GENERALIZING FREEDOM OF CONTRACT

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Abstract

The freedom of contract principle today permits parties to choose a contract's substantive terms; otherwise, contract law overrides the principle in favor of regulating party choices regarding a contract's remedy, interpretive, and modification terms -- the "procedural terms". For example, parties can choose the form that a modification term takes but a mandatory contract law rule prevents parties from barring modifications altogether. A fundamental premise of a liberal state holds that agents should be free to pursue their projects unless a justification for constraint exists. It is this fundamental premise that supports party freedom to choose a contracts' substantive terms. We argue here that the premise, properly applied, also supports party freedom to choose a contract's procedural terms.

A mandatory contract law rule, in theory, functions in service of a policy, such as prohibiting excessively one-sided deals. Our initial argument against mandatory rules is that implementing a policy with a mandatory rule is unwise because these rules in actual effect function arbitrarily: they bind only unsophisticated or occasional players while sophisticated parties use adroit contracting strategies to avoid the rules' impact. Our second argument supposes that mandatory rules are generally binding but shows that, even so, moral and economic theory both fail to support the procedural constraints. There is a divide in the contracts literature, and increasingly among courts, between moral and economic views of

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contract law. Most moral views support constraining the parties' choice of the procedural terms while the economic view, in contrast, supports reducing the constraints to defaults or repealing them. We dissolve this so far intractable divide by showing that deontic moral theories also support extending the freedom of contract principle to include party choice regarding the procedural terms. Our third claim brings the economic case up to date by showing that economic contract theory supports the same extended view of contractual freedom as the classic economic view. Finally, we move beyond the current state supplied contract law to sketch a limiting case for freedom of contract: a commercial world in which parties could create their own contracting regimes in lieu of the current state regime.

Our argument that parties should be free to choose procedural terms has wide ranging implications. The law's mandatory rules bind everywhere, reducing party freedom to contract regarding property, corporations, finance, and elsewhere. Reducing these rules to defaults thus would increase the fairness and efficiency of business law generally.

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Introduction

A. Mandatory Rules in Practice: An Example

The freedom of contract principle permits parties to make any contract that does not affect third parties negatively. The principle implies that contract law rules (e.g., Restatement of Contracts or UCC sections) should function as implied terms in parties' agreements. The rules govern unless parties delete or vary them.[1]

To the contrary, courts and other rule creators intend some contract law rules to be mandatory: these are rules that parties must accept. The liquidated damage rules thus prevent parties from choosing their own remedies for breach,[2] the modification rules prevent parties from tying their hands with no modification clauses,[3] the interpretation rules prevent parties from choosing the evidentiary base on which a court would interpret their agreement,[4] and so

[1] The Uniform Commercial Code, regulating sales recites that parties can contract out of every Article 2 section except the section creating the duty of good faith.

2 See generally Aaron S. Edlin & Alan Schwartz, Optimal Penalties in Contract, 78 Chi.-Kent l. Rev. 33, 34 (2003) (explaining in technical detail the functioning of liquidated damage clauses).

[3] Contract law will not enforce an anti-modification clause on the assumption that "the parties' latest expression of intent is preferred to earlier expressions because courts should implement what parties want, not what they once wanted, and also because later intentions are likely to be better informed than earlier ones." Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 2, 4 (2004).

[4] *See* Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 YALE L. J. 926 (2010).

on. These “procedural” constraints bind even when the contracts they preclude would not have affected third parties.

The doctrinal distinction between mandatory contract law rules and defaults blurs in practice, however. Parties cannot explicitly contract out of a mandatory rule but sophisticated parties commonly can avoid the rule’s impact. Their method is to adopt substantive terms that replicate the economic result a mandatory rule was meant to prevent or require. This is an effective escape route because the freedom of contract principle tells courts to enforce substantive terms.

We make legal, economic and philosophical arguments for generalizing freedom of contract: that is, for eliminating mandatory rules from contract law. The legal argument holds that attempting to implement a policy goal with a mandatory rule is unwise because many parties would escape the rule and thereby frustrate the policy. The economic and philosophical arguments change course to suppose that a mandatory rule actually would bind everyone. Even so, the economic argument holds that mandatory rules severely limit parties’ ability to respond to the asymmetric information barriers that often preclude efficient exchange. The philosophical argument holds that mandatory rules do not belong in a morally just contract law. We begin with an example that illustrates our arguments.

Consider a common term in contracts for “hard goods” -- machines, computers, lathes: the term obligates the seller to repair or replace defective parts of the tendered product. If, after good faith seller efforts, repair or replacement fails to produce a conforming tender, the defect risk shifts to the buyer: it must pay the price or pay damages for rejection. This clause creates a “restricted” return policy. There is a possible alternative term, under which the buyer would be entitled to cancel the contract and to the return of any monies paid, if repair or replacement failed. This term would create a “loose” return policy.

Under the restricted return policy, the buyer bears the defect risk, which we denote “Γ.” The seller’s cost of product returns is zero (there are no returns). Under the alternative loose return policy, the buyer’s risk cost would be zero (the buyer gets its money back) while the seller’s return cost would become “σ” > 0. The seller would have to take products back, lose sales and invest more in return facilities. In a competitive market, price equals cost so the price that sellers would charge for the loose return policy also would be σ.[5] Revealed preference -- the widespread use of the restricted return policy -- implies that the restricted return policy is efficient: the cost to the buyer of bearing he defect risk (Γ) is less than the price sellers would charge for permitting unrestricted returns: that is, $\Gamma < \sigma$.

Nevertheless, a "lawgiver" -- a court or legislature -- believes that a contract which requires the buyer to pay the full price for a useless item is unfair. The lawgiver responds to this fairness concern by requiring *every* contract for hard goods to contain the mandatory rule "X_R", which would require sellers to offer the loose return policy.[6] Note that sellers have an incentive to avoid X_R because the higher price reduces demand and buyers would accept a restored restricted return policy because their purchase costs would be lower.

A seller could escape X_r's impact by adopting term "q," which would replicate the economic effect of the strict return policy. For example, q would define compliance as substantial performance or would reduce warranty coverage, both of which would shrink the buyer's legal basis for a return; or would require returns to be to a factory far away, which would deter returns. Under any of these versions of the replicating q term, the seller's cost of product returns again would approach zero. The seller, however, would incur a contracting cost for creating and adopting the q term, which we denote "c(q)".

We suppose that two markets for selling hard goods exist. In one, the sellers are large firms who contract frequently. These firms have an apparatus for understanding and creating contract terms (a legal department, etc.), so their marginal contracting cost for escaping rule X*r* by adopting the q term would be the low $c(q_L)$. These sellers would adopt that term when the contracting cost would be lower than the loose product return cost: that is, when $c(q_L) < \sigma$. We assume that this inequality is satisfied for many sellers in the large firm market.

The other hard goods market is populated with small firms such as hardware stores, mini-marts that sell toasters and portable air conditioners, local electronics stores and the like.

[5] The intuition this example captures is not limited to competitive markets. The intuition also holds when there is ex-ante competition but the parties' relationship becomes a bilateral monopoly after they contract. *See* Oliver E. Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 241 (1979) (describing transactions in which the relationship between the buyer and seller transforms from ex ante competition to ex post bilateral monopoly because of transaction-specific costs).

[6] See UCC §2-719(2) and Comment 5, which puts the risk of a failed repair or replace term on the seller.

These sellers seldom have a "contracting capacity," such as a legal department, in place. Hence, they could not create and adopt a replicating q term without retaining lawyers, educating themselves about the legal aspects of a loose return policy (warranty claims, etc.), and so forth. The small market sellers' contracting cost for adopting a replicating q term thus would be $c(q_H)$, which would be higher than $c(q_L)$. We assume the following inequalities hold: $c(q_H) > \sigma > c(q_L)$. Thus, many sellers in the small firm market would let X_R stand, and charge buyers σ for the convenience of returns.

To summarize, (a) buyers from low contracting cost sellers would remain effectively bound by the restricted return policy and would pay a price increase that equaled the sellers' contracting cost for adopting the replicating term q: i.e., $c(q_L)$; (b) buyers from high contracting cost sellers would benefit from the legally mandated loose return policy but would face a price increase that equaled the cost of the loose return policy-- σ; (c) this price increase would be lower than the price the high contracting cost sellers would have charged had they adopted term q: i.e., for contracting around the mandatory rule X_R; (d) the price increases X_r induces in both markets would cause marginal sellers to exit and others to charge higher prices. Marginal buyers from those sellers thus also would exit and other buyers would realize less surplus from a purchase.

This example suggests five lessons: First, mandatory rules reduce agents' *autonomy* by raising the cost to the agents of pursuing their commercial projects. The autonomy loss is more severe for less experienced parties, some of whom may be prevented from pursuing particular projects altogether.

Second, the lawgiver would have to make its rule mandatory because revealed preference -- prior widespread commercial practice -- implies that parties would contract out of a loose return default. Because persistent commercial practices usually are efficient (absent externalities), the mandatory rule Xr would be inefficient.

Third, mandatory rules are *regressive taxes* on commercial contracts, increasing all parties' costs but bearing most heavily on smaller, less experienced parties.

Fourth, from the lawgiver's point of view, X_R would have a random impact. Compliance would importantly be a function of seller contracting costs, which do not bear any relation to the policy of liberalizing product returns. In addition, the lawgiver -- especially a court -- is unlikely to know the magnitude and size of the many contracting and return costs that exist in a large commercial economy. Hence, the lawgiver is unlikely to know just whom X_R binds. A contract law with unpredictable mandatory rules -- that is, our law -- must function arbitrarily.

Fifth, the lawgiver could increase compliance with rule X_R by banning likely versions of the replicating q term. But that would abandon the freedom of contract principle that permits parties to adopt any substantive term. Contract law today, however, is committed to implementing particular policies with mandatory rules and also is committed to substantive freedom of contract. Thus, contract law is *incoherent.*[7] In this Article, we show that these five lessons hold generally. .

B. A Roadmap

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

Part II shows that mandatory rules have an arbitrary and unjust incidence, their real-world impact turning largely on factors unrelated to the substantive policies that animated the rules' adoption. The most important such factor is the parties' contracting costs; these largely determine which parties a mandatory rule constrains and which parties remain free. Part II's justice claim appeals to the common intuition that rules which disproportionally disadvantage the unsophisticated and the economically weak are unfair.

[7] These lessons apply beyond contract law. For example, a widespread term in installment or long term sales contracts prior to 1978 permitted the seller to exit if the buyer filed for bankruptcy or incurred material liens. The 1978 Bankruptcy Code made this term unenforceable: a buyer who filed could "assume" the contract if it gave assurances, acceptable to the bankruptcy court, of future payment. See Yeon Koo Che and Alan Schwartz, "Section 365 and Inefficient Continuance", --- JLEO--- (1999). This mandatory rule (i) reduced parties' autonomy by raising the cost of procurement contracts; (ii) by revealed preference (and theory) was inefficient; (iii) was regressive, bearing most heavily on smaller suppliers; (iv) its incidence in a large economy is impossible for the legislature to predict so the rule functions arbitrarily; and (v) given suppliers' control over other terms, contributes to bankruptcy law's incoherence.

Part III bolsters this intuition initially by arguing that Rawls' concept of justice as fairness cannot support legal rules that disproportionally impose costs on the less advantaged. Part IV then considers agent centered moral theories. The regnant view is that these theories support the mandatory rules we oppose. In particular, it is believed that courts should (i) control remedies because otherwise the strong could impose remedy terms that exploit the weak;[8] (ii) control interpretation because otherwise the strong could impose duties (or disclaim them) that the weak could not understand;[9] and (iii) control bargaining protocols because otherwise the strong could impose one-sided deals.[10] We show, to the contrary, that when sophisticated agents contract, autonomy and rights theories actually support *increasing* parties' contractual freedom. Part IV makes this claim out primarily by showing that the moral justifications for substantive contractual liberty *also support* procedural contractual liberty. Part V then shows that mandatory rules prevent parties from using welfare-enhancing bargaining protocols that modern contract theory has developed.[11]

Our arguments in Parts II - V support reforming our current state centered contract law.[12] Part VI develops our conception of a stronger form of freedom of contract, which would

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[8] See BENSON, *supra* note 37, at 212-13; *see also* Seana V. Shriffin, *Paternalism, Unconscionability Doctrine, and Accommodation*, 29 PHIL. & PUB. AFF. 205 (2000).

[9] *Cf.* 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).

[10] *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).

[11] It is difficult to derive criteria for deciding concrete cases from normative ethical approaches. Rather, these approaches illuminate basic features of the system, such as how agents have the moral power to create externally enforceable obligations to perform promises. However, to decide a case requires an instantiation of the general moral conception. An apt instantiation should be derivable from every ethical approach but, as Richard Craswell has shown, only welfare consequentialism has provided such derivations. *See* Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 490 (1989). Economic analysis supplies intermediate moral premises because it applies at the micro level, asking whether particular rules (or their application) are efficient or not.

[12] Reducing mandatory rules to defaults would increase the expected return from contracting and so likely increase the number of contracts. The courts' tasks of interpreting and enforcing contracts would increase commensurately. It is not an argument against our views that the court system may be (temporarily) stressed, however. A contract law needs an enforcement arm because parties become reluctant to perform when their circumstances change. Recognizing that enforcement requires coercion dissolves the argument that a freer contract law would make excessive demands on the state. The state today enforces contracts

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.

C. Our Addresses

Reforming contract law is difficult because the benefits would be spread over millions of contracting parties while the costs of lobbying for change would be concentrated. This helps to explain why the institutions responsible for creating private law -- the ALI and NCCUSL --have left the UCC and the Contracts Restatement unchanged since the 1970s.[13] Change, however, is needed: modern business practices are leaving contact law behind.[14] This paper thus is addressed to courts, who created our contract law and could change it; and to scholars, who can create the intellectual momentum for reform.

I. The Domain, the Rules and the Arguments

A. The actors and the domain

We study the transactions of sophisticated parties. These parties exercise "commercial rationality", the sufficient conditions for which include: (i) a capacity for learning; (ii) memory; (iii) an updating belief mechanism; (iv) a knowledge of payoffs; and (v) weak consistency with probability and logic rules.[15] Rational parties (as defined) can access and process information;

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coercively because enforcement makes real the parties' power to choose substantive terms. If the state accorded parties the power to choose procedural terms, the state would have to enforce the resultant contracts coercively as well. The issue, that is, is not whether increasing the freedom to contract would make excessive demands on the state: the issue is whether the state should increase freedom of contract. To be sure, expanding the court system would benefit sophisticated contractors but be paid for by all. This cross-subsidization should be acceptable 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.

[13] See Alan Schwartz and Robert E. Scott, "Obsolescence: The Production Problem in Private Law", __ Colum. L. Rev. __ (2021).

[14] Cite Bernstein, Hart, Schwartz and Sepe, Texas L. Rev..

[15] These conditions are less stringent than those assumed by the rational choice model used in economic theory See Alan Schwartz & Simone M. Sepe, *Commercial Rationality* (Working Paper, 2023) (on file with authors). We use rationality in its epistemological rather than its economic sense. Our concern is with the

make accurate predictions;[16] and solve the economic problems their transactions pose. The parties, however, also are boundedly rational: that is, they have a limited ability to process information. On the other hand, they are aware of this limitation and can pursue protective strategies, such as bargaining for mechanisms that would induce the more informed party to a transaction to reveal its private information.[17] Finally, asymmetric information is common: our parties understand transactions but sometimes are uninformed about the magnitude of the variables that characterize their own deals may take.[18]

Turning to domain, the freedom of contract principle has no role to play in a general equilibrium framework. Markets are complete in that framework, so agents' tasks are limited to exchanging commodities (where any right is a commodity) against prices.[19] The market aggregates the competitive behavior of consumers and producers to determine prices and terms.[20] By contrast, the price system imperfectly coordinates economic actors in the *real world* of incomplete markets.[21] In this world, parties have the freedom to construct their own

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agent's reasoning process and the criteria for what would be a rational change in an agent's beliefs. *See generally* GILBERT HARMAN, CHANGE IN VIEW: PRINCIPLES OF REASONING (1986).

[16] 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, using their rationality).

[17] *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); 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 imposed constraints).

[18] As a borderline example, a new bookstore might not be sophisticated but a bookstore operating for twenty years would be.

[19] 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).

[20] 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). There is a tension between agency and efficient markets: contractors have less agency as markets become more complete. *See* Thomas Christiano & Simone M. Sepe, *Agency and Markets* (working paper, 2023) (on file with authors).

[21] *See* John Geanakoplos, The *Arrow–Debreu Model of General Equilibrium*, *in* THE NEW PALGRAVE DICTIONARY OF ECONOMICS 451 (3d ed. 2018). When the strong assumptions of the Arrow-Debreu 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

transactions. The paradigm nonmarket case is the bilateral monopoly, in which the competitive forces that determine prices and terms are absent. Rather, each party has significant market power, and the economic mechanism that governs their interactions is the bargain. [22]

B. The rules

Contract law rules are in four categories. *Substantive rules,* which parties are free to choose*,* 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; *interpretive rules* specify the evidence that a court may consider when determining what the substantive terms intend; and *remedy rules* specify what a party must pay, or do, if the party breached a substantive term.[23]

Bargaining rules constitute the doctrines that regulate how parties make and enforce contracts, such as "consideration", "offer and acceptance, "indefiniteness" and the statute of frauds. The bargaining rules also regulate conduct, such as the duty to perform in "good faith", to behave "conscionably", not to commit fraud or to exercise duress. The duty of good faith authorizes a court to remedy opportunistic behavior that the parties' contract did not regulate. The duty is mandatory but parties can specify the criteria that guide courts in its application.[24] Duress prohibits a party from exploiting its counterparty's sunk cost investment in order to

(quoting Kenneth J. Arrow & Gerard J. Debreu, *Existence of an Equilibrium for a Competitive Economy*, 22 ECONOMETRICA 265 (1964)).

[22] *See* OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING 32, 43, 63 (1985). Two additional 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 do influence non-market choices to some extent 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

[23] It is customary for commentators to analyze these procedural restrictions independently. For a general treatment, *see* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L. J. 541, 594-609 (2003).

[24] *See* U.C.C. § 1-302((Am. L. Inst. & Unif. L. Comm'n 1977).

redistribute contractual surplus.[25] Finally, doctrine bars no-modification clauses that would prevent parties from updating their contracts to reflect current conditions.

Interpretive rules specify the evidence a court can use to find the parties' intent. These rules are mandatory but vary across jurisdictions. Hence, many parties can use choice of law clauses to select the governing interpretive rules. For example, in New York parties can restrict the evidence a court would hear with a "merger clause."[26] California courts do not enforce merger clauses, but parties can escape California law with a choice of law clause that specifies New York.[27]

Mandatory remedy rules take three forms. First, the principal remedy for breach is the expectation, which requires the promisor to transfer to the promisee a sum that equals the monetary value performance would have had for the promisee.[28] Parties can specify such a sum in their contract, but courts will not enforce specified sums that necessarily or in application require breaching promisors to pay above value.[29] Second, a disappointed promisee may want to compel the promisor to transfer the contract goods or to perform specified services. Courts will not require promisees specifically to perform, nor will they enforce contract terms that require performance. Rather, courts award specific performance only if, in the court's view, the promisee could not reasonably establish the monetary value of

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[25] *See* RESTATEMENT (SECOND) OF CONTRACTS § 89 A (AM. L. INST. 1981). There is a more illuminating way to put this rule. Suppose the promisee had proposed the terms it later wants to add at contracting time. Would the promisor have accepted or rejected them? If the court believes the promisor would have rejected the term initially, the court permits the promisor to reinstate the original contract.

[26] A merger clause tells the court to consider only the written agreement when making an interpretation. For examples of such clauses, see Luther Williams, Jr., Inc. v. Johnson, 229 A.2d 163, 165 (D.C. 1967); and UAW-GM Human Res. Ctr. v. KSL Recreation Corp., 579 N.W.2d 411, 412 (Mich. Ct. App. 1998).

[27] Julian Nyarko, *Stickiness and Incomplete Contracts*, 88 U. CHI. L. REV. 1, 42 (2021) ("Choice-of-law clauses are almost universally adopted, with most law firms including them in over 96% of their contracts."). The interpretive rules might be more difficult to escape than the text suggests. A party may prefer New York's interpretive rules to California's interpretive rules but otherwise prefer California law either because it is familiar or is more favorable.

[28] See Restatement (Second) of contracts § 344 and comment A (Am. L. Inst. 1981).

[29] *See generally* Aaron S. Edlin & Alan Schwartz, supra note ? at 33, 34 (2003) Further, a court, cannot award the expectation remedy unless it can observe the parameters on which the remedy conditions: price, cost, quantity, and value. *See Contract Remedies for New-Economy Collaborations*, 101 TEX. L. REV. 749, 757 (2023). When parties transact in developed markets the price is a summary statistic for these variables (except quantity) but when sellers specialize goods for a buyer there is no external referent: courts must observe value and cost directly to protect the expectation. *Id*.

performance.[30] Third, courts generally will not enforce a term requiring the promisor to compensate the promisee's reliance -- the cost of the promisee's investment in the contract. Rather, courts award reliance damages only when the promisee had relied on a promise that, if accepted, would have created an enforceable contract.

To summarize, parties can choose their contracts' substantive terms subject to two constraints: (a) the terms would not create a negative externality;[31] (b) the terms would not violate widely accepted moral principles, such as those prohibiting the sale of organs[32] or (in many states) the use of a womb.[33] Courts and legislatures create, and courts apply, the bargaining, interpretive and remedy rules: here "the triad". Courts intend the triad rules to be mandatory so that, under American contract law, freedom of contract formally applies only to substance.[34]

C. Our claims

We argue for a generalized freedom of contract (sometimes herein "GFC"). The argument takes a weak and a strong form. The weak form holds that courts (or other private lawgivers) should reduce the law's interpretive, remedy and structural rules -- "the triad" -- to defaults (or repeal them). The claim is "weak" because authority over contracting behavior remains with the state.

The strong form of our claim holds that the locus of control over contracting behavior should shift to private parties. In particular, we (tentatively) argue that commercial agents should be free to create their own contract laws, with the state's role limited to backstopping

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[30] *See* Restatement (Second) Of Contracts § 349 (Am. L. Inst. 1981).

[31] For a general economic discussion of the relationship between freedom of contract and externalities, *see* MICHAEL J. TREBILCOCK, THE LIMITS OF FREEDOM OF CONTRACT 58-61 (1993); *see also* Carl J. Dahlman, *The Problem of Externality*, 22 J. L. & ECON. 141, 141 (1979).

[32] 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.

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

[34] Michael Trebilcock argues that relaxing procedural constraints would infringe on some autonomy values and raise distributive justice concerns. He also raises the possibility that individual preferences may not be primitive but rather socially constructed, see TREBILCOCK, *supra* note 2, at 17-21. Trebilcock, however, considers contracts of all types, including the contracts of unsophisticated parties. We consider only contracts between sophisticated parties.

private enforcement efforts and deciding which sets of agents qualify for maximal freedom.[35] Our primary goal here is to bring to the attention of scholars and lawgivers a view of a largely constraint free contracting world.

Turning to the theoretical basis for these claims, we argue that (a) a normatively unified contract law actually exists but is not recognized as such; and (b) mandatory rules do not belong in the best version of this contract law. Beginning with the first claim, there is a division among courts and commentators regarding what contract law should be. On one side are the philosophers (and other moralists); on the other, the economists (and lawyer economists).[36] 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 persons have to make binding contracts; the freedom they should have; and which contracting restrictions would prevent the exploitation of weaker parties by stronger ones.[37] The economists' paradigm contract is between sophisticated actors such as companies. Economic analyses of contract law use welfare theory to explain or justify the freedom these actors have and should have to make contracts.[38]

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[35] 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. *See* PHILIP HANSON, THE RISE AND FALL OF THE SOVIET ECONOMY 9-10 (2003). Our proposal would lie at the other end of the spectrum.

[36] 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).

[37] *See generally* Charles Fried, Contract as Promise: A Theory of Contractual Obligation 17-21(2d ed. 2015) (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).

[38] The welfare approach to contract law presupposes a commitment to utilitarianism. 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).

The two 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 ethical theories. Corporations are artificial persons who cannot have second order preferences[39] or desires for fully flourishing lives. According to the moralists, welfare economics is a reductive moral theory that ignores important ethical considerations. The contract law articles of both schools pass by each other largely unnoticed.[40]

We show, in contrast, that mainstream deontological theories (including principle-based and right-based theories) and consequentialist moral theories (including welfarism) yield the same version of contract law. This is our claim (a). The generalized freedom of contract we urge would obtain in this legal version. This is our claim (b). In Rawlesian terms, then, we uncover an overlapping moral consensus for extending the freedom of contract principle to encompass the triad rules.[41]

There are three payoffs to this extension. 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. Reducing the triad 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.

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[39] To clarify, an individual's first-order preferences form the basis for their utility function: if I prefer x over y, I assign a higher utility to x than to y. The analyst thus can infer the first-order preferences of market participants by observing market transactions. Second-order preferences are an individual's preferences to have certain preferences: if I prefer to prefer x over y, I therefore am making a normative choice. A more complete discussion of second-order preferences is Saura Masconale & Simone M. Sepe, *Citizen Corp. - Corporate Activism and Democracy*, 100 WASH. U. L. REV. 257, 290 n. 157 (2022).

[40] Parallel to this indifference, some courts would permit promises to recover "gain based damages" -- the promisor's profit from breach; 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).

[41] There are two intermediate positions: a rights-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. The "convergence thesis" is another theoretical approach that would yield contract law unity. To see what this approach entails, define the set of contract law rules as S and consider any particular rule s_i ε S. The convergence thesis holds that if s_i could be implied by a consequentialist theory, it also could be implied by a deontological theory, and vice versa. We do not take a position regarding this claim but rather show that the GFC approach is different: it would open up the contracting space to eliminate mandatory rules that do not internalize negative externalities.

Second, a generalized freedom of contract would contribute to a more efficient American business law. Common law courts make rules in the course of deciding cases. Contracts is a common law field[42] but bankruptcy and corporations are thought not to be. On the definition here, this consensus is incorrect. Insolvency and corporate codes contain few concrete rules and many abstract standards. As a result, courts also make the rules in the course of adjudicating bankruptcies and corporate disputes.[43] Contract law is the legal substructure that unifies these seemingly disparate transaction fields.[44] That contract law applies so broadly implies that reforming it would free parties to make more efficient bankruptcy, corporate, property and other commercial contracts.

Finally, reforming contract law would eliminate a bias toward the "make" of the make or buy decision firms sometimes face. A firm that buys goods on the market invokes contract law's regulatory apparatus, particularly the restrictive triad rules. A firm that makes the same goods in house is free from contract law regulation and so can pursue otherwise banned strategies such as fining a division for poor performance or making a directive to them non-modifiable.

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[42] 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).

[43] 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 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). In Delaware, a corporation is managed by its board of directors, but the Delaware Corporate 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).

[44] To illustrate, every merchant seller must make an implied warranty. U.C.C. § 2-314 (AM. L. INST. & UNIF. L. COMM'N 1977). A party to a preliminary agreement to develop a product cannot recover reliance costs unless its counterparty made a promise that would, if accepted, create an enforceable contract. *See* Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 HARV. L. REV. 661, 673 (2007). A creditor cannot impose a penalty for late payment; and a merger agreement cannot contain penalties and must be sufficiently definite to enforce. *See* 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). And on and on.

II. The Incidence and Effect of Mandatory Rules

A. *Rule types and their application*[45]

Define a legal rule's "incidence" as the effect the rule has on its addressees. To illustrate, let the lawgiver enact rule ω in order to implement policy Y. The extent to which ω successfully implements Y is a function of three factors. The first is the type of rule. As we will see, prohibitions are easier for parties to escape than commands. The second factor is a party's contracting capacity: the party's ability to create privately efficient contract terms. The third factor is the cost that rule ω would impose on a party's sales. The second and third factors differ across firms.

The lawgiver's ability to affect ω's incidence is limited to the choice of which rule type to enact. The lawgiver cannot otherwise affect contracting capacities or selling costs. We thus analyze rule choice here. Note that our lawgiver enacts the illustrative rule ω in isolation. This is common practice but it also is the crucial mistake. This is because it is relatively easy for parties to escape a single procedural term with substantive terms that would replicate the procedural rule's economic effect.

In any event, the lawgiver can choose among four ω versions, all of which pursue the same policy Y, Each version has the same intent but takes a different form.

(i) Parties must comply with version ω_1 unless they choose not to.
(ii) Parties can choose not to comply with version ω_2, but they may only avoid ω_2 in a legally prescribed way.
(iii) Parties must comply with version ω_3.
(iv) Parties cannot use terms that conflict with version ω_4.

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[45] See Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032, 2036 (2012) (offering a general treatment of "altering rules" that regulate how parties can alter or escape legal rules). We focus here on a more specific question, how parties respond to mandatory contract law rules. Leo Katz and Alvaro Sandroni recently proved that, under plausible conditions, any legal system is "manipulable," in the sense that at least some agents can escape any rule. Leo Katz & Alvaro Sandroni, *Circumvention of Law and the Hidden Logic Behind It*, 52 J. LEGAL STUD. 51, 58, 61 (2023); *see also* Leo Katz, *A Theory of Loopholes*, 39 J. LEGAL STUD. 1 (2010) (pioneering studies in this area). Our results are consistent with the Katz and Sandroni thesis. A few commentators have recognized that parties can escape some mandatory rules by changing contracting strategies. *See* Alan Schwartz & Robert E. Scott, *Obsolescence: The Intractable Production Problem in Contract Law*, 121 COLUM. L. REV. 1659, 1679-80, 1697-1702 (2021).

B. *Party responses to these rule versions: the transformation operator*

Rule version ω_1 is a "simple" default; rule ω_2 is a "sticky" default because it is nontrivially more costly than ω_1 for parties to contract away from; and rules ω_3 and ω_4, the mandatory versions, are increasingly and significantly more costly to escape. To understand possible party responses to these rules, let T be a "transformation operator" that maps a legal rule ω to the parties' contracting response k: formally, T: $\omega_i \mapsto k_I$ where the term to the left of the double arrow indexes the four rule versions -- $i\ \varepsilon\ \omega_1\ \dots\ \omega_4 --$ and the term to the right indexes the corresponding contractual responses $\{i\ \ \varepsilon\ k_1\ \dots\ k_4\}$. To illustrate,

> T: $\omega_1 \mapsto k_{1.}$ Rule ω_1 requires the seller to warrant its product: k_1 is a warranty disclaimer.
> T: $\omega_2 \mapsto k_2$. Rule ω_2 requires the seller to warrant: k_2 also is a warranty disclaimer, but it must be cast in legally required words and be conspicuous.[46]
> T: $\omega_3 \mapsto k_3$.: Rule ω_3 requires the seller to warrant. The seller cannot disclaim the warranty but could use response k_3, which would be to raise the price, or alter other terms, to offset the warranty's effect.
> T: $\omega_4 \mapsto k_4$. Rule ω_4 prevents parties from limiting the remedies for a warranty breach.[47] Response ω_4 requires the buyer to accept repair or replacement as a substitute for damages or rescission.[48]

Transformation operators function by enabling parties to *substitute* unregulated substantive terms for regulated procedural terms. Whether a firm has access to the transformation operators that would permit it to implement responses to the four rule types primarily depends on the firm's contracting capacity. A large market firm's contracting capacity

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[46] *See* U.C.C. § 2-316(2) (Am. L. Inst. & Unif. L. Comm'n 1977).
[47] See U.C.C. §2-719(2) requiring there to be a adequate remedy for a breach of warranty.

[48] See U.C.C. §2-508 (permitting cure). Two further examples may be helpful. The U.C.C. prohibits parties from contracting out of the duty to act in good faith but the Code permits parties to specify the standards a court should apply when adjudicating alleged breaches of the duty. Parties thus can control how the duty will affect them. The U.C.C. (and the common law) prohibits parties from using penalty terms, 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 avoid the penalty prohibition, see Kraus and Scott, supra note ?, at 1368-69.

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. [49] A small market firm's contracting capacity consists of the experience of its owner (such as it is), and not much more.

Creating a contracting capacity is a fixed cost; using a transformation operator to respond to a rule is a variable cost. The greater a firm's contracting capacity is, other things equal, the lower is the variable cost of using a transformation operator. [50] To formalize the relation between legal rules and contracting costs, arbitrarily denote the fixed cost for creating and maintaining *any* contracting capacity "F." The variable cost of escaping a mandatory rule is a function of F and the rule type ω_i: we write variable cost as $C_{\omega i}$. [51] As shown above, it is cheap -- the variable cost is low -- for parties to disclaim rule version ω_1; more costly for parties to disclaim rule version ω_2; more costly still for parties to offset the effect of rule version ω_3 with substantive terms; most costly of all for parties to replicate the effect of using the version ω_4 term by using substantive terms to change business pactices.[52] We summarize the relationships among these responses for any fixed cost F as follows: $C_{\omega 1}(k_1) < C_{\omega 2}(k_2) < C_{\omega 3}(k_3) < C_{\omega 4}(k_4)$.

Applying this analysis to a case, let the lawgiver enact an ω_2 disclaimer: the disclaimer must be conspicuous, use specified words, be explained to buyers individually and so forth. A small market firm -- an individual proprietorship, say -- is likely to have a modest contracting capacity. This firm would have to incur substantial startup costs to respond to the rule: to learn about disclaimers, to consult lawyers, to adopt a new form contract. The large market firm would have already incurred the fixed costs of setting up contracting and legal departments. This firm thus would incur only the variable cost of complying with a sticky disclaimer. Thus, the large market firm is less likely to warrant (and bear warranty costs) than the small market firm is.

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[49] *See* Alan Schwartz and Simone M. Sepe, *Contract Remedies for New-Economy Collaborations*, 101 TEX. L. REV. 749, at 766-767 (2023) (describing in detail the "contracting technology" of big firms such as Cisco System Inc.).

[50] More completely, variable contracting costs include deriving the accurate replicating substantive terms, adjusting other terms to accommodate to the new substance and creating the modified contract.

[51] The notation for the cost function $C_{\omega i}$ indicates that the form of the cost function concerning provision k_i may differ from that concerning a provision k_j, where $j \neq i$.

[52] Remedy rules usually are either ω_3 or ω_4 types, which are the most costly to escape.

Now we can state our result. The extent to which a contract law rule binds -- its actual incidence -- is largely a function of firms' contracting capacities. These vary materially across firms and do not bear a necessary relationship to the policy that animated the rule's adoption. Hence, mandatory rules *bear unequally* on parties and *function arbitrarily.*

We make three summary remarks.[53] First, 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 selling costs.

Second, mandatory rules disproportionally bind the small, occasional players. Sellers in the less experienced market lose a greater portion of customers, because of the relatively high prices they must charge, than the sellers in the more experienced market lose; and buyers from the less experienced sellers incur higher purchase costs than the buyers from the more experienced sellers incur. Also, some buyers in the small firm market may switch to the large firm market (from the local appliance store to the department store). Mandatory rules thus permit large firms to exploit their technological advantage in contracting to maintain and enhance their market positions.[54]

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[53] There is a possible, though unpersuasive, counter argument. Assume: (i) There is a set of avoiding terms q_a that are costly to discover but easy to copy; (ii) terms in q_a apply without serious modification in a wide variety of contexts; (iii) firms with weak or no contracting capacities can follow the contractual innovations of the larger firms. Then the small market firms could use the innovations -- the q_a -- the large market firms developed. As a result, the larger firms benefit from being first movers regarding the q_a terms but their advantage will dissipate. Assumptions (ii) and (iii) are strong, however. Contracting innovations often are context dependent, and so are attended with adaption costs. Firms with weak contracting capacities likely cannot bear the adaption costs. Also, such firms are unlikely to follow the contracting practices of larger dissimilar firms. As a result, contracting innovations are unlikely to diffuse quickly to the small market firms

[54] A mandatory rule could also have perverse effects. 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 version ω_2 that regulates disclaimer form. The lawgivers intend accident costs to be spread 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 terms that replicate the disclaimer than the buyers from small firms because it is less costly for large firms to escape 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.

Regarding our third remark, a contract theory result holds that when asymmetric information materially reduces the efficiency of market contracting, the economic agents' best response is to vertically integrate.[55] The cost to agents of monitoring each other usually are lower within firms and information flows are more efficient there.[56] Consider this possibility:

> T: $\omega_{\#} \mapsto I_{\#}$, where # stands for a strong mandatory rule and I for vertical integration. This is a different response than k, which indexes contracting responses.[57]

It is more costly for parties to create a new business structure than it would be to contract around any particular rule. Therefore, when the cost to parties of contracting around rule $\omega_{\#}$ would exceed the gain, the cost to parties of integrating vertically to escape rule $\omega_{\#}$ *also* would exceed the gain. Vertical integration thus may be a plausible response to asymmetric information that creates contracting constraints, but it is not a plausible response to mandatory rules that create contracting constraints.[58] The theoretical result is that an inescapable mandatory rule $\omega_{\#}$ could exist. No such rule has been identified.

To summarize, a business contract law supports transactions. A lawgiver sometimes may want to implement a policy with a mandatory rule that takes precedence over the law's facilitative role. Part II shows that this is a poor institutional choice: mandatory rules function

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[55] *See* Sanford J. Grossman & Oliver D. Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986) at 691-719 (modeling the firm as a set of contracts and discussing how vertical integration can mitigate issues related to incomplete contracting); 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).

[56] Firms can implement mechanisms to monitor agents that are typically more challenging to execute in markets. See Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386-405 (1937).

[57] $\omega_{\#}$ is a rule belonging to a generic set of provisions, including *I*, because vertical integration, I, is a theoretical response to any set of contractual provisions; however, we consider integration as a plausible response to mandatory or strong mandatory rules (i.e., $\omega_{3 \text{ or }} \omega_4$).

[58] {I suggest deleting this note.} This analysis, however, only captures part of the relationship between vertical integration and mandatory triad rules. Even under the availability of transformation operators, the assumption that contracting around any particular rule is less costly than vertical integration does not go unqualified. Mechanism design studies have shown that theoretical contractual mechanisms exist to solve the obstacles that unverifiable information create. As we shall see in Part V.A.1, however, these mechanisms are *unfeasible* under current mandatory procedural rules, leaving vertical integration as the only solution available to parties. Thus, on the one hand, a key motivation leading parties to choose vertical integration might be their inability to evade procedural terms. On the other hand, if parties had the option to fully dispose of these procedural rules, they would prefer these contractual solutions over vertical integration.

arbitrarily, largely ineffectively, and unjustly. This justice claim, however, does not rest on deep moral foundations. Rather, we infer injustice from the common intuition that unequally applied rules which disproportionally disadvantage the economically weak are unfair. Parts III and IV argue that this justice claim finds foundational support in distributional and moral theory.

III. Equality and Opportunity

In moral theory, equality is used in two senses: in the distribution of resources and in the distribution of opportunities. Commentators often use equality in its distributional sense to support contracting restrictions. The duress doctrine and the duty of good faith, for example, supposedly redress power imbalances between contracting parties, thereby facilitating a more equal division of contractual surplus.

Using contract law to remedy distributional inequalities is unwise for two reasons. First, a new mandatory rule can shift surplus between parties to existing contracts by altering the terms to one party's advantage. But because single rule changes cannot affect relative bargaining power between similarly situated future parties, the new rule would have no other impact. The party whom the rule would disadvantage would replicate the prior surplus distribution by altering the price or other terms. Second, attempting to alter the distribution of resources with contract law rules is incompatible with the principle of the division of institutional labor.[59] This principle holds that the state should specialize policies to institutions because each institution best pursues different social goals.[60] Thus, states commonly use legislatures to implement distributional preferences; agencies to oversee grants and subsidies;

[59] *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.) For an egalitarian approach to the principle of the division of labor, see Thomas Nagel, EQUALITY AND PARTIALITY, Ch. 6,9 (1991); for an economic approach, see LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002). *But see* Liam M. Murphy, *Institutions and the Demand of Justice*, PHIL. & PUB. AFFAIRS 251, 257-264 (1998) (criticizing Rawls' division of labor).

[60] While Rawls does not make explicit the exact roles of these institutions, we argue that private law and contract law fit within this framework. *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).

and antitrust law to protect competition.[61] Private law's comparative advantage is to pursue justice as equality of opportunity.

But mandatory contract law rules undermine equality of opportunity because parties have different access to the transformation operators that enable them to escape a mandatory rule's impact. Rawls' second principle of justice implies that such a disparate opportunity to contract is unjust.[62] 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*);[63] and (b) attached to offices and positions open to all under conditions of fair equality of opportunity (the *Equality of Opportunity Principle*).[64] Mandatory rules that only bind some parties violate the *Equality of Opportunity Principle* in the commercial domain. The constrained parties could not construct their own contracting paths. As our introductory example showed, GFC, by prohibiting mandatory rules, would extend this opportunity to economically weaker small market firms.

Mandatory contract law rules also violate the *Difference Principle*: the rules disadvantage the worst-off commercial parties by restricting these parties' ability to pursue their contracting goals.[65] Generalizing freedom of contract would increase equality under the

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[61] 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. Hence, the division of labor principle requires no exceptions or modifications for them.

[62] *See* RAWLS, *supra* note 59, 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).

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

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

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

Difference Principle because it would empower the worst-off commercial parties to make contracts that otherwise would be unfeasible for them.

IV. Autonomy and Rights

Moral theories that focus on freedom also support relaxing or repealing the triad rules, whether freedom refers to an agent's autonomy to choose,[66] or refers to the exercise of the agent's rights.

A. The Autonomy Claim

a. Autonomy and moral parity

Autonomy consists in an agent's ability to realize self-authorship.[67] An autonomous agent's freely chosen acts necessarily reflect her self-authorship because acts implement preferences and these are the outcome of the agent's own considerations.[68] Turning to our subject, parties have preferences over contract terms, whether those terms are procedural or substantive. The triad rules obviously reduce autonomy by prohibiting parties from choosing their own procedural terms. [69]

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[66] "Autonomy" is a term of art which characterizes common moral, political, and social ideals. The ideals hold that there exists a "notion of the self which is to be respected, not manipulated, and which is, in important ways, independent and self-determining." GERALD DWORKIN, THE THEORY AND PRACTICE OF AUTONOMY 11-12 (1988). 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 holds that autonomy is increasing in the relevant options available to the agent (until bounded rationality becomes a constraint).

[67] 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 thus is one who acts on her own motives.

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

[69] 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 version of autonomy a society must be based on tolerance and permit freedom of association

This restriction is arbitrary as well as obvious because the freedom of contract principle permits parties to pursue their substantive preferences. The principle should also permit parties to pursue their procedural preferences because their pursuit in both contractual domains would exhibit the *same* deontic power. This is a *similarity argument,* which holds that if moral parity should govern transactions, the triad rules arbitrarily reduce autonomy. [70] This implication rests on two premises:

1) Contract terms that are enforceable under substantive freedom are on a moral parity with procedural terms that parties would adopt were they legally free to do so.

2) Contract terms that substantive freedom permits are enforceable.

These premises imply that:

(3) Contract terms that procedural freedom would permit also should be enforceable in consequence of the term types' moral parity.

The first premise rejects a common moralist concern about expanding freedom of contract: it would allow parties to agree to disadvantageous procedural terms as a result of insufficient reflection or unequal bargaining power. For example, a party might agree to ruinous penalty damages because they are temporally myopic. Parties, however, also can use substantive terms to ruin themselves through shortsightedness or desperation for a deal. Absent mistake or coercion, courts will enforce substantively one sided contracts. The substantively unappealing cases, however, are morally similar to the procedurally unappealing cases that repealing the triad rules may produce. The moral power that parties would exercise to create legally enforceable obligations under both types of contractual freedoms is the same.[71]

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 knowingly consented to undertake. Under the two premises, then, the

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

[71] To put this another way, there is a *discontinuity* in the legal autonomy that contract law grants to parties concerning substantive and procedural terms -- a discontinuity which is not justified by differences in the parties' exercise of deontic power.

similarity argument holds that the lawgiver should permit party autonomy regarding procedural terms.[72]

This result challenges the view that party autonomy in the commercial domain is preserved as long as the state provides a wide range of contracting forms for parties to choose among. [73] The "choice theory approach" erroneously assumes that costs do not affect an agent's contractual choices. To the contrary, autonomy shrinks as contracting costs increase.

It would be a mistake, however, to conclude that a mandatory rule does not reduce the autonomy of parties who can preserve their deals by adopting replicating substantive terms. A mandatory procedural rule *always* restricts the exercise of an agent's "first order autonomy" -- to achieve her contracting goal with the terms she prefers. The rule also imposes a cost on the agent for exercising her "second order autonomy"-- to achieve her goal with the more costly substantive terms. Procedural constraints thus reduce autonomy over-all: for parties that have to forego their goals altogether -- for example, because they are occasional contractors-- and for parties that can pursue their goals only at increased cost.[74]

To sum up, we make a straightforward argument that autonomy "on the ground" increases in the degree of *cost-justified control* the agent can exercise over her contracting affairs. Mandatory rules arbitrarily reduce that control. Autonomy arguments in favor of extending the freedom of contract principle recently have received serious criticism,

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[72] Note that 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 (ii) 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 permitted.

[73] *See* DAGAN & HELLER, *supra* note?, at 72 (arguing that agent autonomy is preserved if agents have a choice of relevant contract terms.)

[74] The higher transaction costs parties incur through transformation operators could serve as a screening device to sort parties. Under this view, those who can shoulder higher transaction costs would require less legal protection. A party's contracting technology is irrelevant to the party's moral power to enter into enforceable contracts, however.

however.[75] We respond next to the most serious objections and address a putative qualification to every autonomy claim. The first serious objection is that the conditions for truly autonomous choice seldom exist in a modern market 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 to the exercise of private power that would violate the state's moral norms. The 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 that the agent could not have foreseen, *even if* the contract 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 autonomy.

b. The relational egalitarianism objection

This objection holds that parties' choices are authentically autonomous only when made under "relational egalitarianism," a political condition that cannot exist when some members of a polity face "hierarchies of power, esteem and standing." [76] Such hierarchies obviously exist in market economies, but they do not preclude autonomous choices. To see why, realize that contracting parties have two tasks: to choose surplus maximizing terms and to divide the contract's expected surplus between them. Parties can affect the former choice but not the latter. Surplus division 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. Thus surplus splits are exogenously determined. Parties can exercise autonomous choice only with respect to the terms.

[75] Trebilcock suggests that the difficulties in meeting the conditions for voluntary choice sometimes warrant a paternalistic intervention. *See* Trebilcock, *supra* note?, at 147-148. Among these difficulties are cognitive incapacity, choices that do not reflect underlying preferences, and the endogeneity of particular preferences. *See id*., at 150-158. These reasons do not apply to the sophisticated parties we consider.

[76] *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 n*, *Accomodation* 29 PHIL. & PUB. AFFAIRS 205 (2000); Hanoch Dagan & Avihay Dorfman, *Justice in Private: Beyond the Rawlsian Framework*, 37 LAW & PHILOSOPHY 171, 171 (2017).

Power imbalances in a society do not affect these choices. Because all parties prefer more to less, all parties would prefer the terms that maximize surplus. Small shares of large pies are preferable to small shares of small pies. As a consequence, absent fraud or coercion the contracts of sophisticated parties reflect their autonomous choices. [77]

c. The state's moral agency objection

This objection rests on two premises. First, because parties require the service of the state to enforce contracts, the state and the parties necessarily are partners in conducting commercial contracting.[78] Second, partners have a say in how a partnership functions.[79] Together these premises imply that a state's refusal, for moral reasons, to ban or regulate a procedural term reflects the deal between partners rather than one partner overriding the other partner's will.[80]

This objection falls because providing a service, in the common understanding, does not make the service provider a partner of its customer. Unlike partners, a service provider has no say in how the customer 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

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[77] We state this argument formally. 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 payoffs are $U_A(K_m) = \alpha S_m$ and $U_A(K_n) = \alpha S_n$. Because utility is increasing in payoffs, $U_A(K_m) > U_A(K_n)$ if $S_m > S_n$. Similarly, party B's possible payoffs are $U_B(K_m) = (1-\alpha)S_m$ and $U_B(K_n) = (1 - \alpha)S_n$ with $U_B(K_m) > U_B(K_n)$ if $S_m > S_n$. 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.

[78] *See* Shiffrin, *supra* note?, 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.").

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

[80] *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.").

what the person watches. Similarly, the public utility can regulate use during peak periods but not what the customer puts in the refrigerator.

More deeply, the claim that the state can leverage its enforcement power to affect terms in private contracts rests on a conceptual mistake. The state cannot enforce a contract without defining the elements that constitute the entity "contract". Today, there must be consent, comprehensible terms, a minimum remedy and so forth. But there is a countably infinite set of terms that are consistent with this conception of a contract. Similarly, the state cannot protect "property in rem" without specifying the elements that constitute the entity "property". There must be a right to exclude, a clear title, a definition of boundaries, and so forth. But there is a countably infinite set of uses that are consistent with this conception of property. The state's power to *define* what it wants to enforce or protect therefore cannot of itself support the implication that the state is a partner in private parties' commercial ventures.

d. The new equity qualification

The "new equity" school supposes that a promisor cannot foresee every possible future state in which its contract would literally apply. A good faith promisee would enforce the contract in unforeseen states only if that would be efficient. A bad faith promisee would enforce the contract if that would yield it a higher payoff than renegotiating to a more equitable split. A court should use its equitable powers to rescue the promisor from such promisee "opportunism."[81] These rescues do not compromise the freedom of contract principle because a promisor does not consent in fact to counterparty actions taken in circumstances the promisor did not anticipate, even if the contract permits those actions. Therefore, relaxing mandatory procedural rules would create an opportunism risk. For example, an owner could enforce a penalty for late performance against a contractor, though lateness was caused by an unforeseen foreign conflict that interdicted a supply chain.

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[81] *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).

The new equity qualification of the autonomy argument for GFC is unpersuasive because an action can be unforeseeable in two senses and the qualification proponents focus on the wrong one. A party can fail to foresee a particular counterparty action *but* the party could foresee that its counterparty would enforce the contract whenever enforcement would be to its advantage. It is the latter sense of "foresee" that is relevant to contractual interpretation because a promisee with this knowledge could bargain to restrict its counterparty's rights. Hence, courts take the sophisticated agent to consent to the exercise of every contractual power it does not bargain to qualify.[82] As a commercially significant example, courts enforce a contractual index in a long term contract even when the index fails: that is, generates prices, costs or quantities that fall outside their expected ranges.[83]

To support the courts' view, suppose that at contract time there exists a set Θ of 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. For states in subset Θ_1, the promisee prefers to perform the contract because performance would be efficient. For states in the complementary subset Θ_2, (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 though breach caused little harm).

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 our illustrative case, the answer would be no. Therefore, an *equitable interven*tion is only needed in case (b) because the duty of good faith does not prohibit authorized contractual actions.

When sophisticated parties contract, they know that there always exist Θ possible future states, and that their contract would be profitable to perform in a subset of those states

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[82] Here we expand Kraus and Scott's argument that parties consent to the complete extension of every term in their contract. *See* Kraus and Scott,

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

(the Θ_1 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_2. A sophisticated promisor therefore faces a risk when it lets an unqualified contractual power stand. The risk exists because at least one of the states that constitute Θ_2 occur with positive probability and the promisee *foreseeably* would enforce the contract *whenever* enforcement would benefit it. A promisor therefore would remain silent regarding the strategic enforcement risk only if it had been paid to bear it, usually in the form of a lower price.[84] This is why courts take silence in face of a risk to constitute consent. Another way to put this conclusion is that, in sophisticated contracting situations, the set of cases in which equity should be called on to prevent "opportunism" is empty.

To summarize, we showed that a contract law committed to autonomy would demote the triad mandatory rules 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 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 (the promisor ex ante consents to enforcement in those states).

B. The Rights Argument

Moral theories that protect rights support generalizing freedom of contract. The most important rights theory, Nozick's entitlement theory of justice, is illustrative.[85] The theory holds that individuals have inherent rights that are prior to their social and political rights.[86] Prior

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[84] Rational parties price terms based on the probabilities they attribute to particular states occurring and the payoffs they expect in each of them. But even if parties do not perfectly follow the rational choice model, they can still do better than courts in imprecisely pricing risk ex ante. This is because the court's ex post pricing always comes at the price of distorting ex ante incentives. Thus, it should be up to parties to choose whether to accept the risk of ex ante mispricing against ex post possibly more correct court pricing. The latter equitable power distorts the parties' ex ante incentives. *See* MAS-COLELL ET AL., *supra* note 19, at 168-78.

[85] *See* Robert Nozick, Anarchy, State, and Utopia 150-53 (1974).

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

rights include the right to life, liberty, property and to control one's life.[87] The right to control implies the right to contract because contracts facilitate agent control.

The entitlement theory follows from two principles. First, the *Principle of Justice in Acquisition* concerns the initial acquisition of holdings. It provides an account of how people first come to own unowned natural resources and property, including produced resources.[88] Second, the *Principle of Justice in Transfer* holds that agents justly own something if they acquired it through a voluntary transfer from someone who rightfully owned it herself; that is, through trade and gifting. An agent's trades are legitimate when three conditions are satisfied: (i) each party had the opportunity to participate in a trade or decline; (ii) the property transferred had been justly acquired; and (iii) a transfer does not violate the rights of others. Under entitlement theory so understood, mandatory contract law rules *are unjust* in the pre-political world. They constrain parties' ability to trade even when the three legitimating conditions for voluntary exchange are satisfied.

Sophisticated agents' unconstrained freedom to trade, in Nozick's theory, survives the creation of a civil society. Nozick envisions a minimal state in which individuals form "protective associations" to safeguard their rights.[89] Over time, these associations merge and grow into a "dominant protective association," which is the state.[90] The state-association's role, however, is restricted to protecting individuals from force, theft and fraud, and to enforce contracts that

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

[88] *See id.* at 151. 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.

[89] *See* NOZICK, *supra* note 85, at 12.

[90] 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.

satisfy the three conditions.[91] We especially stress that our argument for relaxing the triad rules is restricted to contracts not attended with negative externalities.[92] And the sophisticated contracting parties we consider would not make contracts that could harm themselves.[93]

To summarize, our moral arguments for GFC hold that agent centered moral theories, properly read, dissolve the current distinction between substantive contract terms (freedom reigns) and procedural contract terms (constraint reigns). More particularly, we argue that the triad rules are unjust because they violate the equality of opportunity principle, unfairly restrict agents' autonomy and unjustifiably restrict their right to contract. These moral arguments raise the question whether an economic justification exists for the triad procedural restrictions that can overcome the non-consequentialist case for relaxing them. Part V below argues not. [94]

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[91] 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.)

[92] 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. These limitations stem from legal institutions which aim to safeguard the interests of non-contracting parties.

[93] GFC also is consistent with a principle-based (i.e., non-libertarian) approach to freedom of contract. In particular, Rawls is authoritative in the (possibly nonexistent) 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. 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 59, at 53. Although contracts, particularly those involving the means of production, are not a basic liberty, 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 private associations (including dyads), when constructed appropriately, can ensure equal opportunities for agents to pursue shared goals regardless of the agents' personal characteristics.

[94] Another advantage of GFC; it is consistent with virtue ethics. 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 expanding the opportunities for commercial experimentation, GFC would accord agents more scope 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* Saura Masconale & Simone M. Sepe, *Moral*

V. The Contract Theory Case for Generalizing Freedom of Contract[95]

A. *Optimization and incentive theory*

Two economic constraints may prevent parties from making efficient contracts. The triad rules harden these constraints and so reduce the efficiency of market contracting. The constraints are the "participation constraint" and the "incentive compatibility constraint".

The participation constraint holds that an agent would not make a contract unless she would be at least as well off under it as she would have been under her next best opportunity. The triad rules make this constraint more difficult to satisfy because each of them reduces parties' expected gains below what their gains would otherwise have been. [96] Thus the rules reduce the number of efficient contracts a market could sustain.

To begin, the mandatory interpretation rules attempt to implement the courts' goal of making the most accurate interpretation. A court that pursues this goal is receptive to the admission at trial of all material evidence relevant to intention. Anticipating this preference for accuracy, parties write detailed costly contracts in order to make trials manageable affairs. [97] Parties, however, would prefer to make their own tradeoffs between the cost of informing courts and the cost of a less accurate interpretation. The mandatory interpretation rules

Capitalism, Ethical Shareholderism and Social Cohesion, SOC. PHIL. & POL. (forthcoming 2023) (manuscript at 5-6) (examining the relationship between the *doux-commerce* thesis and the recent rise of moral capitalism).

[95] We are primarily concerned with nonmarket transactions such as the bilateral monopoly. Introducing a mandatory rule in a competitive market would cause marginal sellers to exit and infra marginal sellers to raise prices. The marginal buyers from the exiting sellers also would exit while their infra marginal buyers would purchase elsewhere but incur switching costs. Technically, mandatory rules move the economy further away from the Pareto frontier: some efficient allocations that would be feasible without mandatory rules are no longer achievable once these rules are introduced. *See* MAS-COLELL ET AL., *supra* note 19, at 312-3.

[96] A basic canon of optimization theory holds that the optimizing function cannot have a higher value under a particular constraint than it would have if that constraint were removed. *See generally* RANGARAJAN K. SUNDARAM, A FIRST 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).

[97] See Schwartz and Watson (2015).

preclude this tradeoff and so raise contracting costs. This makes the participation constraint more likely to bind

Restrictions on remedies also reduce a contract's expected return. Penalties can induce parties to reveal private information to counterparties and to the court. In these schemes, parties tell the truth in equilibrium because deviations that are found out are punished. Because contacts are more efficient when based on more complete information, the ban on penalties also hardens the participation constraint.

As another example, parties use no-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 the agent to make an optimal effort. *After* the agent invests, the agent still bears risk when a contract's return also is a function of economic circumstances. Therefore, a Pareto improving deal arises under which the agent, after investing, is paid a fixed sum (lower than her expected gain) and the remaining risk shifts to the risk neutral principle. But anticipating that her compensation is fixed, the agent makes a suboptimal effort. Parties would use no-modification clauses to preclude these ex post efficient deals, and thereby keep risk on the agent. Banning the clauses thus reduces the parties' expected return.

Regarding the "incentive compatibility constraint", a party sometimes cannot observe whether its counterparty performed tasks the contract assigned to her. As a consequence, the counterparty has an incentive to take the privately efficient action, whether it is the specified action or not. A party, however, can anticipate that its counterparty may inefficiently shirk, in consequence of which the contract would return a smaller surplus. When the reduction is material, the incentive compatibility constraint would bind: the parties either would not contract or would make a less efficient deal. [98]

An efficient contract would induce each party to take only optimal actions, whether the counterparty could observe those actions or not. We provide a realistic example of shirking, and then show how the triad penalty rules prevent parties from responding efficiently to it. Consider a transaction in which the buyer can invest to increase expected surplus. If circumstances were to change, the parties could renegotiate to the ex post efficient deal.

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[98] For a technical overview of this problem, *see* PATRICK BOLTON & MATHIAS DEWATRIPONT, CONTRACT THEORY 560–78 (2005); SALANIÉ, *supra* note ? at 122.

Because the price is fixed, the buyer would have to share expected surplus with the seller to obtain the seller's consent. As a result, the buyer would optimize against a fraction of the expected surplus, rather than all of it, and so would underinvest.[99] A contract could not prevent this result by requiring the buyer to invest optimally. The seller could not observe the buyer's actions, so the buyer would do what would be best for it.

There is a contract theory solution to this version of the underinvestment problem. The contract would give the buyer full bargaining power at the renegotiation stage. The buyer would use this power to make a "take-it-or-leave-it" offer to the seller which would give the buyer the full surplus. As such, the buyer would invest optimally. The efficient contract would also guarantee the seller's sunk costs if renegotiation failed. Therefore, the seller would accept the new deal. [100]

The question is how to create bargaining power for the buyer. The answer is to have the seller pay a penalty such as a per diem tax until an agreement is reached. The penalty would make it too costly for the seller to delay renegotiation; and her consequent impatience for a deal would materially reduce her bargaining power. Knowing this, the buyer would believe that a take-it-or-leave-offer for the entire surplus would succeed. Take-it-or-leave-it offers enforced with penalties, however, would be precluded by the no penalty rule, and probably also would violate the duty to behave in good faith as that duty is currently understood. The triad rules, in sum, harden the incentive compatibility constraint by precluding contracting protocols, such as the one we describe, that would respond efficiently to the underinvestment problem.

B. *Mechanism design*

Mechanism design (MD) theory studies the optimal design of incentives for a group of agents. Because contract law governs interactions between parties and between parties and courts, MD theory is an essential economic tool for contract analysis.[101] Many mechanism

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[99] *See* Schwartz & Sepe, *supra* note ? at 696-97).

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

[101]. In the long-term contracts that 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

design protocols are too abstract and complex for practical use, however. More importantly, they often assign roles to courts that courts will not play.[102] Rather, courts enforce the parties' will only to the extent a court deems it consistent with the public interest. This regulatory approach is incompatible with the implementation of optimal MD protocols, which require courts to obey party instructions regarding remedies and enlist courts in the parties' information revelation schemes.[103]

An important example are the "collaborations" that attempt to create new products, drugs, vaccines or platforms in multi-stage transactions.[104] A feature of these collaborations that distinguishes them from traditional contracts -- where parties exchange goods and services in one-stage transactions -- is the development of new information as the parties continue to invest in their project.[105] This information may outmode the original agreement, so that the parties may come to have different beliefs regarding the efficient path forward. They can renegotiate to a new arrangement but bargaining often fails in the asymmetric information environments that characterize the new collaborations. Such failures often could be deterred if parties could require a court to provide a pre-breach interpretation of their contract on the basis of information that was not available when the parties initially contracted.[106] Such midstream interpretations would facilitate the disclosure of information, through the processes of discovery and trial. Also, parties anticipating that judicial power could be invoked may disclose voluntarily. The now unavailable mechanism of mid-stream interpretation thus could enable parties to make more efficient decisions between continuing or terminating a

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MD theory adds additional value to contracting analysis. See Schwartz & Sepe, supra note **Erreur ! Signet non défini.**, at 690-92

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

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

[104] *See* Schwartz & Sepe, *supra note* 49, at 749. On 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).

[105] *See* Schwartz & Sepe, *supra* note 49, at 754-55.

[106] *See id.* at 771-72; *see also generally* on the efficiency of midstream interpretation, Alan Schwartz & Simone M. Sepe, *Midstream Contract Interpretation*, 99 NOTRE DAME L. REV. 611 (2023).

collaboration.[107] And to summarize, the mandatory triad rules harden the two key constraints and therefore reduce the number of efficient contracts the market will sustain.

VI. Generalized Freedom of Contract in the Liberal Society

Contract law would remain a court-centered system if it only reduced the triad rules to defaults (or repealed them).The state would retain authority over the substantive law (subject to party opt out); exclusive authority over contract enforcement; and command of the rules regulating court intervention and judicial policing powers. In this Part, we explore a world that shifted the locus of control over contract law from courts to parties. A more decentralized law, we argue, would expand the sphere in which autonomous agents can make commercial choices and would increase equality and welfare 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 would enforce; and would authorize parties to make courts players in party designed mechanisms for increasing contracting efficiency.

The implications of this economy are close in spirit to the implications of right-based ethics and Nozick's idea of "private protective associations." Under both ethical schemes, parties become rulers of their local commercial domain (i.e., the associational agreements they voluntarily conclude).[108] There are major difference between our approach and the libertarian position, however. In Nozick's treatment, the power of enforcement -- albeit restricted to the power of contempt -- lies with the state, which possesses a monopoly on legitimate force and is the final authority for dispute resolution. We suggest that this monopoly power could be supplemented, and sometimes replaced, by private enforcement.[109] But we do not argue that parties should be free to exercise coercive power independently from the state, as in the more radical libertarian accounts. [110] Rather, parties could invoke the state's power to enforce the

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[107] In contrast, because classic contract interpretation requires a breach, if a party insists on its interpretation of the contract rather than engaging in renegotiation, the deal may break up.

[108] 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.

[109] Nozick defends the legitimacy of private coercive power in some circumstances. However, we take the existence of the state as given. Therefore, the members of an association (as the principal) would have the option to use the the state's enforcement power (as the agent).

[110] *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 only resist but may have a moral duty to do so); MURRAY

governance mechanisms the parties 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.

We sometimes refer to this expanded role for freedom of contract view as "commercial anarchism" because there would be many loci of private contract law rather than one state system. Also, the state's role in the anarchic world would 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.

A. *The Commercial Archipelago*

The commercial archipelago would consist of industry (or trade) wide and inter-industry associations. The larger associations would govern themselves with "associative contracts". These would specify the local contract law; regulate contracts between the association members; and adjudicate disputes.[111] The parties' moral power would legitimate their choice of contractual governance mechanisms if the parties agreed under ideal contracting conditions and their agreement would create no externalities and violate no deontological constraints. The state should condition association independence on these conditions being met.

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).

[111] 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 **Erreur ! Signet non défini.**, 1524-26 Thee are similarities and differences between industry-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 are consistent with contract law. It is courts that decide whether and how to use custom 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 primarily have enforcement tasks. In this connection, consider practices that have developed in some industries (e.g., for procurement contracts), that create alternative enforcement systems based on reputation 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).

The archipelago thus would resemble a federal polity 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). Each association would 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. The relative small size and similar goals of associations would permit members to exercise an effective autonomy over their commercial affairs.

Associations also could ameliorate the asymmetric information problems that hinder market contracting. Contract law's basic remedy, the expectation interest, is a good example. The remedy authorizes the promisor to transfer the contract goods or perform the contract services, or to reallocate her resources to another use if she transfers to the promisee a sum that equals the gain the promisee would have made. Because the promisor will choose the least costly option, the expectation remedy would make her better off without reducing the promisee's payoff. This efficiency result, however, requires the promisor to know either a buyer's value or a seller's costs (depending on whether the breacher is a seller or buyer). When this strong informational condition does not hold, parties may neither trade nor invest efficiently.[112] But the information condition is more likely to hold for association deals than market deals because members of an association would come to know more about each other than market contractors can know about their counterparties.

Turning to how things could work, associations would regulate the admission of members and their exit. Rejected applicants could incorporate an association's law by reference, as happens today when parties use choice of law terms to select their *lex fori*. Such choices, in effect, would create another protective association, that would have the same contract law as the association that excluded the parties.[113] 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, diversity among the

[112] Cite Texas Paper; Markovits and Schwartz (2011).

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

associations.[114] Were multiple associations to survive, 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.

The right to 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. [115] Using an argument by contradiction, if sophisticated parties lacked freedom of exit, the state would not recognize them as moral agents in practice. But the state must respect individuals as moral agents in order to permit them to form associations.

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 to regulate this tradeoff. Exit, however, is an intra-association problem, not an inter-association problem. Because each association would

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

[115]. 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 Kukathas,* supra note ? 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 exiting. As applied to our analysis of the relationship between transformation operators and party autonomy, because the transformation operators enable 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 transformation operators is restricted to parties that can afford to exercise them. For parties that cannot afford this 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. Also, denying the freedom to exit would imply that contracting parties' morality is subordinate to other parties' moral values. This implication violates the idea that individuals' moral commitments should be minimal because each individual wishes to follow their own morality.

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.

To review, the state would perform five functions under commercial anarchism. First, 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 function in a GFC regime.[116] Second, the state would enforce contracts as the parties' agent, though 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.[117] Fourth, the state would ensure that no association gets so large as to upset the liberal archipelago ecosystem. Fifth, the state could require associations to internalize negative externalities.

B. *Practical and Theoretical Concerns*

We note one practical and one theoretical obstacle to the existence of a commercial archipelago. Regarding practice, no central institution would regulate coordination among associations. Suppose that party A, a member of association π, considers contracting with party C, a member of association Δ. The rules of Association π may impose duties or confer rights on A that would conflict with the duties or rights of association Δ. For example, let A be a seller. Association π, say, requires only that a tender substantially conform to the contract description

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[116] 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.

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

but association Δ 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?

Parties must answer this question today when they are domiciled in different states, and they 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, the other party could have the state enforce the injunction. Policing and enforcement thus would function similarly to the current system.[118]

Turning to the theoretical concern, the associational implications of the strong form of GFC raises a basic question: do parties have the metaphysical power to create a mechanism -- a form -- that makes enforceable exchanges possible?[119] 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. Under a weak GFC regime, individuals could modify state-provided forms, but there would be a pre-existing form (or "metaform") the state supplies as a reference. A commercial anarchy regime, however, requires parties to create moral and legal obligations ex nihilo -- that is, without any state-provided reference form.

The libertarian solution to this problem is relatively straightforward: if parties have the power to transact β before the existence of a political state, they must also have the same power to β in the political state. But given the differences between our approach and the libertarian one, the problem of the parties' power of form creation requires further investigation.[120] Though a full discussion is beyond the scope of this Article, we make a tentative argument here: the normative power that parties employ to create moral obligations also enables the parties' metaphysical power to generate the forms from which those obligations spring.

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[118] 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.

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

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

We deploy this argument in three steps. First, drawing on action theory,[121] we assume that individuals have agency collectively to consent to a specific form of action or interaction. The act of shaking hands -- a mutually agreed form of action symbolizing greeting or agreement -- is a good example of this agentic power. [122] 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,[123] conventions arise from repeated patterns of action due to mutual expectations.[124] 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 action or interaction, which in turn would lead to the development of common expectations. Exercising one's agency to participate in collective actions or interactions thus carries an implicit acceptance of moral responsibility towards fellow participants and toward the agreed-upon practice. This act of engagement (i.e., a metaphysical condition) is what transforms mutual expectations into obligations.[125]

These three steps imply that individuals can generate obligations through their collective actions and intentions in a metaphysical sense. The power of form creation derives

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

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

[123] *See generally* David K. Lewis, Convention: A Philosophical Study (2013 ed.).

[124] *Id.* at 60-61 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.

[125] This progression aligns with Searle's theory of institutional facts, in which obligations arise from mutually acknowledged expectations. *See generally* JOHN 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 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, the duty could arise from the Kantian principle of "universalizability," entailing a moral obligation to act in ways that could be universally adopted without contradiction.

from individuals' ability to shape their social reality through shared forms of action, shared expectations, and shared recognition of obligations.[126]

To summarize, contract law subjects the parties' exercise of their moral power to its own moral commitments.[127] 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 would correspond to the ideal of an open society, in which citizens accommodate their different needs and values in the commercial domain.[128] 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 Θ (say a remedy) for which there is no current legal permission, she may Θ if and only if she can justify Θ to her counterparty. When both parties agree to Θ, Θ-ing is justified by consent.

C. Interpretive Issues

Each association would be constituted by a private agreement, which would take the form of a master-contract among the members. This contract would be distinct from the individual contacts between members. An association would chose its own rules for interpreting the individual contracts; and it would create an adjudicative tribunal. State courts would enforce the tribunals' judgments when necessary. There is a major question, however,

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[126] This conclusion might be subject to objections due to its grounding in a specific metaphysical perspective. First, one could argue that collective intentionality does not exist since intentions belong to individuals. But what we perceive as collective intentionality can be reduced to a complex interaction of individual intentions. *See* MICHAEL E. BRATMAN, SHARED AND INSTITUTIONAL AGENCY 9-10 (2022). 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 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.

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

[128] *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.)

how and by whom the master-contract itself would be interpreted. The answer cannot be state courts, for then they would have ultimate authority over association agreements. Such authority would contradict the premise for commercial anarchism.

An association could retain ultimate control by its choice of an interpretive language and by its choice of a tribunal. Regarding language, parties can write the association contract in the language of a particular trade or industry, and instruct courts to use that language when enforcing the contract. An association agreement also could instruct courts to follow the interpretive rules of a particular state. Finally, parties could write the association contract in their own legal language, and direct courts to interpret it according to the chosen language's semantics and rules. 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.[129] 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. [130]

Regarding adjudication, parties could adapt the privatization practices followed in connection with international contract disputes.[131] These practices are governed by 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 nation state level without a review of the

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[129] In formal linguistics, one can create a function that maps a 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 essentially similar to 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, and not necessarily by courts. Some parties might prefer that their specialized language be interpreted by scientists (e.g., engineers) or even AI machines, and make those interpretations final and enforceable.

[130] When there are many associations, there perhaps would be too many specialized languages for generalist courts to absorb. This concern is not serious in a country with a widely used general language, however. Associations could translate their local language into the general one to facilitate court enforcement.

[131] 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)

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. International commercial parties therefore can ensure that private norms would govern by providing for arbitration.

There are substantial differences between international practice and commercial anarchism, however. First, under commercial anarchism parties could mine the new lex mercatoria for rules and access other international privatization contract forms.[132] Second, in international transactions courts cannot review a case on the merits, but review for procedural issues. Under commercial anarchism, courts would not have discretion to review privately adjudicated decisions. Third, the enforcement of a foreign arbitral award is constrained by the remedies available in the jurisdiction where the parties are seeking enforcement. With commercial anarchism, parties would have states enforce party designed remedies, even when those remedies would otherwise be unavailable under state law.

We briefly end with three clarifications. First, when contracts between members are obligationally complete, parties could direct the adjudicator to interpret those contracts based on their formal obligational content. If a member dyad did not stipulate a different arrangement, the parties' obligations would then be those obtaining in normal times. In contrast, when an association tells courts to interpret their contract (or contracts between members) according to the canons of formal linguistics or any other disambiguating technique, adjudicators could uncover otherwise hidden aspects of their contract. Second, associations can specify normative criteria that would guide courts in interpreting its and its members' contracts. For example, if an association choose efficiency, a state court should choose interpretive rules that would maximize welfare. An association also could specify the efficiency type they want courts to stress, such as exchange or investment efficiency. Finally, associations could direct courts to participate in the mechanisms that facilitate parties' ability to create efficient contracts.

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[132] 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 II, particularly in the standardization of contract terms 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. [Cite]

Conclusion

This article analyzes three sets of mandatory contract law rules: (i) the rules regulating bargaining and renegotiation between contracting parties; (ii) the rules regulating contract interpretation, and (iii) the rules regulating remedies. Contract doctrine makes these rules mandatory. For example, parties can reduce proof costs by specifying a sum in their contract that is the parties' best estimate of what their expectation interest would be. But the penalty doctrine prevents them from specifying a materially higher sum and the unconscionability doctrine prevents them from specifying a materially lower sum, though under or over liquidating damages could be efficient.[133]

We make two contributions to contracts scholarship. First, we argue that the three sets of mandatory rules -- the triad -- should be repealed or reduced to defaults. Our argument is in three parts. (A) Mandatory contract law rules have an unjust incidence, in the sense that the rules cannot consistently implement social goals but rather constrain only occasional or inexperienced agents. Well counseled and well-resourced parties can escape a mandatory rule with substantive terms that replicate the rule's economic impact. This is an effective (though costly) escape route because the freedom of contract principle tells courts to enforce substantive terms. (B) Taken on their merits (i.e., assuming mandatory rules nontrivially bind), the triad rules find no support in, or violate, the ethical theories relevant to commercial contracting. In particular, the triad rules violate distributional justice because they constrain the weak while the strong remain free; and the rules restrict parties' autonomy and trespass on their right to contract even when a contract does not affect third parties. (C) The triad rules reduce welfare: parties set free would contract more efficiently. In sum, today's contract law is a morally unjustified, inefficient regressive tax on the commercial economy.

Our second contribution is to sketch a commercial world in which contracting would be truly free. Control over contracting, in this world, would shift from the state to the parties, who would exercise it through commercial "associations". Each association would have the power to choose and enforce its own contract law. Changing from the world we have to a world of associations would require reforms that we lack the space here fully to explore. New worlds, however, must be imagined before they can be implemented.

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[133] We have discussed the efficiency role penalties can play above. Schwartz (2010) shows that under-liquidating damages can be privately efficient.

This article also opens new areas for research. Initially, the triad rules constrain commercial contracting generally. For example, parties cannot deter strategic behavior by parties to debt contracts with penalties nor can they increase the efficiency of construction contracts by constraining renegotiation. Corporate, property and bankruptcy scholars, however, seldom supplement their work with contract theory insights.[134] As just one example, a mandatory bankruptcy law rule prevents supplier parties to procurement contracts to condition future deliveries on the buyer not filing for bankruptcy. The objections to mandatory rules developed here would support repealing this inefficient prohibition.

Further, scholars have not considered the impact mandatory rules have on industrial organization. Consider this simple example. Two agents are deciding 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 to the agreements that constitute the joint venture. Contract law would not apply to the practices of the merged firm, however. For example, the firm's Board of Directors could penalize a division for a late or unsatisfactory performance or make board directives non-modifiable by a division for a prescribed period. Our illustrative agents may prefer a joint venture to a merger because, they believe, market contracting would be the more effective way to pursue their project. But a market contract would trigger the entire regulatory apparatus of contract law, and the consequent costs could cause the parties to merge. Contract law thus could affect the choice of organizational forms, a possibility that deserves further study. And to end, generalizing freedom of contract would produce positive changes in contract law and would produce positive changes in other parts of business law as well.

May, 2024

[134] For exceptions, cite me, Skeel and Triantes, others?