error! Bookmark not defined.**, at 1765. There are similarities and differences between i ndustry-wide associations and trade associations. Commercial practices would be an interpretive resource for both institutions. Commercial practices today, however, are a legal resource when they conform to contract law. It is courts that decide whether and how to use commercial practices in contract interpretation. Under commercial anarchism, the "law" of the trade or industry association (i.e., the equivalent of current commercial practices) would be much of the contract law for the association; the state would only have enforcement tasks. Consider practices that have developed in some industries (e.g., for procurement contracts) where parties have created alternative enforcement systems based on reputational mechanisms in response to the insufficiency of ordinary enforcement mechanisms. *See also* Lisa Bernstein, *Opting Out of the Legal System: Extra Legal Contractual Relations in the Diamond Industry*, 21 J. LEG. STUD. 116 (1992). Under commercial anarchism, parties could create such alternative dispute resolutions and enforcement institutions and use state power to ensure compliance.

The state, however, should constrain the process of association formation by preventing parties from forming one unitary system. Any such system would reduce, or altogether preclude, competition among associations.[205] For example, some associations might adopt a more paternalistic local contract law (e.g., providing for expert adjudicators who could choose the remedy that best fits the ex-post state of the world), while other associations may provide efficient private mechanisms (e.g., rules that restrict adjudicator discretion). How parties sort themselves out thus would determine which association types would flourish.[206]

Freedom of contract would empower associations to regulate the admission of members. Rejected applicants, however, could incorporate an association's law by reference, as happens today when parties use choice of law terms to select their *lex fori*.[207] Such choices, in effect, would create another protective association, that would have the same contract law as the association that excluded the parties.[208]

We note two practical obstacles to the existence of a commercial archipelago. First, there would be no central institution to regulate coordination among associations. Suppose that party A, a member of association X, considers contracting with party C, a member of association Y. The rules of Association X may impose duties or confer rights on A that would conflict with the duties or rights of association Y. For example, let A be a seller. Association X, say, requires only that a tender substantially conform to the contract description but association Y requires a seller to make a perfect tender. If party A and C contract but C rejects A's tender, which law would define breach? Deals between members of different associations thus may be difficult to make.

Parties face this problem today, however, when they are domiciled in different states, and solve it with terms specifying which state law governs. An association would make its bylaws and other important governing rules public, to guide current members, to inform new members, and to tell the world what type of association it is. As a consequence, parties could use "choice of association" terms to specify which set of association rules would govern their transaction. In addition, the state, as the parties' agent, would enforce association rules. For example, if an association adjudicator orders a party to comply with its contract (i.e., specific performance) and

[205] We thus envision an antitrust law for associations.

[206] We note the difficulty experienced by the ALI default rule project in identifying default contract terms that would have universal application. *See* Schwartz & Scott, *supra* note 1, 1524-26.

[207] *See supra* note **Error! Bookmark not defined.**.

[208] In more stylized terms, consider the case where Party A and Party B form association X but do not want to include Party C in X. Party C, however, can use the terms of association X, by reference, in dealing with Party D if D accepts those terms. By doing so, Party C and Party D have formed another association, A, whose law of contract is identical to that of association X.

the party refuses to do so, the other party could have the state enforce the injunction. Policing and enforcement thus would function similarly to the current system.[209]

The second possible obstacle concerns exit. Agents in the commercial archipelago would be free to enter associations and be free to exit from them. This right of exit is central to the architecture of the commercial archipelago. No full-scope freedom of association can exist if the state prevents individuals from exiting existing associations and joining new ones, or makes it excessively costly to do so.[210] Using an argument by contradiction, if sophisticated parties lacked freedom of exit, the state would not recognize them as moral agents in practice. Parties have difficulty planning their interests without legal enforceability. [211]

Even under a strong GFC, however, freedom to exit could be complex, because parties may make collaborative long-term contracts with other association members or make sunk cost investments that exit would render worthless. Many parties thus would face a tradeoff between freedom to exit from an association and freedom to maximize returns within one. Associations themselves likely would create rules or defaults to regulate this tradeoff. Exit, however, is an intra-association problem, not an inter-association problem. Because each association would resolve the exit/gain tradeoff differently, agents would have a choice among solutions: to choose an association would be to choose a solution to this central problem.

The governance of the freedom of exit reinforces our claim that commercial anarchism presupposes a collaboration between the parties and the state. In particular, the state would have four important functions. First, and most importantly, the state would determine whether parties are eligible for commercial anarchism and only relinquish its sovereignty in the commercial domain for such parties. This role would shift state oversight from being ex-post and conditional to being ex-ante. Currently, the state, through its courts, intervenes only when there is a breach to determine which parties complied with the contract, and whether the contract and the parties' behavior under it are compatible with state contract law. Under commercial anarchism, the state would exercise its power ex-ante to check whether parties have the epistemic and equality prerequisites – they are sophisticated enough -- to permit them to

[209] The state is necessary because a private law contract system sometimes requires coercion to ensure compliance. The state must act when coercion is required because it has a monopoly of violence.

[210] *See supra* note 100 (discussing Kukathas's freedom of exit and Moon's critique in the context of the autonomy argument).

[211] Denying the freedom to exit would imply that contracting parties' morality is subordinate to a different system of moral values, although the parties' transaction did not violate the tangible interests of other parties who hold those values. This outcome would violate the idea that individuals' moral commitments should be minimal because each individual wishes to follow their own morality

function in a GFC regime.[212] Second, the state would enforce contracts as the parties' agent – although by applying the law of the association not the law of the state. Third, the state could create standardized formats for the disclosure of association bylaws and other important rules as well as enforce inter-associational contracts. Standardized disclosure would facilitate both association cooperation and association competition, for members and for financing.[213] Fourth, the state would ensure thatno association gets so large as to upset the liberal archipelago ecosystem. Fifth, the state could require associations to internalize negative externalities.

D. Privatizing Contract Law

The commercial anarchism version of GFC would require a more ambitious privatization than reducing the number of mandatory rules. We have not considered the legal nature, and related implications, of the protective associations that would administer the various local contract laws. In the end, each association is a private agreement—whether taking the form of an actual contract (when the association is dyadic) or a master-contract (when the association includes more members, and the associative contract is distinct from the individual contacts between members). Can the association *itself* be reduced to just a contract? If so, how should this contract be interpreted and by whom? If contract law is applicable, the state would have ultimate authority over private local laws. This would contradict the point of commercial anarchism.

There are several strategies that parties could use to retain control, with each strategy functioning as a distinct form of contract law privatization. First, the parties can choose a specific legal language for sections (or all) of their contracts. For example, parties may want the bargaining process regulated by one law and other parts, e.g., remedies, by another law. Note that this strategy does not involve the choice of the governing law under which the parties agree to be subject to the jurisdiction of a given state. Rather, the parties would choose a legal *language*, signaling their will to have their association contract (or portions of it) interpreted according to the chosen language's semantics and rules. Thus, say, the parties have chosen a given law-language for their contract, but that law does not permit them to seek a specific remedy. The parties would retain discretion to make the remedy available for that contingency. In case of ambiguity, then, the parties would instruct the adjudicator to use the law-language they have chosen but subject to this escape. Another way to explain this power is that parties

[212] As we saw above, the state can use presumptions to this end, such as when commercial parties are corporations or have fiduciaries with equal epistemic standing to assist them. It would be in the parties' interest to seek such state validation to ensure that their local commercial sovereignty will withstand challenge.

[213] Standardized disclosure is a common solution to the problem agents face choosing among market offerings.

would be acting as "lawmakers by reference" but would retain exclusive authority over the associative contract.

Second, parties can write important portions of their contracts in the technical language of a trade or industry. They can then instruct courts to use that language when making an interpretation. Such directive clauses are common.[214]

Third, parties can refer to other legal languages to implement their own. For example, parties can choose the contract law of another jurisdiction. A similar privatization practice already exists in the international commercial context, where parties can shape much of their own contract law.[215] This practice is facilitated through the conjunction of two state-level mechanisms. International parties have the enhanced autonomy, by state concession, to select international commercial arbitration as a form of almost final private adjudication. Parties can enforce foreign arbitral awards at the individual nation state level without a review of the merits. In addition, states allow arbitrators to decide international commercial disputes on the *sole* basis of private norms, which they interpret on their own terms. These norms include, for example, *lex mercatoria*, which is a body of commercial rules inferred by private experts from observed merchant practices.[216] International commercial parties therefore may ensure that private norms govern their contracts by providing for arbitration.

There are substantial differences between international practice and commercial anarchism, however. Under commercial anarchism, *all* equally sophisticated commercial parties could access that form of privatization rather than just parties to international commercial transactions. Further, under current privatization practices in international transactions, courts cannot review a case on the merits, but can still review it on procedural matters. Under commercial anarchism, courts would not have discretion to review privately adjudicated decisions. Last, the enforcement of a foreign arbitral award is constrained by the remedies

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[214] *See* Bernstein, *supra* note **Error! Bookmark not defined.**, at 1769.

[215] See Gilles Cuniberti, *The Merchant Who Would Not Be the King: Unreasoned Fears about Private Lawmaking*, in PRIVATE INTERNATIONAL LAW AND GLOBAL GOVERNANCE 142-143 (2014)

[216] The Lex Mercatoria (or "new lex mercatoria," relative to the old medieval lex mercatoria) was rediscovered in the 1960s by Berthold Goldman and Clive Schmitthoff, following developments in the global economy since World War -- particularly in the standardization of contract clauses for sales, maritime transports, international trade and finance, and the proliferation of international commercial arbitration. *See* Clive M. Schmitthoff, *The Unification of the Law of International Trade*, 105 J. BUS. L. (1968); Bethold Goldman, *Frontières du Droit et Lex Mercatoria*, Archives de Philosophie du Droit (1964). Goldman and Schmitthoff shared the conviction that a transnational body of legal principles and rules was gradually emerging from the spontaneous activities (usages, practices, use of model contracts and contract clauses etc.) of the international business community. *See id.* The multiple activities of international formulating agencies also unify the law of international trade and finance.

available in the jurisdiction where the parties are seeking enforcement. With commercial anarchism, parties would have the freedom to use the state's enforcement power to enforce the remedies they have designed, even when these remedies would otherwise be unavailable under state law.

Fourth, parties may create their own legal language and use it as an exclusive source for regulating their relationship. Creating a precise language, interpretable on its own terms, to define the law of contract is possible given the theoretical progress made in formal linguistics. This field of study suggests that parties can develop a *universal grammar* à la Montague.[217] This is not the venue to explore the legal implications of formal linguistics, but we note that linguistic tools would permit the interpreter to recover meanings that today would remain obscure.

Even a self-sufficient contract language, however, could not avoid the problem of writing complete state-contingent plans of action. One of the functions of contract law is to provide adjudicators with a structural framework that can help address unforeseen contingencies that may arise in the parties' relationship. Today, this is a function for courts to exercise. With GFC, however, parties could also provide precise instructions to the adjudicator on how to address unforeseen contingencies. That is, parties could provide *rules of closure* for how to solve the incomplete contract problem.

We briefly conclude with two examples to illustrate how rules of closure would work. First, parties could use a formalistic approach, specifying that the adjudicator must interpret their contracts based on its formal obligational content. Most contract, independent of the level of their economic incompleteness, are obligationally complete. Thus, if parties did not stipulate a different arrangement for exceptional circumstances, the parties' obligations would be those obtaining in normal times. It follows that when English is interpretable according to the canons of formal linguistics or any other disambiguating technique, it would be possible to determine the entire normative structure of the contract with clarity. Second, parties can appeal to general

[217] In formal linguistics, one can create a function that maps natural language (say English) to a precise logical language. This logical language is then mapped into a universal meaning through an interpretation function. More precisely, Richard Montague showed that the relation between syntax and semantics in a natural language such as English is not essentially different from the relation between syntax and semantics in a formal language such as the language of first-order logic. *See* Barbara H Partee & Herman L. W., *Montague Grammar*, in HANDBOOK OF LOGIC AND LANGUAGE 17-23 (Johan van Benthem & Alice ter Meulen eds. 1997). Thus, the meaning of a complex expression would be a function of the meanings of its parts and of the syntactic rules by which they are combined, through the *principle of compositionality*. It should then be intuitive to see how formal linguistics could help parties develop a legal language that is interpretable on its own terms. In fact, parties could develop a contract language that is not necessarily legal and does not necessarily need to be interpreted by legal experts. For example, parties might prefer that their specialized language be interpreted (i.e., adjudicated) by scientists (e.g., engineers) or even AI machines, and make those interpretations final and enforceable.

criteria for closure. For example, they can choose efficiency. And they can either delegate the determination of efficiency to the adjudicator or specify the notion of efficiency they want to be considered or, as we saw, the mechanisms through which they can reach efficient allocations. Their contract can stipulate that if an unforeseen task is necessary to perform, the party with the lowest cost will carry it out or the cost can be split.[218]

7. Conclusion

Contract law rules are the framework within which transactions occur. Some rules are defaults that fit particular transaction areas better than other areas; parties commonly disclaim the inapt rules.[219] Other contract law rules are mandatory and so apply throughout the commercial world. We analyze three sets of mandatory rules: (i) the rules regulating bargaining; (ii) the rules regulating interpretation, and (ii) the rules regulating remedies. These rules are materially constraining.

The bargaining rules prevent parties from committing to ex post inefficient transfers in order to implement ex ante efficient schemes. The interpretation rules prevent parties from specifying the evidence that, they believe, is sufficient for courts to determine their intentions, nor can parties affect the interpretive criteria courts will apply to their contracts. The mandatory remedy rules have an especially broad scope. A bidder party to an acquisition agreement cannot get specific performance as of right if a potential target reneges; a successful bidder cannot recover costs above a low judicially specified cap if the target later takes a higher offer; sellers of goods cannot retain down payments that courts believe are too high; buyers cannot use penalties to encourage performance or efficient seller investment in the contract's subject matter; parties to lending agreements cannot prohibit prepayments or penalize late payers; parties to research and development collaborations cannot recover sunk costs or use fines to discourage counterparties from inefficiently exiting or not complying with promises to station workers in each other's factory. These examples could be multiplied many times.

This article apparently is about mandatory rules in the field of contracts, but it actually is about material and far ranging restrictions on American commerce. These restrictions should be

[218] When parties are sophisticated, the rules of closure would operate in the background because parties can address the problem of unforeseen contingencies through renegotiation. But different rules of closure indirectly determine parties' relative bargaining power at the renegotiation stage.

[219] As one example, manufacturers commonly disclaim the implied warranties in favor of making tailored express warranties.

relaxed: contract law's mandatory rules should be demoted to defaults or, in some cases, repealed. Our argument is in three parts. First, mandatory contract law rules have an arbitrary and unfair incidence, in the sense that the rules cannot consistently implement substantive policies but rather constrain only occasional or inexperienced agents; the "pros" often can escape mandatory rules' application by adroit (though costly) contracting.[220] Second, considered on their merits (i.e., assuming mandatory rules are sometimes effective), they either violate or find no support in the ethical theories relevant to commercial contracting.[221] In particular, the rules we consider violate distributional justice because they constrain the weak while the strong remain free; and the rules restrict agents' autonomy and trespass on their rights even when a contract does not affect third parties.[222] Third, contract law's mandatory rules reduce welfare: parties set free would contract more efficiently.[223] In sum, today's contract law is a morally unjustified and inefficient tax on the commercial economy.

Our argument against the triad rules focuses on their intrinsic defects, but the argument is illustrative of a broader theme. To change these rules is to increase the control sophisticated parties have over their transactions. In the latter part of this article, we seriously consider generalizing this transfer of control. There would be major gains, we argue, to permitting parties to form new "associations'" and to create the contract law that would govern associations inter se and among them. The role of courts, in this world, would be to police the domain of the associations, ensuring that their members are sophisticated commercial parties, and to support association rules by enforcing their dispute settlements. We are, we believe, on firm ground in our critique of the mandatory rules. Here, we hope to interest lawgivers and scholars in the possible benefits of a freer legal universe.

September, 2023

[220] *See supra* Part II.A.

[221] *See supra* Part II.B.

[222] *See supra* Part III and Part IV.

[223] *See supra* Part V.