

JUSTICE AND THE LAW OF CONTRACTS: A CASE FOR THE TRADITIONAL APPROACH

ALAN SCHWARTZ*

I thought that because the Federalist Society is a society tied to law schools, someone should discuss a traditional legal concept. So, I shall discuss a traditional legal concept: justice and contract law.

By justice, I mean two things. One aspect, which I will discuss first, follows from utilitarian premises and basically holds that just outcomes arise when people are permitted to do the best they can, given their circumstances. This is because, the theory goes, people are the best judges of what maximizes their own utility; hence, allowing them to make unrestrained choices is most likely to maximize utility for the individual and for society as a whole. The second aspect of justice, which I will discuss more briefly later, is called justice as fair distribution. This principle holds that the state has an obligation to insure that the circumstances in which people are trying to do the best they can are not terribly unfair to them.

I want to begin this discussion of contract law by using the first concept of justice: that utilitarian and Kantian notion that says that just outcomes result when people are allowed to do the best they can.¹ In the Nineteenth Century, contract law was

* Maurice Jones, Jr., Professor of Law, University of Southern California; Professor of Law and Social Science, California Institute of Technology.

1. Utilitarianism and Kant represent two very different starting points for moral analysis, but each starting point implies outcomes that are quite similar to the other for contract law purposes. Utilitarianism justifies freedom of contract if one accepts the view that persons are the best judges of what maximizes their own utility, for then, utility is maximized by letting people make the contracts they choose and enforcing those contracts. Kantian thought justifies freedom of contract because it holds that a person's autonomy should be respected and permitted to flourish. One aspect of autonomy is the conducting of transactions that a person believes will be in his or her best interests. See C. FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* (1981).

Utilitarianism will support limitations on the right to contract freely in circumstances when the assumption that persons can best decide what maximizes their own utility is unlikely to hold. Such circumstances include lack of information relevant to choice, fraud and the like. But it is in just those circumstances that a respect for autonomy requires limitations on the right to contract freely: contract choices made in ignorance, for example, are not entitled to great respect. See *id.* Because most persons in our society are Kantians or utilitarians or both, and because both starting points imply similar conclusions about the appropriate roles of freedom of contract, the text simply refers

thought to promote justice in just this sense because contract law permitted the parties to make almost any agreement they wanted and would then enforce the result. This was seen as letting people do the best they could for themselves.

In the Twentieth Century, this traditional view is thought to be obsolete. It is commonly believed that contract law in the traditional sense is an obstacle to justice because it permits the strong to exploit the weak in the name of freedom of contract. Through such doctrines as unconscionability, contract law today is attempting to perform its traditional function of insuring justice in the marketplace, not by permitting people to do what they want to do, but by preventing them—in certain circumstances—from doing what they have agreed to do.

I argue that the traditional theory was—with some exceptions—basically correct for several reasons. The principal reason is that, while there are evils in markets, they are evils that judges, given the tools that are available to judges, can seldom rectify. They are evils that are best rectified by other social institutions. Thus, it is still as true today as it was in the Nineteenth Century that judges who are deciding contract cases will best effect just outcomes by letting people do the best they can for themselves, given their circumstances.

I wish to turn now to an alleged evil that the traditional regime of contract was thought to permit. The evil is that large companies exploit small consumers—if you read unconscionability scholarship you will find that there is no consumer taller than five feet—by presenting consumers with one-sided form contracts that consumers cannot alter, leaving them no choice but to sign. The premise that underlies the view that form contracts are an alleged evil of freedom of contract is clear, and it takes two forms. The first is that each firm operates in isolation, not in markets. Each firm exploits the consumers who come to visit it; a firm can do this because there are no alternative firms for its customers to visit. The alternative form of this premise is that, while many firms exist, they do not compete with each other. Effectively, there is only one firm because all firms act alike.

to the aspect of justice under discussion as letting people do the best they can for themselves by their own choices. For a claim that the similarity between Kantian and utilitarian thought is general in the realm of policy choice, see Hare, *Liberty and Equality: How Politics Masquerades as Philosophy*, 2 SOCIAL PHIL. & POL'Y 1 (1984).

It is fairly obvious that this premise, though widely believed, is questionable because firms do operate in markets and often do compete with each other. My claim is that competition in markets prevents even very large firms from exploiting even very small consumers. This can be illustrated by a simple example.

A typical contract clause that has been regulated extensively by judges and also by legislators is the warranty disclaimer. Warranty disclaimers are thought to be unfair because, if a product is defective, the consumer may have to bear a large loss, especially if the consumer is injured. The disclaimer prevents the consumer from shifting this loss to the firm because the consumer has no warranty on which to sue. Because consumers allegedly have no choice but to take disclaimers, and because disclaimers have this unfortunate effect, they are thought to be unfair. Consequently, judges will not enforce them against consumers who suffer personal injuries. The crucial premise underlying this argument, again, is that consumers have no choice but to accept disclaimers.

How would the case against disclaimers change if the effect of markets is explicitly considered? Suppose we let the price of a product, exclusive of the risk that it might be defective, be represented by a quantity "P." The risk that a product might break can be assigned a dollar figure: the amount of harm multiplied by the probability that that harm will occur. Let us suppose that, if a consumer gets a warranty disclaimer, the consumer will have to pay the purchase price, P, and bear a risk that is valued at one hundred dollars. This one hundred dollars may be thought of as the insurance the consumer would have to buy in order to protect him or herself—the risk value plus administrative risk-bearing costs—or the one hundred dollars may be thought of as the cost of taking precautions. Let us assume that a firm could bear this risk at a cost of fifty dollars—if the firm had to bear the risk—either because there are economies of scale for firms in purchasing insurance if a lot of it is purchased, or because firms have expertise in making repairs such that they can repair a broken product more cheaply than a consumer can. In this example, if the firm were to bear the risk, the ultimate cost to the consumer could be reduced by fifty dollars; the cost would be P plus fifty dollars, not P plus one hundred dollars.

Consider a market and suppose that Firm 1 in it decides to use warranty disclaimers. The total cost to a consumer of purchasing from Firm 1 will be P plus one hundred dollars. Firm 2, however, might offer to make the warranty and delete the disclaimer because, if it does so, the total cost to the consumer will be the price of P plus fifty dollars. This should bring many customers to Firm 2 because its product is ultimately fifty dollars cheaper.

If we assume that firms seek to maximize profits, then Firm 2 will make a warranty in this case. But Firm 1 then will also have to make a warranty or face a decrease in its trade. Thus, if competitive markets work, and if firms can bear risks more cheaply than consumers can, firms will bear them. Furthermore, if we assume consumers want to pay as little as possible, disclaimers will be used only when consumers can bear risks more cheaply than firms can, and thus consumers prefer disclaimers. In either case, contracts will be fair in the related senses that the price firms charge to bear the risks they do bear will equal the cost to the firms of bearing those risks, and that is about the best that can be done.

The question regarding justice and contract law that ought to be asked is not one about how large firms are or how small consumers are, or about the vacuous concept of "unequal bargaining power," but about how well consumer markets work. If they do work well, there is little to worry about in terms of justice—that is, justice in the sense of allowing people to do the best they can for themselves under given circumstances. If markets do not work well, then there is room for improvement.

What can go wrong with markets? In briefly discussing some of the things that can go wrong, I will be summarizing the results of a good deal of economic and legal research, both mine and that of others.² There are basically two things that can go wrong. The first is that markets might not work well because of imperfect information. But what is meant by "imperfect information?" It is a vague concept. One aspect of imperfect information involves what economists call "search," which is the cost to consumers of acquiring information about the offerings

2. See, e.g., Schwartz & Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983); Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979).

of different firms. Let us recall the earlier illustration in which Firm 1 issued warranty disclaimers while Firm 2 issued warranties, thereby agreeing to bear risks and reduce the consumer's cost by fifty dollars. Firm 2's strategy would only work if consumers would go from firm to firm, comparing each firm's mix of product and associated contract. It is, however, costly to go from firm to firm. One thing that is meant by imperfect information is that these "search costs" sometimes may prevent people from seeking out the optimal deal. The questions one then should ask are whether this happens often, and if so, what is the result.

There is a fair amount of evidence about search, and that evidence suggests that people tend to search a lot.³ They search much more than judges and others suppose them to search. Markets thus often work fairly well, because even though the costs of searching are positive—that is, the cost of acquiring information about firms exceeds zero—there is a fair amount of searching that goes on.

The recent economic research also shows something else that is relevant to the issue of justice and contract law. When enough consumers will not go from firm to firm—will not search—then firms have a reduced incentive to compete for the consumers' business. Another way to put this is that firms have a greater incentive to exploit consumers by offering what consumers do not want to buy, because lack of searching gives firms some power. Firms have a choice of responses if they are able to exploit consumers. One response would be to degrade the quality of the contract, meaning here to issue warranty disclaimers. A second response would be to make a warranty but charge a supracompetitive price. It turns out that, in many circumstances, the profit-maximizing response for firms is to charge a higher price—to exploit the power that a lack of search confers on them by charging exploitative prices, *not* by degrading the quality of contracts.⁴

3. See Katona & Mueller, *A Study of Purchase Decisions*, in 1 CONSUMER BEHAVIOR: THE DYNAMICS OF CONSUMER REACTION 30, 49, 52, 79-80 (L. Clark ed. 1954); Claxton, Fry & Portis, *A Taxonomy of Prepurchase Information Gathering Patterns*, J. CONSUMER RESEARCH, Dec. 1974, at 35; Newman, *Consumer External Search: Amount and Determinants*, in CONSUMER AND INDUSTRIAL BUYING BEHAVIOR 79 (1977); Newman and Staelin, *Prepurchase Information Seeking for New Cars and MAjor Household Appliances*, 9 J. MARKETING RESEARCH 249 (1972).

4. See Schwartz & Wilde, *Imperfect Information in Markets for Contract Terms*, *supra* note 2.

This is not to say that exploitative prices are a good thing. That firms are more likely to respond to imperfect information by raising prices rather than by degrading contracts, however, has immensely important implications for contract law. This is because the power of the judge is limited to banning or enforcing a contract clause. If, as appears to be the case, firms respond to imperfect information not by supplying consumers with clauses they do not want, but by supplying consumers with clauses they do want at supracompetitive prices, then there is rarely much of a role for judges to play. *It would be better for the consumer to get the clause he or she wants and pay too much for it than to get the clause that he or she does not want and pay too much for that.* If, as research so far shows, firms respond to imperfect information by supplying the contracts that people do want, then judges should enforce those contracts. "Imperfect information" of the search cost variety cannot justify nonenforcement.

There is another implication for contract law that is significant. If prices are too high because people do not search very much, there is a role for legislative, not judicial, intervention. Judges cannot reduce the costs to people of shopping, but some of the most effective legislative interventions have done just that. The Truth in Lending Act⁵ is an obvious example. It reduces the costs to consumers of comparing interest rates across firms and therefore makes consumer credit markets more competitive.

In sum, if imperfect information is thought to result from the lack of consumer search—going from one firm to another—there are two things to be said about it. The first is that there is a fair amount of searching going on. The second is that when there is not much searching going on, there is little that judges can do. Contract law is the law the judges make, so contract law, at least so far, seemingly has no role to play concerning imperfect information. The law does justice by ignoring this phenomenon.

There is another important aspect of imperfect information, which concerns the inability of consumers to cost out risks. What does this mean? Suppose a firm does issue warranty disclaimers. This puts on the consumer the risk that the product

See also Schwartz & Wilde, *Product Quality and Imperfect Information*, 52 REV. ECON. STUDIES 251 (1985).

5. 15 U.S.C. §§ 1601-14, 1631-46, 1666-67, 1671-77 (1982).

will break. It is said that consumers lack the resources to test products, and therefore consumers might not compute correctly the value of the risk. They might, for example, be optimistic and think the product will never break. If consumers are optimistic and think products will never break, then firms can exploit them by charging a higher price than the quality of the product justifies and not making a warranty. It will then turn out that products break more frequently than people expect, and they will be without the protection they themselves would want. The question thus arises, in terms of market imperfections, whether people routinely make mistakes about the value of risks and in the direction of optimism, of thinking that risks are lower in value than they really are. This is a question that so far has no definitive answer. There is, however, a fair amount of evidence from the cognitive psychology literature that is suggestive of an answer.

This evidence suggests that people are likely to make mistakes about product risks, but that those mistakes in the aggregate tend either to be unbiased or in the direction of pessimism.⁶ Obviously, unbiasedness cannot prejudice consumers, and pessimism actually helps consumers because they will then demand more contract protection rather than less. Thus, if by "imperfect information" one means that people make mistakes about risks, then the recent evidence suggests that such mistakes either do not hurt consumers or actually advantage them. Therefore, while imperfect information is a possible market imperfection and should sometimes be remedied, it turns out that things are a good deal better than many people assume.

There is another market imperfection that is worth noting

6. This evidence is summarized in Schwartz & Wilde, *Imperfect Information in Markets for Contract Terms*, *supra* note 2, at 1435-46. Unbiased means that while each person may misvalue a risk, the high estimates and the low estimates cancel out so that consumers as a group tend to be accurate. Pessimism means that people in the aggregate believe that the quality of products is lower than it really is.

Professor Jackson recently claimed, unpersuasively in my view, that the cognitive psychology literature supports an inference that consumers underestimate the chance that they will be unable to repay loans. See Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1410-14 (1985). He implicitly supposes default to be a disjoint event, a category of events whose likelihood consumers underestimate, but default seems a conjoint event, whose likelihood consumers should overestimate. Default is conjoint when it is the product of a set of necessary causes, such as job loss and a simultaneous drying up of alternate employment possibilities. Events such as default are often the product of several causes acting at once, rather than one cause.

briefly: monopoly. It is said that monopolists exploit consumers. In one sense, this is plainly true. Monopolists can exploit people by charging them high prices. For contract law, however, the question is different. It is the question discussed earlier: will monopolists exploit consumers by charging them high prices or will they degrade the quality of the contract? Most scholarship about monopoly suggests that exploitation takes place through price and not through degrading the quality of the contract.⁷ Thus even though monopoly exists and is disadvantageous to consumers, contract law once again has no role to play, because the contracts that monopolists offer are the contracts people want, albeit at an excessive price. This does not mean that the state should fail to respond to monopoly. Judge Bork, for example, has spent much of his life arguing that the state ought to prevent and eradicate monopoly.⁸ Judges deciding *contracts* cases, however, have no role to play in this task because the vice of monopoly is supracompetitive pricing, and judges are not responding to this vice when they refuse to enforce contract clauses. The source of monopoly power must instead be addressed directly.

Therefore, if by justice one means allowing those social outcomes that result from people doing the best they can for themselves given their circumstances, then justice in contract law is best achieved through the marketplace, unless there are market imperfections that prevent a particular market from working well. While it would be silly to deny that market imperfections often exist and cause markets to work badly, the best place to get help is through institutions other than the judiciary and through doctrines other than contract law. Even though markets are imperfect, judges should enforce the contracts they yield.⁹

I conclude by briefly discussing the other aspect of justice, which is justice as fair distribution. It is said that market outcomes are unfair because while individuals may do the best they can in markets given their circumstances, the circumstances are unfair. Market outcomes can be analogized to polit-

7. See, e.g., Schwartz, *A Re-examination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053 (1977).

8. See R. BORK, *THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF* (1978).

9. This not to say that such traditional defenses to contract enforcement as fraud, infancy, compulsion and the like should be repealed. The claim, rather, is for enforcement unless such defenses can be sustained in particular cases.

ical outcomes: In markets one votes with dollars, and people who have fewer dollars have fewer votes. I shall not discuss generally the question of wealth distribution in society. I do argue that contract law is the wrong vehicle for improving inequities in wealth. Why is that? Because not enforcing contract clauses, which is all judges can do, tends to make people poorer rather than richer.

To make a person poorer is meant here to shrink the number of options a person has available to improve his or her lot in life. Suppose a judge bans a contract clause. He has imposed a restriction on the choices available to persons who agreed to it or would have agreed to it in preference to other contract clauses that firms could offer. Poor people tend to have fewer choices than rich people because they have less money. Poor people do have free will, however. If a judge bans a contract clause on the ostensible ground of protecting the poor, the judge actually is reducing the choices of poor people and is therefore preventing poor people from doing as well as they can, given their circumstances, in the realm of contractual choice.

To be concrete, if one purchases warranties, one purchases insurance against product defects. A poor person might rather buy a pair of shoes than purchase insurance against product defects. Hence, the poor person may prefer a warranty disclaimer, which lowers the purchase price, and take his or her chances on the product's reliability. If the judge refuses to enforce the disclaimer, he precludes the choice. When judges refuse to enforce contract clauses and rich people are involved, the matter is not so serious. The rich have many choices. They may be compelled, if the judge will not enforce the disclaimer, to buy insurance and can then drown their depression in Bermuda. The poor person, however, has a real problem; the fewer choices one has, the more important each choice is. Thus, while distribution inequities ought to be remedied, remedying them through contract law is unwise because all contract law can do is increase or reduce a person's choices. It is hard to see how people can be made better off by limiting rather than expanding the number of things they can do.

My view about contract law and justice, then, is that contract law as the Nineteenth Century jurists conceived it did relatively well in achieving those aspects of justice about which most of

us care greatly. The ideology of the Nineteenth Century seems to have been that markets worked well and that there was nothing in them that needed curing. I do not believe that. Markets generally work well, but often there are imperfections to which the state should respond. But legal institutions other than courts should do the responding; judges should do the enforcing.