

DEREGULATING CONTRACTS

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A contract's substantive terms specify what the parties will trade; a contract's procedural terms regulate the parties' bargain. Quantity and quality terms are substantive; damage, interpretive, and modification terms are procedural. Parties are free, under contract law, to specify substantive terms, but they are not free to specify procedural terms. Rather, courts regulate damages from breach, how courts interpret agreements, when parties can modify their agreements, and so forth.

This Article argues that parties should be as free to specify procedure as substance, for three reasons: (i) Corporations largely escape procedural regulation by substituting equivalent substantive terms, which are free, for regulated procedural terms, which are restricted. Economically weak and occasional contractors lack the means and knowledge to pursue this costly contracting strategy. Thus, procedural regulation functions ineffectively and unfairly. (ii) Procedural regulation, to the extent it binds, is inefficient, with the inefficiency costs falling especially on the weak. (iii) Moral theories of contract, such as those explaining how contract law can and should protect persons' autonomy in the commercial sphere, do not support, indeed they sometimes oppose, procedural regulation.

Contract law is a residual legal category that affects business transactions generally. For example, damages for breach of a lending agreement or a long-term contract for raw materials cannot exceed the promisee's expectation interest nor can the parties

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to such contracts control how those contracts should be modified. Increasing party freedom over the procedural terms would therefore increase the fairness, efficiency, and morality of business contracts generally.

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I. BUILDING BLOCKS

Contract law in action primarily impacts the transactions of commercial parties. This impact, it is widely believed, is light: Parties can transact as they wish, as long as their contracts do not harm unrelated persons. This common belief is incorrect. Rather, the law materially constrains sophisticated parties' ability to contract efficiently by regulating a contract's procedural terms. Moral theories of contract law do not support restricting parties' control over these terms. "Deregulation" would repeal the restrictions or reduce the rules that require them to defaults.

We begin to make this argument with a famous case, by a famous judge, to illustrate, at the outset, how mandatory rules prohibit efficient contracting practices. We then sketch out the paper's domain: the market actors whom courts should regard as sophisticated commercial parties; the mandatory rules that constrain these parties; and the normative theories that animate the rules.

A. A Case

Lake River Corp. v. Carborundum Co. is a staple in contract law casebooks.¹ The case applies the rule that courts will not enforce penalties² to strike a pricing scheme in a contract between business firms.³ The opinion is by Richard Posner.⁴

Lake River—the seller—sold the service of bagging and shipping minerals.⁵ Carborundum—the buyer—agreed to ship to the seller “for bagging a minimum quantity of [22,500 tons]” of a mineral, Ferro Carbo, over a three-year term.⁶ If the buyer fell short, the seller was required to “invoice [the buyer] at the then prevailing rates for the difference between the quantity bagged and the minimum guaranteed.”⁷ The seller also was required to install “a new bagging system” that would cost \$89,000.⁸ It expected to “make a profit of 20 percent of the contract price.”⁹ If the buyer shipped the required contract minimum for bagging, revenue would have been \$533,000 and profit \$107,000.¹⁰

1 *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284 (7th Cir. 1985).

2 *See* U.C.C. § 2-718 (A.L.I. & UNIF. L. COMM'N 2023).

3 *Lake River*, 769 F.2d at 1287.

4 *Id.* at 1286.

5 *Id.*

6 *Id.* (alteration in original).

7 *Id.*

8 *Id.*

9 *Id.*

10 *Id.* at 1290.

The buyer shipped, and paid for, 12,000 tons over the three-year term.¹¹ The seller sued for a sum that equaled the unshipped minimum—10,500 tons—times the contract price: \$241,000.¹² The buyer successfully challenged these damages as a penalty.¹³ Judge Posner wrote that the seller could allocate revenue to recovering the fixed cost of the new bagging system.¹⁴ After that, the seller was entitled to the price on each unit less the marginal cost of bagging it.¹⁵ Hence, the seller's total expected gain would be price times contract quantity less total variable cost.¹⁶ Under the minimum guaranteed term, however, the seller would realize the contract price less the marginal cost of bagging on each item the buyer shipped for bagging but would also receive the price, without incurring any marginal cost, on items the buyer failed to ship.¹⁷ If the buyer fell short, the seller necessarily would realize a total sum that exceeded its expectation.¹⁸ Judge Posner wrote that the difference between the total and the expectation was a penalty.¹⁹

Judge Posner was reluctant to issue this holding because he preferred not to upset a deal between business parties, but he believed he was bound by a clear rule: A contractual transfer term that requires the promisor to pay a sum on breach that exceeds the promisee's expectation is an unenforceable penalty.²⁰ The result under the rule seems obvious, and the case is taught as a sophisticated application of the rule.

The *Lake River* contract was a variant of the common "take or pay" clause.²¹ To see how such a clause functions, suppose that parties to a multi-year contract expect to trade the total quantity (Q_T), but their contract requires the buyer to pay the full price for items up to a "minimum" quantity (Q_M) where $Q_M < Q_T$, whether the buyer ordered all of Q_M or not. Compare this transfer term to expectation interest damages when the contract had no minimum guaranteed term. If the buyer breached without taking any product, the buyer would be liable for the

11 *Id.* at 1286.

12 *Id.*

13 *Id.* at 1290.

14 *Id.* at 1288. The seller's fixed cost had to exceed the cost of one machine, but the court said, "[T]here is no indication of any other fixed costs." *Id.* at 1290.

15 *Id.* at 1292.

16 *Id.* at 1290–91.

17 *Id.* at 1286.

18 *Id.* at 1290–91.

19 *Id.* at 1290.

20 *See id.* at 1288–89.

21 *Id.* at 1292.

difference between the contract and market²² prices times the total *expected* quantity, or $Q_T \cdot (p_k - p_m)$ ²³ where p_k is the contract price and p_m is the market price.

Penalties reduce parties' contractual surplus to below its possible maximum because they induce the seller to perform in states in which the cost of a sale would exceed the buyer's value.²⁴ Therefore, if a take-or-pay clause is not a penalty, the sum the buyer would be required to pay under the minimum guarantee if it takes no product would equal the sum the buyer would be required to pay under expectation damages. The following equality would hold:

$$Q_T \cdot (p_k - p_m) = \beta \cdot (Q_T) \cdot (p_k) = Q_M \cdot (p_k).$$

The left-hand side is expectation damages; the middle is take-or-pay damages: the contract price times the fraction, β , of the total product the parties expected to trade, which yields the contractual minimum. The fraction solves the equality: $\beta = 1 - (p_m / p_k)$.

Take-or-pay damages usually *undercompensate* the seller. To see how, let parties expect to trade $Q_T = 100$ units; the contract price $p_k = 20$ per unit; and the market price is $p_m = 10$. Then $\beta = 1/2$, and the required minimum quantity would be $100 \cdot 1/2 = 50$. Continuing with our example of total breach, expectation damages would be $100 \cdot (20 - 10) = 1,000$. Take-or-pay damages would be $50 \cdot 20 = 1,000$. The clause would not overcompensate the seller though the seller incurred no variable cost at all.

But now let the buyer breach after taking 53.3% of the contract minimum—26.65 units—as in *Lake River*.²⁵ Expectation damages would be $73.35 \cdot (20 - 10) = 733.5$. Contract damages would be $23.35 \cdot 20 = 467$. Take-or-pay clauses substitute predictable damages for the risk of fluctuating damages caused by varying market prices in future periods and also avoid the cost savings of proving those future prices. Judge Posner's mistake was to assume that the *Lake River* parties intended to trade exactly 22,500 tons when that sum was only a minimum.²⁶

22 Here, "market" refers to the price the seller can obtain outside the contract, not to any specific market structure, competitive or otherwise.

23 The function assumes that $p_k > p_m$. Without this assumption, the function must be written as a convex function, i.e., $\max[0, Q_T \cdot (p_k - p_m)]$.

24 See Alan Schwartz, *The Myth that Promisees Prefer Supra-compensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 374 (1990).

25 See *Lake River*, 769 F.2d at 1286.

26 See *id.*

Sophisticated parties will generally solve for the efficient remedy term.²⁷ Regulating that term therefore will either be innocuous—the court enforces the parties’ transfer term—or harmful—the *Lake River* result that the court does not enforce the parties’ transfer term.²⁸ Contract law applies to *every transaction everywhere*. We begin with the *Lake River* case to show that even the very best commercial judges make consequential mistakes because they cannot be experts everywhere. Put in modern terms, contract law enacts a regulatory scheme that is “enforced” by inexpert regulators.

B. *The Parties*

Lake River illustrates the domain that we want to free: sophisticated agents contracting to maximize expected commercial gains.²⁹ These parties may not adhere strictly to the rationality of economic decision theory,³⁰ but they do exhibit a form of commercial rationality that any merchant can be presumed to possess. Merchants are sensitive to payoffs—a characteristic inherent to their trade.³¹ They also can learn, recall, and update beliefs.³² These abilities, essential for survival in a market economy, over time aggregate to an inductive form of rationality that converges with the deductive rationality described in economic decision theory.³³

27 See Schwartz, *supra* note 24, at 398.

28 See *Lake River*, 769 F.2d at 1293.

29 See *id.*

30 See KEN BINMORE, RATIONAL DECISIONS 35–38 (2009); ANDREU MAS-COLELL, MICHAEL D. WHINSTON & JERRY R. GREEN, MICROECONOMIC THEORY 11–15 (1995).

31 By nature, a merchant has a clear normative goal: conducting business successfully. This goal requires a sensitivity to payoffs.

32 Here, we are not only considering Bayesian updating as employed in economic decision theory, which requires the computation of precise probabilities—an activity often impractical for most merchants—but also exploring other methods for belief updating. See RICHARD C. JEFFREY, THE LOGIC OF DECISION (2d ed. 1983). For example, belief revision methods like the AGM model suffice. The AGM model outlines postulates for rational belief revision without relying on exact probabilities, focusing instead on maintaining logical consistency when incorporating new information. See Carlos E. Alchourrón, Peter Gärdenfors & David Makinson, *On the Logic of Theory Change: Partial Meet Contraction and Revision Functions*, 50 J. SYMBOLIC LOGIC 510 (1985). Simple rules, such as adjusting beliefs when contradicted by new evidence while retaining most of the original belief system, provide practical decision-making tools for merchants without complex calculations.

33 See Simone M. Sepe, *Freedom of Contract, Commercial Rationality, and State Cooperation*, 42 YALE J. REG. 1, 5 (2026).

Such commercially rational parties can access and process information,³⁴ make accurate predictions,³⁵ and solve the economic problems their transactions present.³⁶ However, their rationality is bounded: They have a limited ability to process information. Aware of this limitation,³⁷ parties adopt protective strategies, such as requiring terms that prompt the more informed party to reveal private information.³⁸

Commercially rational merchants also compare actual payoffs to prior expectations and adjust their beliefs accordingly. As merchants accumulate experience, their estimates become more accurate, converging toward the maximizing payoffs their transactions will yield. Merchants also learn to select commercial partners with whom they can make efficient deals. The processes of honing parties' abilities and their inducting of lessons from experience ultimately facilitate a reduced but effective form of optimization.³⁹

34 Sophisticated parties may not be at the same economic scale but they usually are "epistemic peers": That is, they have similar abilities to access and process information. See generally THE EPISTEMOLOGY OF DISAGREEMENT: NEW ESSAYS (David Christensen & Jennifer Lackey eds., 2013) (examining the problem of peer disagreement).

35 See MICHAEL MASCHLER, EILON SOLAN & SHMUEL ZAMIR, GAME THEORY 321 (Mike Borns ed., Ziv Hellman trans., 2013) (showing that with common knowledge, parties can predict future outcomes—i.e., conjecture equilibria—using their rationality). What we argue, however, is that the ability to predict future outcomes accurately is acquired over time through experience. See also Sepe, *supra* note 33, at 12–17.

36 See Sepe, *supra* note 33, at 5; Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 551–52 (2003).

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

38 See generally Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 103–04 (1955) (formally analyzing how individual rationality is inherently restricted by available information, cognitive limitations, and time constraints); see also BOUNDED RATIONALITY: THE ADAPTIVE TOOLBOX 43 (G. Gigerenzer & R. Selten eds., 2002) (arguing that the human mind is not an "optimize[r]" but rather an "adaptive toolbox," deploying heuristics to make satisfactory decisions under imposed constraints).

39 Cf. W. Brian Arthur, *Inductive Reasoning and Bounded Rationality*, 84 AM. ECON. REV. 406, 407 (1994). There are paternalistic critiques of rationality, e.g., *id.* at 406, but these critiques are inapplicable to the sophisticated actors that we study. A paternalistic approach to protect lesser commercially rational parties would hinder the learning processes just described.

C. *The Regulatory Structure*

The *Lake River* parties addressed three of the four central questions business contracts answer: (i) What should the substantive terms be (that is, what do we want to trade?) (Bagging minerals)?⁴⁰ (ii) What should the remedy for breach be (enforcing the contract's minimum guarantee)?⁴¹ (iii) How should a decision maker interpret our contract (literally)?⁴² Question (iv) asks, in what future states can we renegotiate the contract? Contract law permits parties to answer the first question as they wish but regulates the answers to the remaining questions. We term these regulatory rules "procedural."

Several mandatory procedural rules regulate the bargaining process, but the rules relevant to undue influence, physical duress, and unconscionability seldom apply to business deals. The duty of good faith is applicable, but, as we will see, business parties can importantly influence its impact. The rules regulating renegotiation, however, are difficult to avoid. Parties generally prefer to renegotiate agreements that turn out to be ex post inefficient, but want to constrain renegotiation when that would undo an efficient incentive scheme.⁴³ Courts, however, will not enforce a "no-renegotiation clause" because courts want to hold parties to fully informed bargains.⁴⁴ Even so, courts will not enforce renegotiated agreements unless they are supported by consideration (the preexisting duty rule) and triggered by (what the court regards as) new material information.

Remedy regulation takes three forms. First, parties must use the expectation interest remedy, which requires a breaching promisor to transfer to the promisee a sum that (a court finds) equals the monetary value performance would have had for the promisee.⁴⁵ A contract can substitute a contractually specified sum—"liquidated damages"—for a court finding, but that sum cannot necessarily or in application exceed (according to the court) the payoff the substantive terms would have yielded.⁴⁶ Parties also may prefer to require the promisor actually to

40 See *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1286 (7th Cir. 1985).

41 See *id.*

42 See *id.* at 1288–89.

43 See Alan Schwartz & Robert E. Scott, *Obsolescence: The Intractable Production Problem in Contract Law*, 121 COLUM. L. REV. 1659, 1682 (2021).

44 Parties can require renegotiated contracts to be written.

45 See RESTATEMENT (SECOND) OF CONTRACTS § 344(a) & cmt. a (A.L.I. 1981).

46 As the *Lake River* case showed, a transfer term that, in a court's view, would exceed the expectation interest payoff is an unenforceable penalty. See *Lake River*, 769 F.2d at 1290; see also Aaron S. Edlin & Alan Schwartz, *Optimal Penalties in Contracts*, 78 CHI.-KENT L. REV. 33, 33–34 (2003).

comply with the substantive terms, but clauses requiring specific performance are not enforceable.⁴⁷ Rather, a court will award specific performance when, the court believes, only the performance itself would allow the promisee to realize its contractual payoff.⁴⁸ In doctrinal language, the promisee's remedy at law—damages—would be inadequate.⁴⁹ Personal service contracts are not specifically enforceable at all.⁵⁰ Finally, when a deal breaks up a promisee may prefer to sue for sunk investment costs rather than attempt to prove the contractual gain it would have realized.⁵¹ Courts, however, award such costs—protect “reliance”—only if the promisee had invested on the basis of a promise that, had it been accepted, would have concluded an enforceable contract.⁵²

Party preferences regarding interpretation primarily run to the evidence a court uses when attempting to find intent. Courts will consider any evidence that, a court believes, would permit the court to recover the parties' actual agreement, and thereby protect the promisee's expectation.⁵³ In contrast, some parties may prefer to restrict the court's interpretative base largely to the written contract when, in the parties' view, this would reflect an optimal tradeoff between the risk of judicial inaccuracy and the costs of a trial.⁵⁴ Courts, however, retain discretion to ignore party interpretative instructions.⁵⁵ New York, and the jurisdictions that follow it, attach considerable weight to, though they doctrinally are not bound by, the interpretive instructions sophisticated parties give.⁵⁶ California, and the jurisdictions that follow it, attach little weight to such instructions.⁵⁷ Finally, parties to long-term

47 See RESTATEMENT (SECOND) OF CONTRACTS § 357 (A.L.I. 1981).

48 See *id.* § 359.

49 See *id.*

50 See Kimberly D. Krawiec & Nathan B. Oman, *The Case for Specific Performance of Personal Service Contracts*, 110 IOWA L. REV. 751, 752–53 (2025).

51 RESTATEMENT (SECOND) OF CONTRACTS § 349 cmt. a (A.L.I. 1981).

52 See *id.*

53 See, e.g., U.C.C. § 2-202 (A.L.I. & UNIF. L. COMM'N 2023).

54 See Alan Schwartz & Simone M. Sepe, *Midstream Contract Interpretation*, 99 NOTRE DAME L. REV. 611, 632 (2023).

55 See U.C.C. § 2-202 cmt. 1(c) (A.L.I. & UNIF. L. COMM'N 2023) (stating that interpretation is a matter of law).

56 See Schwartz & Sepe, *supra* note 54, at 613–14, 614 n.5.

57 *Id.* Parties can choose the jurisdiction whose interpretive rules will control with a choice of law clause, but the choice may be costly. For example, parties may prefer New York's interpretive rules (which privilege the contract) to California's interpretive rules (which open up the context) but otherwise prefer California law either because it is familiar or because it is more favorable. Regarding general practice, see 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.”).

contracts sometimes would want courts to make interim interpretations in order to resolve mid-stream contracting disputes, but interpretation can only occur after a breach.⁵⁸

D. The Courts' Regulatory Theory

Contract law is composed of defaults and regulative provisions. The defaults substitute for legal rules that would otherwise complete the substantive part of a commercial contract.⁵⁹ A simple adjudicative mechanism helps ensure that these defaults are efficient.⁶⁰ To see how the mechanism functions, suppose that a court at time *t* resolves a substantive dispute for parties in industry *A*. Parties in industry *B* anticipate that a similar dispute may arise between them. If they do nothing, the initial court's resolution—its rule—for the industry *A* dispute would be a precedent applying to the similar *B* party dispute. But the industry *B* parties also could contract out of the industry *A* rule.

Suppose, however, that the *B* parties and parties in industries *C* through *X* all let the rule initially developed for the industry *A* parties' dispute stand. That rule would then be a precedent for resolving similar disputes among all of these parties: That is, the *A* industry rule would become a contract law substantive default. And it would remain so until commercial practice materially changed. Then parties would begin to contract out and courts would develop a new rule. The simple mechanism thus (very slowly) generates default rules that efficiently support current transcontextual business practices. The mechanism cannot function for the procedural provisions summarized above, however, because those provisions apply everywhere and are mandatory.⁶¹

Judicial regulation of procedure (and much supportive commentary) follows from two largely implicit premises. To understand the first, recall that the seller's expectation interest—its contractual gain—is price less cost; the buyer's expectation is value less price. The initial premise holds that price, cost, and value are verifiable.⁶² As a result, courts will know the values these parameters take in particular cases and can thereby award the expectation interest remedy. The second

58 See Schwartz & Sepe, *supra* note 54, at 638.

59 Alan Schwartz & Robert E. Scott, *The Common Law of Contract and the Default Rule Project*, 102 VA. L. REV. 1523, 1525 (2016).

60 See *id.* at 1526 (observing that the mechanism assumes that business parties know the law).

61 We show below that well-resourced parties can avoid the effect of much contract regulation, but avoidance methods are costly, tend to be specific to parties, and are embedded in private contracts. Hence, the various avoidance methods we uncover have not crystallized into efficient substantive rules.

62 A bit of information is verifiable if the gain to a party of proving the bit in court would exceed the litigation cost.

premise holds that contracts create *a right* in the promisee to the promisor's performance of the contract's substantive terms, but only to it.⁶³ Thus, undercompensation—a too-stringent remedy limitation⁶⁴—and overcompensation—a penalty—are unenforceable. The interpretive rules protect the promisee's right to the expectation by requiring a court to admit as much evidence as the court needs to recover the actual contract, and thus the gain the promisee expected to make.⁶⁵ Courts ignore interpretive instructions parties give when the instructions would impede a court's search for the actual contract.⁶⁶ Courts also will not obey contractual prohibitions on renegotiation because parties will renegotiate to the ex post efficient deal⁶⁷: As a result, the promisee does as well or better under renegotiation than it would have done under the original contract. And recently, some courts have held that the promisee's right to the promisor's performance extends to any gains the promisor made by trading the contract goods or services to a third party.⁶⁸

The two animating premises—verifiability and rights—are in tension. The expectation interest remedy is exchange efficient when its dependent parameters are verifiable.⁶⁹ Hence, unconstrained parties would contract for the remedy unless they could not verify those parameters. The parties then would choose a different remedy that would be preferable to an expectation interest remedy that a court could not award. The second regulatory premise holds that the court should protect the actual contract right that the promisee purchased. It follows that courts should be as willing to enforce contracts that depart from the expectation interest contract as they now are to enforce only it.

Another way to put this claim is that the courts' regulatory theory is incoherent. The theory posits contracting conditions under which one of the many contracts parties could make would be efficient and

63 CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* 17 (2d ed. 2015).

64 Section 2-719 of the Uniform Commercial Code (UCC) requires there to be at least a "minimum" remedy for breach. See U.C.C. § 2-719 cmt. 1 (A.L.I. & UNIF. L. COMM'N 2023).

65 See Schwartz & Scott, *supra* note 59, at 1543–44.

66 See Schwartz & Sepe, *supra* note 54, at 631 n.64.

67 See Schwartz & Scott, *supra* note 43, at 1697–98.

68 *E.g.*, *Lawton v. Nyman*, 327 F.3d 30, 49 (1st Cir. 2003). "Gain-based damages" entitle the promisee to its expectation plus the marginal profit the promisor made by trading elsewhere. Some commentators also support punitive damages for strategic breaches. See, *e.g.*, Daniel A. Farber, *Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract*, 66 VA. L. REV. 1443 (1980) (arguing for the economic justification of super-compensatory damages).

69 Alan Schwartz & Simone M. Sepe, *Contract Remedies for New-Economy Collaborations*, 101 TEX. L. REV. 749, 778 (2023).

then attempts to protect the parties' rights under that contract even when the parties would prefer a different contract. Current regulatory theory thus holds that courts should reduce party gains in the service of protecting party gains.

The *Lake River* case exemplifies this perverse result. Market prices can be difficult to verify when the parties' transaction is partially unique (bagging a particular mineral),⁷⁰ and the parties there also wanted to share commercial risks.⁷¹ The parties thus preferred the minimum-guarantee contract, which efficiently resolved the verifiability and risk-sharing concerns, to an expectation interest contract, which would have resolved neither. A great judge, however, enforced the expectation interest contract.⁷²

Deregulation, we next introduce, would implement a coherent theory of contract.

II. INTRODUCTION

The building blocks just constructed support the three new contributions this Article makes. First, we add a modern case for deregulation to the neoclassical critique of contract regulation in Section I.D by showing that economic contract theory also supports reversing (or reducing to defaults) the rules that govern remedies, interpretation, and renegotiation (sometimes herein the "triad"). This theory creates mechanisms that attempt to reconcile the search for exchange efficiency—the traditional legal goal—with the search for investment efficiency—the modern aim. The triad rules largely preclude implementing those mechanisms. This is Part III.⁷³

70 *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1286 (7th Cir. 1985).

71 *Id.* at 1286–87.

72 *Id.* at 1290.

73 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 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

Turning to the literature, there is a divide among commentators (and some courts) regarding what the appropriate normative basis for contract law should be. On one side are the philosophers (and other moralists); on the other, the economists (and lawyer economists).⁷⁴ The moralists' paradigm contract is between two individual persons.⁷⁵ Philosophical analyses of contract law use nonconsequentialist theories to explain or justify the freedom these persons have to make binding contracts and attempt to identify contracting restrictions that would prevent the exploitation of weaker parties by stronger ones.⁷⁶ The economists' paradigm contract is between sophisticated actors such as companies.⁷⁷ Neoclassical economic analyses of contract law argue that these actors should be free to make the contracts they wish.⁷⁸

The two scholarly traditions function largely independently of each other. According to the economists, it would be a category mis-

the domain in which sophisticated parties 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.

74 For an illuminating description of the theoretical divide between deontic and consequentialist moral theories, as well as the attempt to formulate a convergent thesis, see Jody S. Kraus, *Philosophy of Contract Law*, in THE OXFORD HANDBOOK OF JURISPRUDENCE AND PHILOSOPHY OF LAW 687, 689 (Jules Coleman & Scott Shapiro eds., 2002).

75 See, e.g., Seana Valentine Shffrin, *The Divergence of Contract and Promise*, 120 HARV. L. REV. 708, 746 (2007).

76 See generally FRIED, *supra* note 63, at 17–21 (pioneering a deontological 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); Shffrin, *supra* note 75, at 710 (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 personal relationships).

77 See Schwartz & Scott, *supra* note 36, at 545; Sepe, *supra* note 33, at 3; cf. Alan Schwartz & Simone M. Sepe, *Economic Challenges for the Law of Contract*, 38 YALE J. REGUL. 678, 701 (2021).

78 The welfare approach to contract law presupposes a commitment to utilitarianism. See, e.g., Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103, 105 (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, *About Law and Economics: A Letter to Ronald Dworkin*, 8 HOFSTRA L. REV. 553, 556 (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 principle for welfarists); Duncan Kennedy & Frank Michelman, *Are Property and Contract Efficient?*, 8 HOFSTRA L. REV. 711, 713–14 (1980) (offering a radical criticism to the traditional welfarist approach—in particular as applied in law and economics to property and contracts); Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 519 (1980).

take to evaluate contract law rules with agent-centered ethical theories.⁷⁹ Corporations are artificial persons who cannot have second order preferences⁸⁰ or desires for fully flourishing lives. According to the moralists, welfare economics is a reductive moral theory that ignores important ethical considerations.⁸¹ The contract law articles of both schools pass by each other largely unnoticed. Commentators from both scholarly schools, however, implicitly accept the first regulatory premise—the variables that constitute the expectation interest are verifiable.⁸² These articles differ (largely implicitly) on the second—that contracts create a right in the promisee to performance of a contract's substantive terms.⁸³

Almost all courts and commentators, however, *also accept* a third premise: The triad rules effectively bind contracting parties.⁸⁴ Our *second contribution* is to reject this descriptive premise. Rather, we show that well-resourced parties—usually repeat players—can escape the law's mandatory rules by adopting substantive terms that replicate the contracting results the rules were meant to regulate. This strategy succeeds because the courts' regulatory theory holds that parties can adopt the substantive terms they wish.

As a result, the law imposes inefficient rules on parties who cannot escape procedural regulation, *and* it imposes dead weight losses—the costs of contracting efficiently—on parties who can. Contract law

79 See Kraus, *supra* note 74, at 694–96.

80 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. See the seminal work of Harry G. Frankfurt, *Freedom of the Will and the Concept of a Person*, 68 J. PHIL. 5, 7 (1971), for a discussion of second-order preferences tailored for a legal audience; see also Saura Mascone & Simone M. Sepe, *Citizen Corp.—Corporate Activism and Democracy*, 100 WASH. U. L. REV. 257, 290 n.157 (2022).

81 See Kraus, *supra* note 74, at 740–41 (summarizing a moralist critique of economists' arguments with regard to forced transfers).

82 Schwartz & Scott, *supra* note 36, at 616.

83 See, e.g., Shiffrin, *supra* note 75, at 722–29; Seana Shiffrin, *Could Breach of Contract Be Immoral?*, 107 MICH. L. REV. 1551, 1552 (2009) (arguing that promissory morality treats the promisee as entitled to performance rather than merely to an option to take damages); BENSON, *supra* note 76, at 468–69 (developing a Kantian, interactional-justice account under which contracts confer a normative right to performance rather than a bare “perform or pay” option); Daniel Friedmann, *The Efficient Breach Fallacy*, 18 J. LEGAL STUD. 1, 1–4 (1989) (rejecting the Holmesian “perform or pay” picture and defending a “simple entitlement,” *id.* at 2, view under which contractual damages vindicate a pre-existing right to performance, which the promisor must honor absent a release by the promisee).

84 See Schwartz & Scott, *supra* note 43, at 1693 (noting that triad rules persist). For a unique exception, see *id.* at 1670 (describing the triad regulatory rules as “quasi-mandatory”).

therefore is arbitrary in action because whether any regulatory rule achieves its objective is determined by a factor irrelevant to the rule's goal: The factor is the ability of particular parties to contract out. Contract law also functions unjustly because it imposes inefficient rules on the weak but not the strong. Establishing these economic and moral results is Part IV.

Our *third contribution* is to reject the moralists' view that distributional and moral theories support the triad regulations. We initially argue that Rawls's concept of justice as fairness cannot support legal rules that disproportionately impose costs on the least advantaged. We then consider agent-centered moral theories. The regnant view is that these theories support the mandatory triad rules. In particular, commentators believe that courts should (i) control remedies because otherwise the strong could impose remedy terms that exploit the weak,⁸⁵ (ii) control interpretation because otherwise the strong could impose duties (or disclaim them) that the weak could not understand,⁸⁶ and (iii) control bargaining protocols because otherwise the strong could impose one-sided deals.⁸⁷ We show, to the contrary, that autonomy and rights theories actually support *increasing* sophisticated parties' freedom over contracting procedure. Part V makes this claim out primarily by showing that the moral justifications that support the parties' freedom to choose their contract's substantive terms *also support* their freedom to choose the contract's procedural terms.⁸⁸

In Part VI, we sketch the limiting case for deregulation. This case holds that the locus of control over contracting behavior should shift from the state to the parties. Such a transfer would entail, among other

85 See, e.g., BENSON, *supra* note 76, at 214; Seana Valentine Shffrin, *Paternalism, Unconscionability Doctrine, and Accommodation*, 29 PHIL. & PUB. AFFS. 205, 205–07 (2000).

86 See 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, 47 (2007).

87 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).

88 It is difficult to derive criteria for deciding concrete cases from high-level normative ethical approaches. These approaches illuminate basic features of the system—for example, how agents have the moral power to create externally enforceable obligations by promising—but they are largely silent on how to choose among competing background rules. As Richard Craswell emphasizes, autonomy- and fidelity-based promissory theories are “content-neutral” in this sense and therefore “have nothing to contribute to the selection of [contract] default rules,” whereas efficiency-based economic analysis has in fact been used to generate micro-level criteria for remedies, excuses, and other background doctrines. Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 515–16, 509–16, 528–29 (1989).

things, authorizing private associations to create their own substantive and procedural contract law.⁸⁹

There would be three payoffs to deregulation. 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.⁹⁰

Second, deregulating contracts would make American business law more efficient generally. Common law courts make rules in the course of deciding cases. Contracts is a common law field⁹¹ but bankruptcy and corporations are thought not to be.⁹² On the definition here, this consensus is incorrect. Insolvency and corporate codes contain few concrete rules and many abstract standards.⁹³ As a result, courts also make the rules in the course of adjudicating bankruptcies and corporate disputes.⁹⁴ Contract law is the legal substructure that

89 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: AN ECONOMIC HISTORY OF THE USSR FROM 1945*, at 9–11 (2003). Our limiting case lies at the other end of the spectrum.

90 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 increasing 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 $s_i \in S$. 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. See, e.g., Kraus, *supra* note 74, at 688. We do not take a position regarding this claim but rather show that the deregulatory approach is different: It would open up the contracting space to eliminate mandatory rules that do not internalize negative externalities.

91 Much of the doctrine and principles of contract law have been developed over centuries by judges while deciding individual cases. See Schwartz & Scott, *supra* note 59, at 1533–35.

92 See Mark J. Roe, *Three Ages of Bankruptcy*, 7 HARV. BUS. L. REV. 187 (2017).

93 See *id.* at 189.

94 For example, § 363 of the Bankruptcy Code authorizes a debtor in possession to sell assets “in the ordinary course” if the bankruptcy court, “after . . . a hearing,” permits the sale. 11 U.S.C. § 363(c) (2018). Section 363, however, does not say which findings would justify or bar a sale. Rather, courts have developed a “jurisprudence” of § 363. In the area of asset sales, and many others, bankruptcy thus is a common law field. See, e.g., Roe, *supra* note 92, at 189; see also Mark J. Roe & Michael Simkovic, *Bankruptcy's Turn to Market Value*, 92 U. CHI. L. REV. 285, 286–87 (2025) (discussing how bankruptcy courts on their own changed the rules regarding how to value the insolvent firm and thereby materially shortened the time such firms spend in bankruptcy). In Delaware, a corporation is managed by

unifies these seemingly disparate transaction fields.⁹⁵ That contract law applies so broadly implies that deregulating it would free parties to make more efficient bankruptcy, corporate, property, and other commercial contracts.

Third, deregulating contract law would eliminate a bias toward the “make” option in the make-or-buy decision manufacturing 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 it nonmodifiable. Deregulation would permit firms to make the choice between make or buy free from legally induced bias. And to generalize, legal contract theory could illuminate important industrial organization questions.

We end this Part with two remarks. An argument to repeal or reform private law rules can proceed from either of two fundamental political premises. The first premise would hold that persons have pre-political rights, including the right to contract, and that contracting freedom survives the creation of the state. Hence, the state must justify any restrictions on contracting behavior. The procedural regulations we argue should be repealed or reduced to defaults are unjustified for the reasons we give. The second premise would hold that the state has the right to regulate commercial transactions but can grant “permissions” to private agents, such as the permission that permits parties to create the substantive terms of their agreements. It is open to the polity, through its courts or its legislature, to withdraw or extend these permissions. The current permissions regarding contract, we argue, should be extended to include permitting parties to construct the procedural terms of their agreements, again for the reasons we give. Our

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 while 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, 3, 5 (2005).

95 To illustrate, every merchant seller must make an implied warranty. U.C.C. § 2-314 (A.L.I. & UNIF. L. COMM’N 2023). 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).

argument in this Article thus “spans” the basic political premises relevant to private contracting.

Second, contract law reform has been difficult to achieve because the benefits would be spread over millions of contracting parties while the costs of lobbying for change are concentrated. This helps to explain why the institutions responsible for creating private law—the ALI and NCCUSL—have been unable to enact broad reforms since the 1970s.⁹⁶ Change, however, is needed: Modern business practices are leaving contract law behind.⁹⁷ This Article thus is addressed to courts, who created our contract law and could change it; to scholars, who can create the intellectual momentum for reform; and to state legislatures, who could materially improve their economies by deregulating contract law.

III. THE CONTRACT THEORY CASE FOR DEREGULATING CONTRACT LAW⁹⁸

A. *Optimization and Incentive Theory*

Two economic constraints reduce the ability of imperfectly informed parties to make efficient contracts. These are the “participation constraint” and the “incentive compatibility constraint.” The triad rules harden both constraints and so reduce the efficiency of market contracting.

The participation constraint holds that an agent would not make a particular contract unless she would be at least as well off under that contract as she would have been under her next-best opportunity.⁹⁹ Thus, the regulations reduce the number of efficient contracts a market could sustain.¹⁰⁰

96 See Schwartz & Scott, *supra* note 43, at 1669 & n.33.

97 See, e.g., Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765, 1771–77 (1996); Schwartz & Sepe, *supra* note 69, at 755.

98 We are primarily concerned with transactions that parties do not make in classically competitive markets. Introducing a mandatory rule in a competitive market would cause marginal buyers to exit and marginal sellers to raise prices. The marginal sellers from the exiting buyers also would exit while their 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 would no longer be achievable once these rules are introduced. See MAS-COLELL ET AL., *supra* note 30, at 312–13.

99 See BERNARD SALANIÉ, *THE ECONOMICS OF CONTRACTS: A PRIMER* 122 (2d ed. 2005); PATRICK BOLTON & MATHIAS DEWATRIPONT, *CONTRACT THEORY* 17–18 (2005).

100 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

The triad interpretation rules attempt to implement the courts' goal of recovering the actual contract. 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.¹⁰¹ 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 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.¹⁰² In these schemes, parties tell the truth in equilibrium because deviations that are found out are punished.¹⁰³ Because contracts are more efficient when based on more complete information, the ban on penalties also hardens the participation constraint.¹⁰⁴

As a final 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.¹⁰⁵ After the agent invests, the agent still bears

removed. See generally RANGARAJAN K. SUNDARAM, *A FIRST COURSE IN OPTIMIZATION THEORY* (1996); ALPHA C. CHIANG & KEVIN WAINWRIGHT, *FUNDAMENTAL METHODS OF MATHEMATICAL ECONOMICS* (4th ed. 2005) (introducing the concepts of optimization, including the effect of constraints on the optimal solution).

101 See Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 2, 11–12 (2004).

102 See Schwartz & Sepe, *supra* note 77, at 682.

103 See *id.* at 704.

104 *Id.* at 682; see, e.g., Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 74–80 (1979) (showing how optimal contracts use state-contingent rewards and punishments to induce truthful revelation or effort in equilibrium under asymmetric information); JEAN-JACQUES LAFFONT & DAVID MARTIMORT, *THE THEORY OF INCENTIVES: THE PRINCIPAL-AGENT MODEL* 28–31, 39–45, 71–77 (2002) (explaining how transfers and penalties can relax these constraints by inducing agents to reveal private information).

105 See Schwartz & Scott, *supra* note 36, at 614 n.153. For formal models in which ex post renegotiation of incentive contracts can undermine ex ante effort and investment incentives, and in which parties may prefer simple or non-renegotiable arrangements to preserve those incentives, see Drew Fudenberg & Jean Tirole, *Moral Hazard and Renegotiation in Agency Contracts*, 58 ECONOMETRICA 1279, 1279–88 (1990) (showing how the possibility of renegotiation changes the structure of optimal incentive contracts under moral hazard); Eric Maskin & John Moore, *Implementation and Renegotiation*, 66 REV. ECON. STUD. 39, 39–41 (1999) (characterizing what outcomes can be implemented when parties cannot commit not to renegotiate); Ilya Segal, *Complexity and Renegotiation: A Foundation for Incomplete Contracts*, 66 REV. ECON. STUD. 57, 57–60 (1999) (showing how renegotiation in complex environments pushes outcomes toward incomplete-contract benchmarks); Eric Maskin & Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83, 84–85

risk when a contract's return also is a function of exogenous circumstances.¹⁰⁶ Therefore, an ex post Pareto-improving deal arises when the agent, after investing, is paid a fixed sum (lower than her expected gain) and the remaining risk shifts to the risk-neutral principal.¹⁰⁷ But anticipating ex ante that her compensation actually will be fixed, the risk-averse 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.¹⁰⁸ Banning the clauses thus reduces the parties' expected return.¹⁰⁹

Turning to the incentive compatibility constraint, a party sometimes cannot observe whether its counterparty performed tasks the contract assigned to her or performed tasks the contract prohibited.¹¹⁰ As a consequence, the counterparty has an incentive to take privately efficient actions, whether they constituted breaches or not.¹¹¹ A party, however, may realize that its counterparty could "shirk." The incentive compatibility constraint then would not hold: That is, when shirking could not be deterred parties would make a less efficient contract (whose terms could be performed "publicly") or not contract at all.¹¹²

A contract that satisfies the incentive-compatibility constraint would induce each party to take optimal actions, whether the counterparty could observe those actions or not.¹¹³ The triad regulations impede the parties' ability to make such contracts. Consider an example

(1999) (arguing that sophisticated mechanisms can, in principle, replicate fully contingent contracts even when contingencies are unforeseen ex ante); Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 REV. ECON. STUD. 115, 117–26 (1999) (responding that complexity and renegotiation constraints help explain why real-world contracts are simple and incomplete and why commitment devices matter for investment incentives).

106 See Schwartz & Scott, *supra* note 36, at 553–54.

107 See Schwartz & Sepe, *supra* note 77, at 700; Schwartz & Scott, *supra* note 36, at 614 n.153.

108 See Schwartz & Scott, *supra* note 36, at 614 n.153.

109 Schwartz & Sepe, *supra* note 77, at 682–83.

110 See Schwartz & Scott, *supra* note 43, at 1676; Schwartz & Scott, *supra* note 36, at 605–08.

111 See Holmström, *supra* note 104, at 75–80.

112 This is the standard incentive-compatibility problem in principal-agent models with hidden actions: When actions are unobservable, the agent may "shirk" and choose privately optimal but socially inefficient behavior, forcing the parties either to adopt second-best, more easily monitored contracts or to forgo trade. See *id.* at 74–78 (deriving optimal incentive schemes when effort is unobservable); Oliver Hart & Bengt Holmström, *The Theory of Contracts*, in ADVANCES IN ECONOMIC THEORY: FIFTH WORLD CONGRESS 71, 84–101 (Truman F. Bewley ed., 1987) (surveying how incentive-compatibility constraints limit feasible contracts under asymmetric information); LAFFONT & MARTIMORT, *supra* note 104, at 28–144 (developing the participation and incentive-compatibility constraints that characterize efficient contracts with hidden actions).

113 For general treatments of how optimal contracts are characterized by participation and incentive-compatibility constraints that implement first- or second-best actions despite

in which, after the parties contract, the buyer is supposed to invest to increase the contract's expected return. If circumstances outmoded the contract's substantive terms, the parties could renegotiate to the ex post efficient deal. Renegotiation, however, requires both parties' consent. The buyer thus would have to give up surplus to get the seller to agree. But anticipating this possibility, the buyer would invest to maximize its fraction, rather than all, of the contract's surplus and so would underinvest.¹¹⁴ A contract could not prevent this result by requiring the buyer to invest optimally if, as often happens, the seller could not observe the buyer's actions.¹¹⁵

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 the renegotiated contract would create. The buyer would invest optimally if it anticipated that the seller would accept the offer. The parties therefore must create sufficient bargaining power for the buyer. Their contract could require the seller to 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 anticipate that its take-it-or-leave-it offer for the entire surplus would succeed. The efficient contract would also guarantee the seller's sunk costs if renegotiation failed.¹¹⁶

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.¹¹⁷ The triad rules, in sum, harden the incentive-compatibility constraint by precluding contracting protocols that would respond efficiently to the underinvestment problem.

hidden information, see LAFFONT & MARTIMORT, *supra* note 104, at 7–144; BOLTON & DEWATRIPONT, *supra* note 99, at 3–8, 35–44.

114 For a technical overview of the underinvestment problem, see BOLTON & DEWATRIPONT, *supra* note 99, at 560–78; SALANIÉ, *supra* note 99, at 122; Benjamin E. Hermalin, Avery W. Katz & Richard Craswell, *Contract Law*, in 1 HANDBOOK OF LAW AND ECONOMICS 3, 84–86 (A. Mitchell Polinsky & Steven Shavell eds., 2007) (discussing the holdup problem and renegotiation); Benjamin Klein, *Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationships*, 34 ECON. INQUIRY 444, 444–47 (1996) (explaining that holdup occurs because the contract form provides a place for opportunism).

115 See Schwartz & Sepe, *supra* note 77, at 696–97.

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

117 Cf. Schwartz & Sepe, *supra* note 77, at 689.

B. Mechanism Design

Mechanism design (MD) theory studies the optimal design of incentives for a group of agents.¹¹⁸ Because contract law governs interactions between parties, and between parties and courts, MD theory is an essential economic tool for contract analysis.¹¹⁹ Many mechanism design protocols are too abstract and complex for practical use, however. More importantly, they suppose that courts will play roles that courts today would reject.¹²⁰ 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 request courts to follow party instructions regarding remedies and enlist courts in the parties' information revelation plans.¹²¹

An important example is the "collaborations" that attempt to create new products, drugs, vaccines, or platforms in multi-stage transactions.¹²² 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.¹²³ This information may out-mode the original agreement, so that the parties may come to have different beliefs regarding the efficient path forward.¹²⁴ They can renegotiate to a new arrangement, but bargaining often fails in the asym-

118 See *id.* at 690–91.

119 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 MD theory adds additional value to contracting analysis. See *id.* at 690–92.

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

121 See Schwartz & Sepe, *supra* note 77, at 692–97 (discussing some of these protocols and their limitations).

122 See Schwartz & Sepe, *supra* note 69, at 751–52. On new collaboration contracts, see also Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Text and Context: Contract Interpretation as Contract Design*, 100 CORN. 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).

123 See Schwartz & Sepe, *supra* note 69, at 754–55.

124 *Id.* at 759.

metric information environments that characterize these collaborations.¹²⁵ 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.¹²⁶ Such midstream interpretations would facilitate the disclosure of information, through the processes of discovery and trial. Also, parties may disclose voluntarily when they anticipate that a court would require disclosure. The now-unavailable mechanism of midstream interpretation thus would enable parties to make more efficient decisions between continuing and terminating a collaboration.¹²⁷ And to summarize, an appropriate mechanism induces parties to reveal private information but requires the court to be a player.¹²⁸ The mandatory triad rules preclude this role and generally harden the two key contracting constraints. The rules thus reduce the number of efficient contracts the market will sustain.¹²⁹

IV. HOW THE ATTEMPT TO REGULATE CONTRACTING PROCEDURE FUNCTIONS

Part III's contract theory analysis assumed that the triad rules bind everyone alike, but they are binding only for some. As a result, the rules function arbitrarily and unfairly. We first show this with an example and then set out the formal case.

125 *Id.* at 782.

126 *See id.* at 760. On the efficiency of midstream contract interpretation, see generally Schwartz & Sepe, *supra* note 54, at 617.

127 *See* Schwartz & Sepe, *supra* note 54, at 617. 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.

128 *Id.* at 659.

129 There is also a consequentialist but not strictly welfarist argument favoring deregulation: its potential for increasing commercial experimentation. Experimentation with possible social improvements, despite uncertain outcomes, has a historical basis in political philosophy. *See* Jacob Barrett & Allen Buchanan, *Social Experimentation in an Unjust World*, in 9 OXFORD STUDIES IN POLITICAL PHILOSOPHY 127, 130–34 (David Sobel & Steven Wall eds., 2023). Similarly, commercial experimentation, despite its inherent risks and uncertainties, can lead to valuable insights and improvements through trial and error. An enlarged contracting sphere can enhance state-led experimentation, which today is limited by its centralized nature. The state can modify rules, but its ability to induce localized experimentation is restricted compared to decentralized, private-order experimentation. State-mandated experiments lack the horizontal dialectical process that fosters innovation and marginal improvements. Additionally, state experimentation becomes less frequent as democracies mature. Although competitive pressure among states could theoretically drive them to develop better commercial practices to attract business, in practice, there is a convergence of state common law on fundamental contract doctrines with little variation. This convergence may stem from transcontextual constraints or the need for state common law to apply uniformly to sophisticated and unsophisticated commercial parties alike.

A. *An Example*

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 $\sigma > 0$. The seller would have to take products back, lose sales, and invest more in return facilities. In a workably competitive market, price equals cost, so the price that sellers would charge for the loose return policy also would be σ .¹³⁰ 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 the 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.¹³¹ 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 it would reduce purchase costs.

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

130 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).

131 See U.C.C. § 2-719(2) & cmt. 3 (A.L.I. & UNIF. L. COMM’N 2023), which puts the risk of a failed repair-or-replace term on the seller.

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, minimarts that sell toasters and portable air conditioners, local electronics stores, and the like. 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. The small market sellers' contracting cost for adopting a replicating q term thus would be $c(q_H)$. 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 ; and (c) the price increases that 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.¹³²

This example suggests five lessons: First, mandatory rules reduce agents' *autonomy* by raising the cost to the agents of pursuing their commercial projects.

Second, X_R is mandatory because revealed preference—prior widespread commercial practice—suggests that parties would contract

132 Similar economic effects would occur in the experienced firm market, but their magnitude would be materially less because the contracting cost increase for these sellers probably would be lower than the product-return cost increase. Part VI discusses the welfare effects of mandatory rules in more detail.

out of a loose return default. Because persistent commercial practices usually are efficient (absent externalities),¹³³ X_R 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. This is a very large class. Most U.S. firms lack the staff to support a contracting technology.¹³⁴

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 parties incur in a large commercial economy.¹³⁵ Hence, the lawgiver is unlikely to know just whom X_R binds. A contract law with unpredictable mandatory rules—that is, our law—functions 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.¹³⁶ Thus, contract law is *incoherent*.¹³⁷ We next show that these five lessons hold generally.

133 See generally Sepe, *supra* note 33 (discussing commercial rationality).

134 See U.S. SMALL BUS. ADMIN., OFF. OF ADVOC., FREQUENTLY ASKED QUESTIONS: JULY 2024, at 1 (2024) (reporting that 99.9% of all U.S. firms are “small businesses” and that 81.9% of small businesses have no employees), see also MARK P. KEIGHTLEY & JOSEPH S. HUGHES, CONG. RSCH. SERV., R44086, PASS-THROUGHS, CORPORATIONS, AND SMALL BUSINESSES: A LOOK AT FIRM SIZE 3–4, 4 fig. 1 (2018) (finding that eighty-five percent of corporations and ninety-one percent of pass-throughs have fewer than twenty employees, and ninety-nine percent of both have fewer than five hundred employees). Taken together, these data imply that most U.S. firms have fewer than twenty employees, and thus almost never maintain dedicated legal or contract-administration departments capable of designing and operating sophisticated contracting technologies.

135 Richard Craswell, *The “Incomplete Contracts” Literature and Efficient Precautions*, 56 CASE W. RES. L. REV. 151, 152, 155 (2005).

136 See Schwartz & Scott, *supra* note 59, at 1533.

137 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. See Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 J.L. ECON. & ORG. 441, 444 (1999). The Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, 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 Che & Schwartz, *supra*, at 442. 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) due to its incidence in a large economy, was impossible for the legislature to predict, so functioned arbitrarily; and (v) given suppliers' control over other terms, contributed to bankruptcy law's incoherence.

B. The Formal Argument

1. Rule Types and Their Application¹³⁸

Define a legal rule's "incidence" as the effect the rule has on its addressees. To pursue the triad's impact, let the lawgiver enact a rule ω in order to implement the 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 affect contracting capacities or selling costs. Note that the lawgiver enacts ω but does not change other rules. This is common practice, but it also is the crucial mistake. Parties can escape a mandatory rule set out in one procedural term by altering the *substantive terms* to replicate the economic outcome the rule was meant to ban.

138 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, 1–2 (2010) (pioneering studies in this area). Our results are consistent with the Katz and Sandroni thesis. An informal recognition that parties sometimes can escape mandatory rules by changing contracting strategies is in Schwartz & Scott, *supra* note 43, at 1679–80, 1697–1702.

The lawgiver can choose among four ω versions, each of which attempts to implement policy Y , which, illustratively, imposes on the seller the defect risk its product poses. The versions are:

ω_1 : The seller must implement policy Y but can contract out.

ω_2 : The seller must implement policy Y ; the seller can contract out but only in the legally prescribed way.¹³⁹

ω_3 : The seller must implement policy Y .

ω_4 : The buyer cannot specifically enforce a Y contract, however.

2. Party Responses: 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 $i \in \{\omega_1, \dots, \omega_4\}$, and the term to the right indexes the corresponding contractual responses $i \in \{k_1, \dots, k_4\}$. To illustrate:

$T: \omega_1 \mapsto k_1$. Rule ω_1 requires the seller to warrant: k_1 is a disclaimer.

$T: \omega_2 \mapsto k_2$. Rule ω_2 regulates disclaimer form: k_2 is to comply or to reduce warranty coverage.

$T: \omega_3 \mapsto k_3$. Rule ω_3 makes the seller strictly liable for a warranty breach. Response k_3 would (a) raise the price to offset increased warranty costs; (b) reduce quality to make a warranty easier to satisfy; or (c) lease the product to the “buyer/lessee” with an option to purchase: The lease would make a relatively low-quality commitment.

$T: \omega_4 \mapsto k_4$. Rule ω_4 restricts the parties’ ability to enforce Y with a penalty or specific performance. Response k_4 would be (a) to draft an extensive whereas clause setting out the reasons why contract damages would be noncompensatory, or (b) use a third-party quality certification.

Lake River illustrates a version of rule ω_4 . Recall that the parties there expected to trade the quantity Q_T but required the buyer to pay the full price on the lesser quantity Q_M , whether the buyer ordered all of that quantity or not.¹⁴⁰ The court held this pricing scheme to be a penalty.¹⁴¹ Sellers allocate a portion of revenue to fixed costs and to a return on capital.¹⁴² The parties thus could have substituted for the minimum guarantee a pricing formula that would increase the price

139 See U.C.C. § 2-316(2) (A.L.I. & UNIF. L. COMM’N 2023).

140 *Lake River Corp. v. Carborundum Co.*, 769 F.2d 1284, 1292 (7th Cir. 1985).

141 *Id.* at 1290.

142 *Id.* at 1288, 1291.

on units ordered to compensate for the reduction in these allocations that shortfalls from Q_T caused, but stop the increases after the buyer ordered the minimum quantity. This scheme would have been enforceable because it protects the seller's expectation, but the parties' contracting cost would have materially increased.¹⁴³

Transformation operators function by enabling parties to substitute unregulated substantive terms for regulated procedural terms. Whether a firm has access to transformation operators primarily depends on the firm's contracting capacity. A large market firm's contracting capacity is composed of an administrative apparatus to create and administer terms, such as a warranty department, a legal department (or routine access to lawyers), experience with the contract type at issue, and so forth.¹⁴⁴ A small market firm's contracting capacity consists of the experience of its owner (such as it is), and not much more.

With this as premise, we partition contracting costs as follows: (a) F_1 : Creating a contracting capacity such as a legal department or warranty administration; (b) F_2 : the startup cost of creating a transformation operator that would implement a replicating response to the mandatory rule at issue. These costs include deriving the new substantive terms, adjusting other contract terms to accommodate to the new substance, and creating the modified contract; (c) $C_{\omega i}$:¹⁴⁵ the variable cost of using the new contract sale by sale. The greater a firm's contracting capacity is, other things equal, the lower are the costs of creating the relevant transformation operator: The firm would already possess expertise, have the personnel in place, and so forth. A small firm commonly would have first to construct a contracting capacity—incur cost F_1 —that the large firm had already incurred in order effectively to create the necessary transformation operator—incur cost F_2 . Thus, it usually is more costly for a small firm to escape a mandatory rule than for a large firm to escape the rule.

143 Here are two more important examples. The UCC prohibits parties from contracting out of the duty to act in good faith, but the Code permits parties to specify the standards that would guide the court in applying the duty. Parties thus can control how the duty affects them. The UCC (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 Jody P. Kraus & Robert E. Scott, *The Case Against Equity in American Contract Law*, 93 S. CAL. L. REV. 1323, 1368–69 (2020).

144 See Schwartz & Sepe, *supra* note 69, at 766–67 (describing in detail the contracting technology of big firms such as Cisco System, Inc.).

145 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 $j \neq i$.

C. *Results and Implications*

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 any rule's adoption. Hence, our principal result: Mandatory rules *bear unequally* on parties and *function arbitrarily*.

We make three explanatory remarks.¹⁴⁶ First, the lawgiver cannot accurately predict the effect of a mandatory rule because the lawgiver cannot observe even a small fraction of total firms in the economy and so cannot assess firms' contracting capacities and selling costs.

Second, mandatory rules disproportionately 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.¹⁴⁷

The class of disadvantaged small firms that almost certainly lack contracting technologies is very large. According to the U.S. Small Business Administration, 33.3 million firms qualify as small businesses,

146 There is a possible counter argument. Assume: (i) There is a set of replicating terms that are costly to discover but easy to copy; (ii) those terms 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. These premises imply that the small market firms could use innovations large market firms develop. As a result, the larger firms only enjoy being first movers regarding replication. Assumptions (ii) and (iii) are strong, however. Contracting innovations often are context dependent, and so are attended with adaptation costs. Firms with weak contracting capacities likely cannot bear the adaptation costs. Also, such firms are unlikely to follow the contracting practices of larger, dissimilar firms. As a result, large firm contracting innovations are unlikely to diffuse quickly to the smaller firms.

147 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 lawgiver intends 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 a disclaimer than the buyers from small firms because it is less costly for large firms to escape rule ω_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 would warrant and raise prices. Losses would be spread, but over a small and arbitrarily selected buyer universe.

making up 99.9% of all U.S. businesses.¹⁴⁸ Although 80% of small businesses *operate without any staff*, they employ 61.6 million people, representing 45.9% of the entire U.S. work force.¹⁴⁹ Over eight out of ten small businesses *have no employees* but rather are solo ventures managed by their owners.¹⁵⁰ An additional 16% have one to nineteen employees.¹⁵¹ The tax that mandatory contract law rules impose on much of the U.S. economy thus is both regressive and large. No economic or moral principles, we show below, justify this tax and its associated efficiency costs.

Third, a contract theory result holds that when asymmetric information materially reduces the efficiency of market contracting, the parties' best response is to integrate vertically.¹⁵² The costs to agents of monitoring each other usually are lower within firms, and information flows are more efficient there.¹⁵³ Consider this possibility:

$T: \omega_{\#} \mapsto I_{\#}$, where $\#$ stands for a strong mandatory rule and I for vertical integration. This institutional response differs from the k responses, which indexed contracting strategies.¹⁵⁴

It is more costly for parties to create a new business structure than it would be to contract around any specific rule. Therefore, if the cost to parties of contracting around rule $\omega_{\#}$ would exceed the gain, the cost to parties of integrating vertically to escape $\omega_{\#}$ necessarily would exceed the gain. Vertical integration thus is a possible response to asymmetric information that creates contracting constraints,¹⁵⁵ but it is not a possible response to mandatory rules that create legal constraints.

To summarize, a business contract law should support transactions. A lawgiver sometimes may want to implement a policy with a

148 Kelly Main, *Top Small Business Statistics*, FORBES (Apr. 1, 2024, 06:50 ET), <https://www.forbes.com/advisor/business/small-business-statistics> [<https://perma.cc/D76U-SU29>].

149 *Id.*

150 *Id.*

151 *Id.*

152 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, 716–17 (1986) (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).

153 Firms can implement mechanisms to monitor agents that are typically more challenging to execute in markets. See R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 387–88 (1937).

154 $\omega_{\#}$ 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 only consider integration as a plausible response to mandatory or strong mandatory rules (i.e., ω_3 or ω_4).

155 See Grossman & Hart, *supra* note 152, at 717.

mandatory rule that takes precedence over this facilitative role. Part III shows that the lawgiver would be making a poor institutional choice: Mandatory rules function arbitrarily, largely ineffectively, and unjustly. Part V next shows that our characterization of mandatory rules as unjust finds foundational support in distributional and moral theory.

V. EQUALITY AND OPPORTUNITY

In moral theory, equality is used in two senses: in the distribution of resources and in the distribution of opportunities.¹⁵⁶ Commentators often use equality in the former sense to support contracting restrictions.¹⁵⁷ 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 resource inequalities is unwise for two reasons. First, an unanticipated mandatory rule can shift surplus between parties to existing contracts by retroactively altering the terms to one party's advantage. But because single rule changes cannot affect relative bargaining power, similarly situated future parties would alter prices or other terms in their contracts to replicate the prior distribution. Second, attempting to alter the distribution of resources with contract law rules is incompatible with the principle of the division of institutional labor.¹⁵⁸ This principle holds that the state should assign the task of implementing a policy to the institution that could best perform it.¹⁵⁹ Thus, states commonly use legislatures to implement distribu-

156 See JOHN RAWLS, A THEORY OF JUSTICE 62 (rev. ed. 1999).

157 See, e.g., Anthony T. Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472 (1980).

158 See RAWLS, *supra* note 156, at 244 (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 53–62, 85–95 (1995); for an economic approach, see LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 15–81 (2002). *But see* Liam B. Murphy, *Institutions and the Demands of Justice*, 27 PHIL. & PUB. AFFS. 251, 257–64 (1998) (criticizing Rawls's division of labor).

159 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. 1657, 1670–77 (2022) (defending a distributive view of private law in Rawlsian terms).

tional preferences, agencies to oversee grants and subsidies, and anti-trust law to protect competition.¹⁶⁰ Private law's comparative advantage is to pursue justice as equality of opportunity.¹⁶¹

A. *Fairness*

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's second principle of justice implies that such disparate opportunities to contract are unjust.¹⁶² This principle is composed of two subprinciples: 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);¹⁶³ and (b) attached to offices and positions open to all under conditions of fair equality of opportunity (the Equality of Opportunity Principle).¹⁶⁴

Mandatory rules that only bind some parties violate the Equality of Opportunity Principle in the commercial domain. Constrained parties cannot construct their own contracting paths. Deregulating contracts would open this opportunity to many more firms.¹⁶⁵ Mandatory contract law rules also violate the Difference Principle: The rules disadvantage the worst-off commercial parties by restricting these parties'

160 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 not subject to similar inequality concerns. Hence, the division of labor principle requires no exceptions or modifications for them.

161 See Simone Sepe & David Clark, *Contract as Equal Defense* (2024) (unpublished manuscript) (on file with authors) (arguing that the institution of contract serves as an instrument to equalize opportunities among parties that employ promissory morality and have different enforcement resources).

162 See RAWLS, *supra* note 156, 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 (Erin Kelly ed., 2001) (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. ENCYC. PHIL. (Sep. 3, 2025), <https://plato.stanford.edu/entries/rawls/> [<https://perma.cc/QJD3-WME3>] (same); G.A. COHEN, *RESCUING JUSTICE AND EQUALITY* (2008) (providing a comprehensive analysis and Marxist critique of Rawls's principles).

163 COHEN, *supra* note 162, at 65–70 (discussing the Difference Principle).

164 *Id.* at 87–91 (discussing the Equality of Opportunity Principle).

165 Cf. Sepe & Clark, *supra* note 161 (arguing that the institution of contract serves as an instrument to equalize opportunities among parties that employ promissory morality and have different enforcement resources; in our case, the difference lies in the disparate resources available to parties for circumventing mandatory rules).

ability to pursue their contracting goals.¹⁶⁶ Rawls's second principle of justice thus also supports deregulating contract law (the Equality of Opportunity Principle).¹⁶⁷

B. *Autonomy and Rights*

Moral theories that focus on freedom also support relaxing or repealing the triad rules, whether freedom is cast in terms of the agent's autonomy to choose,¹⁶⁸ or the exercise of the agent's rights.

1. *Autonomy and Moral Parity*

Autonomy consists in an agent's ability to realize self-authorship.¹⁶⁹ An autonomous agent's freely chosen acts necessarily reflect her self-authorship because acts implement preferences and these are

166 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.

167 Under Rawls, there would be no violation of the Equality of Opportunity Principle when the lawgiver enacts a mandatory rule that no party can avoid. This rule would not violate the Equality of Opportunity Principle because it constrains all parties equally. However, one could argue that this might violate Rawls's first principle of justice, which states 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 156, at 53. Although contracts—particularly those involving the means of production—are not considered a basic liberty, freedom of association is, and commercial contracts may be viewed as associations, thus falling under the first principle of justice. See RAWLS, *JUSTICE AS FAIRNESS*, *supra* note 162, at 44. This is because private associations (including dyads), when properly constructed, can ensure equal opportunities for individuals to pursue shared goals, irrespective of personal characteristics. Nevertheless, the extent to which these primarily economic associations are protected by the first principle remains unclear.

168 "Autonomy" is a term of art that characterizes common moral, political, and social ideals. The ideals hold that there exists "a notion of the self which is to be respected, left unmanipulated, and which is, in certain ways, independent and self-determining." GERALD DWORKIN, *THE THEORY AND PRACTICE OF AUTONOMY* 11–12 (1988). 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* 68 (2017). This view of autonomy holds that autonomy is increasing in the relevant options available to the agent. *Id.*

169 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. RAZ, *supra* note 168, at 372–73. Autonomy is self-government. An autonomous agent thus is one who acts on her own motives. DWORKIN, *supra* note 168, at 13.

the outcome of the agent's own considerations.¹⁷⁰ Relevant here, parties have preferences over contract terms, whether those terms are procedural, such as the triad rules, or substantive. Constraining the former choice reduces autonomy by preventing the agent from fully acting on her preferences.¹⁷¹

This restriction is arbitrary as well as obvious because the freedom of contract principle permits parties to pursue their substantive preferences. This principle, we argue, also authorizes parties to pursue their procedural preferences because their pursuit in both contractual domains would exhibit the same deontic power. This is a *similarity argument* for autonomy.¹⁷² It follows from two premises:

P1: Contract terms that implement substantive freedom are on a moral parity with terms that would implement procedural freedom.

P2: Contract terms that implement substantive freedom are legally enforceable.

These premises imply that:

C: Contract terms which would implement procedural freedom also should be legally enforceable in consequence of both term types' moral parity.

P1 rejects a common moral objection to expanding freedom of contract: The expansion 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

170 See Gerald Dworkin, *The Concept of Autonomy*, in *THE INNER CITADEL: ESSAYS ON INDIVIDUAL AUTONOMY* 54, 60 (John Christman ed., 1989).

171 In his book, *The Liberal Archipelago*, Chandran 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 CHANDRAN KUKATHAS, *THE LIBERAL ARCHIPELAGO: A THEORY OF DIVERSITY AND FREEDOM* 205 (2003). In his review of *The Liberal Archipelago*, Donald Moon observes that an exit option for the agent from any polity also is required fully to realize freedom. See J. Donald Moon, *The Liberal Archipelago: A Theory of Diversity and Freedom*, 115 *ETHICS* 422, 424 (2005) (book review). Many agents lack all of 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 111–14. 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 transformation operators enable exit from mandatory rules, Kukathas's 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.

172 We thank Lisa Bernstein for providing the intuition behind this argument.

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.¹⁷³ P2 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 they knowingly consented to undertake. Under the two premises, then, the similarity argument holds that the lawgiver should permit party autonomy regarding the triad procedural terms.¹⁷⁴

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.¹⁷⁵ This “choice theory approach” implicitly supposes that it is costless for an agent to choose among the forms. To the contrary, autonomy shrinks when the state arbitrarily increases the cost of some options—here, the procedural ones—relative to others or increases the cost of all options alike.

Mandatory rules also reduce the autonomy of parties who 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 overall: 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.¹⁷⁶ To sum up, we make a straight-

173 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 that is not justified by differences in the parties’ exercise of deontic power.

174 Note 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 should be normatively permitted.

175 See DAGAN & HELLER, *supra* note 168, at 72 (arguing that agent autonomy is preserved if agents have a choice of relevant contract terms).

176 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.

forward argument that autonomy “on the ground” increases in the degree of *cost-justified control* the agent can exercise over her contracting affairs. Mandatory procedural regulation arbitrarily reduces that control.

2. The Rights Argument

Moral theories that protect rights support deregulating contract law. The most important theory, Robert Nozick’s entitlement theory of justice, is illustrative.¹⁷⁷ The theory holds that individuals have inherent rights that are prior to their social and political rights.¹⁷⁸ Prior rights include the right to life, liberty, property, and to control one’s life.¹⁷⁹ 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 governs the initial acquisition of holdings. It provides an account of how people in pre-political states are permitted to own natural resources and property, including produced resources.¹⁸⁰ 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 or gifting.¹⁸¹ 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, contract law regulation is *unjust* in the pre-political world. It constrains parties’ ability to trade even when the three legitimating conditions for voluntary exchange are satisfied.

177 See ROBERT NOZICK, *ANARCHY, STATE, AND UTOPIA* 150–53 (1974).

178 See *id.* at 10–12 (arguing that individual rights are foundational and not contingent on social or political institutions).

179 See *id.* at 10, 28–35 (discussing the rights to life and liberty as fundamental individual rights); *id.* at 171–72, 177, 226–29 (discussing the right to property as a fundamental individual right).

180 See NOZICK, *supra* note 177, at 150–51.

181 *Id.* The Principle of Justice in Transfer presupposes that the Principle of Justice in Acquisition is satisfied. Thus, the contract laws of advanced economies regulate *trades* between rights holders: They do not regulate how parties came to own what they are trading. However, the “patterned principle of distribution” that may emerge from this system is compatible with liberty. *Id.* at 193–94, 194 n.*. Suppose a pattern of entitlements and consider a person who inherited a special musical talent. She cannot sing for everyone, however, and so rations appearances partly by price. Many persons much prefer hearing her sing to the price of a ticket. As a result, the singer becomes wealthier than many of her customers. This distributive result is just, in Nozick’s view, because no affected agent prefers an outcome other than the one that occurred. See *id.* at 161 (discussing the now-classic Wilt Chamberlain’s example).

Sophisticated agents' unconstrained freedom to trade, in Nozick's theory, survives the creation of a civil society.¹⁸² Nozick envisions a minimal state in which individuals form "protective associations" to safeguard their rights.¹⁸³ Over time, these associations merge and grow into a "dominant protective association," which is the state.¹⁸⁴ The state-association's role, however, is restricted to protecting individuals from force, theft, and fraud, and to enforce contracts that satisfy the three conditions.¹⁸⁵ We especially stress that our argument for relaxing the triad rules is restricted to contracts that satisfy Nozick's three conditions.¹⁸⁶

C. *Objections*

We respond to two objections to the autonomy and rights arguments and then address a putative qualification to every such argument. The first objection is that the conditions for truly autonomous choice do not exist for many citizens 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.

1. The Relational Egalitarian Objection

This objection holds that parties' choices are authentically autonomous only when made under "relational egalitarianism," a political

182 Freedom over triad terms might also be consistent with a principle-based (non-libertarian) approach to freedom of contract.

183 See NOZICK, *supra* note 177, at 12.

184 *Id.* at 15, 22–25. 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, 17.

185 In Nozick's view, the monopolization of the use of force by the state is just 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).

186 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 meant to safeguard the interests of non-contracting parties.

condition that cannot exist when some members of a polity face hierarchies of power, esteem, and standing.¹⁸⁷ Issues of esteem seem beyond the ability of courts to regulate and so are beyond our scope. Standing questions also are not relevant here because our parties do have standing to make transactions. This leaves the question of power.

Recall that our context is the contract between two commercial entities. Power in this context can have two meanings: the better ability to conduct the transaction or the power to command a larger share of the contractual surplus. A power imbalance could exist in the former sense when a company is contracting with individual persons. We assume here, however, that our agents are equally qualified to contract. A power imbalance would exist in the latter sense when parties have unequal bargaining power.

Power imbalances as differences in surplus division obviously exist, but they do not affect our autonomy-based argument for greater procedural freedom. This is because the strong and the weak both prefer the same substantive terms. To see why, realize that contracting parties have two tasks: to choose efficient terms and to divide the resultant expected surplus. 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. A party, however, seldom could affect her counterparty's discount rate or disagreement point. Parties thus recognize that surplus splits are exogenously determined.

As a consequence, both parties will prefer the same substantive terms: those that maximize expected surplus. This is an implication of rationality: A party who attempts to maximize her expected return will prefer a small share of a large pie to a small share of a small pie.¹⁸⁸ The contracts of sophisticated parties therefore reflect their autonomous choices, whether a party has much bargaining power or little.¹⁸⁹

187 See Elizabeth S. Anderson, *What is the Point of Equality?*, 109 ETHICS 287, 308 (1999); ELIZABETH ANDERSON, PRIVATE GOVERNMENT: HOW EMPLOYERS RULE OUR LIVES (AND WHY WE DON'T TALK ABOUT IT) 3 (2017); Samuel Scheffler, *What is Egalitarianism?*, 31 PHIL. & PUB. AFFS. 5, 5 (2003); Shffrin, *supra* note 85, at 243; Hanoch Dagan & Avihay Dorfman, *Justice in Private: Beyond the Rawlsian Framework*, 37 LAW & PHIL. 171, 171 (2018).

188 Parties may disagree on which terms are surplus maximizing but will not disagree on the goal the terms should serve.

189 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 (with $0 < \alpha < 1$) of any S and Party B can capture $(1 - \alpha)$ of S . Party A's possible payoffs are $U_A(K_m) = \alpha \cdot (S_m)$ and $U_A(K_n) = \alpha \cdot (S_n)$. 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 $U_B(K_m) = (1 - \alpha) \cdot S_m$ and $U_B(K_n) = (1 - \alpha) \cdot S_n$ 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 $\alpha = 0.9$. Party B

2. The State's Moral Agency Objection

The moral agency objection to deregulation begins with the state's unique power coercively to enforce contracts. This power, the objection holds, makes the state and the parties "partners": Parties create the contracts that the state enforces.¹⁹⁰ Partners to an ordinary partnership have a say in how their partnership functions.¹⁹¹ When the state refuses, for moral reasons, to enforce a procedural term, or to regulate it, the state thus is exercising the power of a partner; it is not overriding the private parties' will.¹⁹²

This objection rests on two false premises. First, the state and the parties are partners because only the state can enforce coercively. Second, as with any partnership, the state has a veto power over what the partnership should do. Taking the second premise first, private parties have equal moral standing with the state because the consent of each of them is necessary for their partnership to function. It is a separate question how much influence each partner should have in particular partnership decisions, however. The Shapley value of each partner is a normatively attractive way to allocate influence in a coalition (a contract is a two-party coalition).¹⁹³ The Shapley value is a function of the marginal contribution a player makes to the coalition of which the player is a part; the greater a player's marginal contribution to a coalition's outcome, the more influence the player should have.¹⁹⁴ Because commercial contracts, in fact, are largely self-enforcing, the state's Shapley value is lower than the private parties': That is, the state's marginal contribution to the outcome of the typical state/party coalition

nevertheless would prefer contract K_m because $0.1 \cdot (S_m) > 0.1 \cdot (S_n)$. 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. Therefore, relational egalitarianism is not violated when parties' bargaining power is unequal (by a factor of nine in our example). For a full argument addressing the paternalistic view aimed at protecting less sophisticated parties in contracts between sophisticated parties, see Sepe, *supra* note 33, at 15–17.

190 See Shiffrin, *supra* note 85, 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.").

191 See *id.* at 223–25.

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

193 See Sepe, *supra* note 33, at 5 n.10. The Shapley value is justified by axioms that ensure fair payoff distribution based on contributions: Efficiency, where the total value is fully allocated among players; Symmetry, where equal contributors receive equal payoffs; Dummy Player, where non-contributors get zero; and Additivity, where a player's value in a combined game is the sum of their values from individual games. See L.S. Shapley, *A Value for n -Person Games*, in 2 CONTRIBUTIONS TO THE THEORY OF GAMES 307, 307–17 (H.W. Kuhn & A.W. Tucker eds., 1953).

194 See Shapley, *supra* note 193, at 316.

usually is less than the commercial parties' contribution because parties seldom need the state's help.¹⁹⁵ As a result, the state should accept that party preferences over contract content should count more than state preferences.¹⁹⁶

Turning to the first premise, under common linguistic usage the state and the private parties are not partners at all. For example, a cable company can regulate a customer's use of the modem or prevent the customer's access to unpaid content, but the company has no control over what the customer watches. Thus, in common parlance the company is not the consumer's partner. Similarly, a public utility can manage usage during peak times, but it does not dictate what the customer stores in his refrigerator. The public utility also is not thought to be the consumer's partner. And to generalize, providing a service—here, contract enforcement—does not make the provider a partner because providers have no say in how customers use the service.

More deeply, the claim that the state can leverage its enforcement power to affect terms in private contracts is never defended. To see why a defense is needed, consider two forms of state power: the power to choose what the state will protect and the power to choose how to regulate the protected entity. The moral agency objection conflates these two types of power. The state cannot enforce a contract without defining the elements that constitute the entity "contract." There must be consent, comprehensible terms, a minimum remedy, and so forth. Nor can the state protect "property in rem" without specifying the elements that constitute the entity "property." But there is a countably infinite set of terms that are consistent with the conception of a contract. And there is a countably infinite set of uses that are consistent with the conception of property. Therefore, after the state has decided to protect contracts, by enforcing them, the state has a *second decision*: how to regulate, if at all, the possible terms contracting parties could use. The moral agency objection assumes that the decision to protect contracts implies a *particular form* of regulation: to control the procedural terms. It is this decision that requires, but has not received, a defense.

195 See Sepe, *supra* note 33, at 24.

196 *Id.* Moreover, independently of the Shapley value, the moral objection that gives the state the right to refuse enforcement for justice reasons (i.e., because the state views the contract terms as incompatible with the community's morality) would cause injustice. Commercial parties with more enforcement resources could enforce their agreements through promissory morality, while those with fewer resources could not. For more on this point, see the philosophical discussion in Sepe & Clark, *supra* note 161.

D. *The New Equity Qualification*

Promisors cannot foresee every possible future state in which they could be held to account. A good faith promisee would enforce a contract in unforeseen states only if enforcement would be efficient. A bad faith promisee would enforce the contract if enforcement would yield it a higher payoff, whether enforcement would be efficient or not. The “new equity school” holds that a court should use its equitable powers to rescue the promisor from bad faith promisee “opportunism.”¹⁹⁷ Such 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 literally permits those actions. The mandatory triad terms may reduce the opportunism risk, the argument goes, so they should be retained. For example, an owner should be prevented from enforcing a liquidated damage clause against a contractor whose lateness was caused by an unforeseen foreign conflict that interdicted a supply chain.

To see why the new equity qualification does not affect the autonomy and rights arguments for deregulation, 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_i . For a realized state in subset θ_1 , performing the contract would be efficient. For a realized state 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_i 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 parties would have contracted to permit the not-prohibited action a_k if the parties had foreseen that the promisee would take that action. In our illustrative case, the answer would be no. Therefore, an *equitable intervention* is only

197 See, e.g., Kenneth Ayotte, Ezra Friedman & Henry E. Smith, *A Safety Valve Model of Equity as Anti-Opportunism*, in CAMBRIDGE ELEMENTS: L. POL. & ECON. 1 (2023) (arguing that the goal of preventing opportunism can explain and justify the exercise of ex post equity); Kostritsky, *supra* note 86, at 45; 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).

needed in case (b) because the duty of good faith itself does not prohibit authorized contractual actions.

This analysis is fatal for the new equity qualification because sophisticated parties know that there always exist θ possible future states and know also that their contract could turn out to be profitable to perform in only a subset of those states (the θ_1 states). It follows that parties can anticipate that 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 occurs with positive probability and the promisee *foreseeably* may enforce the contract in that state if 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.¹⁹⁸ This is why courts take silence in the face of a contractual 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.

Put more intuitively, the new equity qualification of the argument for deregulation fails because it does not distinguish between the two ways in which an action can be unforeseeable. A party (i) can fail to foresee a particular counterparty action; but (ii) the same party could foresee that its counterparty might enforce the contract *whenever* enforcement would be to the counterparty’s advantage. The new equity qualification focuses on (i) when (ii)—the more general sense of “foresee”—is relevant to contract enforcement.¹⁹⁹ This is because a party who foresees that its partner might exploit literal contract language could bargain to restrict the counterparty’s ability to exploit. For example, parties often cabin the promisor’s unqualified duty to tender performance with force majeure clauses that specify general excusing events such as war, embargo, etc. Courts enforce unqualified tender obligations. And generally, courts suppose that a sophisticated agent consents to the exercise of every contractual power the agent does not

198 Rational parties price terms based on the probabilities they attribute to particular states occurring and the payoffs they expect in each of them. See MAS-COLELL ET AL., *supra* note 30, at 168–78. 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 parties’ *ex ante* incentive to invest in their contract. Thus, the parties should be permitted 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.

199 See Kraus & Scott, *supra* note 143, at 1365 (illustrating when the more general sense of foreseeability is relevant in contracting).

bargain to qualify.²⁰⁰ To conclude with a common example, courts enforce contractual indices in long-term contracts even when an index fails: that is, generates prices, costs, or quantities that fall outside their expected ranges.²⁰¹

To summarize, we showed that a contract law committed to autonomy would demote the triad procedural 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 the parties' partner regarding contract 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).²⁰²

VI. DEREGULATION IN A 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 coercive contract enforcement, and command of the rules regulating court intervention and judicial policing powers. In this Part, we explore a world that would shift 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

200 Here we expand Kraus and Scott's argument that parties consent to the complete extension of every term in their contract. See Kraus & Scott, *supra* note 143, at 1365.

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

202 Deregulation is also 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). 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 4 *OXFORD STUDIES IN NORMATIVE ETHICS* 13, 14 (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, *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 *id.* at 60. By expanding the opportunities for commercial experimentation, deregulation 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, *Economic and Political Objections to "Moral Capitalism"*, 42 SOC. PHIL. & POL'Y 37, 42–43 (2025) (examining the relationship between the *doux-commerce* thesis and the recent rise of moral capitalism); see also *supra* note 129 (discussing the non-welfarist consequentialist argument in favor of experimentation).

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 to increase contracting efficiency.

This economy would function similarly to an economy implementing right-based ethics or Nozick’s libertarian economy of private “protective associations.”²⁰³ Under these ethical schemes, parties are rulers of their local commercial domain (i.e., the associational agreements they voluntarily conclude).²⁰⁴ There are major differences 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.²⁰⁵ We suggest that this monopoly power could be supplemented, and sometimes replaced, by private enforcement.²⁰⁶ 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.²⁰⁷ Rather, parties would be authorized to invoke the state’s power to enforce governance

203 See NOZICK, *supra* note 177, at 12.

204 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.

205 See NOZICK, *supra* note 177, at 23–24.

206 Nozick defends the legitimacy of private coercive power in some circumstances. *See id.* at 24. 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 state’s enforcement power (as the agent). The permissibility of private enforcement power against a breach of promissory morality must be necessary and proportional to the harm the breaching party may inflict on the non-breaching party. Once the state has provided an enforcement system that is less harmful than certain self-defense measures parties might resort to in a state of nature, those measures may no longer meet the necessity standard. *See Sepe & Clark, supra* note 161, at 6.

207 *See generally* JASON BRENNAN, WHEN ALL ELSE FAILS: THE ETHICS OF RESISTANCE TO STATE INJUSTICE (2019) (arguing that when governments violate our rights, citizens may not only resist but also have a moral duty to do so); MURRAY N. ROTHBARD, FOR A NEW LIBERTY: THE LIBERTARIAN MANIFESTO (Ludwig von Mises Inst. 2d ed. 2006) (1973) (proposing an anarcho-capitalist society where voluntarily funded competitors, rather than taxation, would provide law enforcement, courts, and other security services); DAVID FRIEDMAN, THE MACHINERY OF FREEDOM: GUIDE TO A RADICAL CAPITALISM (3d ed. 2014) (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).

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 private contracting as “commercial anarchism” because there would be many contracting systems rather than one. Also, the state’s role in an anarchic world would become fully clear only *after* the world was brought into existence: One of its justifying features is to free parties to experiment with new commercial practices.

A. *The Commercial Archipelago*

The commercial archipelago would consist of industry-wide (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.²⁰⁸ 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.

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).²⁰⁹ Each association would be a site in which agents would

208 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 59, at 1524–26. There 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. See *id.* at 1545. 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: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115, 157 (1992).

209 Under a federal system, the federal government does not lose its moral agency when enforcement is governed by lower level, local laws because it retains the power to check whether certain constitutional conditions are met. For instance, a federal court may be required to apply state law. Federal courts will generally respect and enforce the parties’ choice of law, as long as there is a connection between the chosen jurisdiction and the contract. See Nyarko, *supra* note 57, at 57.

realize the moral and economic benefits of decentralization. Associations would likely be homogeneous commercially, so members would participate in conditions of relative economic equality. The relatively 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.²¹⁰ Because the promisor will choose the least costly option, the expectation remedy would make her better off without reducing the promisee's payoff.²¹¹ 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).²¹² When this strong informational condition does not hold, parties may neither trade nor invest efficiently.²¹³ 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. 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 associations.²¹⁴ 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

210 See RESTATEMENT (SECOND) OF CONTRACTS § 344 & cmt. a (A.L.I. 1981).

211 *Id.*

212 See Schwartz & Sepe, *supra* note 54, at 663–64.

213 *Id.*

214 We thus envision an antitrust law for associations.

prevents individuals from exiting existing associations and joining new ones or makes it excessively costly to do so.²¹⁵ 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 this limiting case for deregulation, 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 associations would resolve the exit/gain tradeoff differently, agents would have a choice among solutions: To choose an association would be to choose a solution to this central problem.

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 completely deregulated regime.²¹⁶ 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 con-

215 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 171, at 95–96. 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 her own morality. *Id.*

216 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 state validation to ensure that their local commercial sovereignty will withstand challenge.

tracts. Standardized disclosure would facilitate both association cooperation and association competition, for members and for financing.²¹⁷ 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 but association *Δ* requires a seller to make a perfect tender. If parties *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, however, 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.²¹⁸

Turning to the theoretical concern, the associational implications of the strong form of deregulation raise a basic question: Do parties have the metaphysical power to create a mechanism—a form—that makes enforceable exchanges possible?²¹⁹ 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 freedom of contract regime, individuals could

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

218 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.

219 We thank Daniel Markovits for raising this question.

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, would require 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 transact 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.²²⁰ 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.

We deploy this argument in three steps. First, drawing on action theory,²²¹ 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.²²² 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,²²³ conventions arise from repeated patterns of action due to mutual expectations.²²⁴ 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.²²⁵ 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

220 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. *See* NOZICK, *supra* note 177.

221 *See generally* THE PHILOSOPHY OF ACTION (Alfred R. Mele ed., 1997).

222 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.

223 *See generally* DAVID LEWIS, CONVENTION: A PHILOSOPHICAL STUDY (2002).

224 *Id.* at 60–61 (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.”).

225 *Id.* at 41.

an implicit acceptance of moral responsibility towards fellow participants and toward the agreed-upon practice.²²⁶ This act of engagement (i.e., a metaphysical condition) is what transforms mutual expectations into obligations.²²⁷

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 from individuals' ability to shape their social reality through shared forms of action, shared expectations, and shared recognition of obligations.²²⁸

To summarize, contract law subjects the parties' exercise of their moral power to its own moral commitments.²²⁹ A commercial "anarchical" regime would permit parties to make legally enforceable contracts in accordance with their own moral commitments. A more complete deregulation, in the form of commercial anarchism, thus would

226 *Id.* at 99.

227 This progression is consistent with John Searle's theory of institutional facts, in which obligations arise from mutually acknowledged expectations. *See generally* JOHN R. SEARLE, *THE CONSTRUCTION OF SOCIAL REALITY* (1995). The thought that participation in a practice can ground a duty to conform can be expressed in consequentialist terms, where the point of compliance is to avoid the bad outcomes that would follow if agents treated the practice as optional. *See, e.g.*, J.J.C. SMART & BERNARD WILLIAMS, *UTILITARIANISM: FOR AND AGAINST* 9–12 (1973); BRAD HOOKER, *IDEAL CODE, REAL WORLD: A RULE-CONSEQUENTIALIST THEORY OF MORALITY* 1–3, 88–102 (2000). It also fits deontological, practice-based accounts on which obligations arise from our collective or "joint" commitment to a practice rather than from particular reliance losses. *See* John Rawls, *Two Concepts of Rules*, 64 *PHIL. REV.* 3, 25–29 (1955); MARGARET GILBERT, *ON SOCIAL FACTS* 185–213 (1989). A familiar Kantian way to capture this idea is via the principle of universalizability—requiring one to act only on maxims that could be willed as universal laws. *See* IMMANUEL KANT, *GROUNDWORK OF THE METAPHYSICS OF MORALS* 31 (Mary Gregor trans., Cambridge Univ. Press 1997) (1785).

228 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: TOWARD A PLANNING THEORY OF HUMAN PRACTICAL ORGANIZATION* 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.

229 *See* KUKATHAS, *supra* note 171, at 17.

correspond to the ideal of an open society, in which citizens accommodate their different needs and values in the commercial domain.²³⁰ 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 φ (say a remedy) for which there is no current legal permission, she may φ if and only if she can justify φ to her counterparty. When both parties agree to φ , φ -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 contracts between members. An association would choose 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, 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.²³¹ This field of study suggests that parties can develop a *universal grammar* à la Montague.²³²

230 *Id.* at 17 (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 (emphasis omitted)).

231 See Barbara H. Partee & Herman L.W. Hendriks, *Montague Grammar*, in HANDBOOK OF LOGIC AND LANGUAGE 5, 13–14 (Johan van Benthem & Alice ter Meulen eds., 1997).

232 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

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.²³³

Regarding adjudication, parties could adapt the privatization practices followed in connection with international contract disputes.²³⁴ 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.²³⁵ Parties can enforce foreign arbitral awards at the nation-state level without a review of the merits.²³⁶ In addition, states allow arbitrators to decide international commercial disputes on the *sole* basis of private norms, which they interpret on their own terms.²³⁷ International commercial parties therefore can ensure that private norms would govern by providing for arbitration.²³⁸

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.²³⁹ Second, in interna-

as the language of first-order logic. *See id.* at 17–23. 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*. *Id.* 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.

233 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.

234 *See* Gilles Cuniberti, *The Merchant Who Would Not Be King: Unreasonable Fears About Private Lawmaking*, in PRIVATE INTERNATIONAL LAW AND GLOBAL GOVERNANCE 141, 142–43 (Horatia Muir Watt & Diego P. Fernández Arroyo eds., 2014).

235 *See id.*

236 *Id.* at 142.

237 *Id.* at 142–43.

238 *Id.*

239 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 generally* CLIVE M. SCHMITTHOFF, *The Unification of the Law of International Trade*, in CLIVE M. SCHMITTHOFF’S SELECT ESSAYS ON INTERNATIONAL TRADE LAW 170 (Chia-Jui Cheng ed., 1988); Berthold Goldman, *Frontières du Droit et “Lex Mercatoria,”* in 9 ARCHIVES DE PHILOSOPHIE DU DROIT 177 (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*

tional 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 obligatorily 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, an association can specify normative criteria that would guide courts in interpreting its and its members' contracts. For example, if an association chooses 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.

CONCLUSION

Our argument for deregulating contract law focuses primarily on three sets of mandatory contract law rules: (i) the rules regulating bargaining and renegotiation; (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 sometimes would be efficient.²⁴⁰

SCHMITTHOFF, *supra*, at 170–71; Goldman, *supra*, at 177–78. The multiple activities of international formulating agencies also unify the law of international trade and finance.

240 Cf. Alan Schwartz, *Price Discrimination with Contract Terms: The Lost-Volume Problem*, 12 AM. L. & ECON. REV. 394, 420 (2010). We have also discussed the efficiency role of penalties throughout the Article; in particular, see Section III.A.

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) We show, using economic contract theory, that the triad rules reduce welfare: Eliminating their mandatory character would permit parties to contract more efficiently. (B) We enrich understanding of how mandatory contract law rules function. Using the triad as an example, we show that mandatory rules cannot consistently implement social goals. Well-counseled and well-resourced parties can escape a mandatory rule’s effect with substantive terms that replicate the rule’s economic impact. This is an effective (though costly) escape route because the freedom of contract principle directs courts to enforce substantive terms. Thus, mandatory rules primarily constrain occasional or inexperienced agents. This is a very large class: The data show that most American firms lack the legal capacity to create replicating substantive terms. (C) Assuming that 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. To summarize, contract law should be deregulated because today the law functions as 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 control 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.

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.²⁴¹ As just one example, a mandatory bankruptcy law rule inefficiently prevents suppliers from conditioning future deliveries on the

241 For exceptions, see, for example, Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998); David A. Skeel, Jr. & George Triantis, *Bankruptcy’s Uneasy Shift to a Contract Paradigm*, 166 U. PA. L. REV. 1777 (2018).

buyer not filing for bankruptcy.²⁴² The arguments for deregulating contracts developed here would support repealing this 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 instead.²⁴³ Contract law, that is, affects the choice of organizational form, a possibility that deserves further study. And to end, deregulating contracts would produce positive changes in business law generally.

242 See 11 U.S.C. § 365(e) (2018); Che & Schwartz, *supra* note 137, at 444.

243 Cf. *supra* notes 152–54 and accompanying text.