

A Theory of Mandatory Rules: Typology, Policy, and Design

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Introduction

In a perfectly competitive market, the law should simply give effect to the parties' agreements (assuming, that is, that efficiency is all we care about). Real-world markets and real people are often a far cry from this ideal. Market failures (including behavioral ones) call for serious consideration of regulation. For decades, market regulation has focused on disclosure duties.¹ However, mounting evidence suggests that such duties are often ineffective. Alongside endless attempts to make disclosures more effective—driven in part by ideological aversion to other modes of regulation, and in part by regulatory capture—there is growing disillusion about this path, which is shared by some law-and-economics scholars.² In the past decade or so, there has been much enthusiasm about the use of *nudges*—“low-cost, choice-preserving, behaviorally informed approaches to regulatory problems”³—as a non-intrusive way to influence people's behavior in desirable ways.⁴ However, there are increasing doubts about the effectiveness of nudges as well,⁵ especially when suppliers have an incentive to counter their effects.⁶

In response to these realizations, some are inclined to conclude that regulation (or much of it) should be abandoned altogether, leaving the scene

1. See, e.g., Magnuson–Moss Warranty Act, 15 U.S.C. §§ 2301–2312 (2012) (requiring structured disclosure of warranties); Truth in Lending Act (TILA), 15 U.S.C. § 1601 (2012) (mandating disclosure about the terms and cost of consumer credit); Regulation Z, 12 C.F.R. pt. 226 (2012) (implementing TILA).

2. See, e.g., MARGARET J. RADIN, *BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW* 219–20 (2013) (contending that disclosure duties do not accomplish much); OMRI BEN-SHAHAR & CARL SCHNEIDER, *MORE THAN YOU WANTED TO KNOW: THE FAILURE OF MANDATED DISCLOSURE* (2014) (critically discussing the overuse and limited efficacy of disclosures); Florencia Marotta-Wurgler, *Will Increased Disclosure Help? Evaluating the Recommendations of the ALI's "Principles of the Law of Software Contracts"*, 78 U. CHI. L. REV. 165 (2011) (arguing, based on a large-scale empirical study, that disclosure duties are unlikely to change contracting practices); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707 (2006) (arguing that the disclosures mandated by federal law for home loans do not effectively facilitate price shopping).

3. Cass R. Sunstein, *Nudges.Gov: Behaviorally Informed Regulation*, in *THE OXFORD HANDBOOK OF BEHAVIORAL ECONOMICS AND THE LAW* 719, 719 (Eyal Zamir & Doron Teichman eds., 2014).

4. See generally RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* (rev. ed. 2009) (advocating the use of nudges).

5. See, e.g., Ryan Bubb & Richard H. Pildes, *How Behavioral Economics Trims Its Sails and Why*, 127 HARV. L. REV. 1593 (2014) (analyzing the limitations and drawbacks of nudges).

6. See, e.g., Lauren E. Willis, *When Nudges Fail: Slippery Defaults*, 80 U. CHI. L. REV. 1155, 1200–10 (2013) (arguing that default rules are unlikely to be sticky when consumers lack clear preferences and suppliers are able to contract around the defaults); Stephanie M. Stern, *Outpsyched: The Battle of Expertise in Psychology-Informed Law*, 57 JURIMETRICS 45 (2016) (arguing that business and interest groups are better than government officials at deploying psychological insights).

to market forces of reputation and competition.⁷ An alternative conclusion is that the failure of disclosure duties and the limited efficacy of nudges call for more serious consideration of the use of mandatory regulation of the content of transactions. This Article focuses on such measures, which we dub “substantive mandatory rules.” Other regulatory means, such as disclosure duties and cooling-off periods, are also often nonwaivable. But these other means, which we dub “procedural mandatory rules,” regulate the process by which contracts are formed.⁸ Regulation of the substantive content of transactions is unique in the sense that it does not content itself with improving the conditions under which people make contracts, but rather intervenes in their content. Examples of substantive mandatory rules include usury laws, minimum-wage statutes, and statutes that set minimal liability of construction firms for building defects. Substantive mandatory rules sometimes respond to procedural defects in contracts, such as information problems, and sometimes aim at other goals. Some mandatory rules respond to defects in both the process of contracting and the substance of contractual provisions. A case in point is the doctrine of unconscionability, which limits enforcement where there is an improper admixture of procedural and substantive unconscionability.⁹

But what do we know about the design of mandatory rules? Since the late 1980s, when new theories of default setting appeared,¹⁰ many studies have analyzed default rules in contract law and beyond, and even larger bodies of literature have dealt with ways to improve disclosure duties¹¹ and

7. See Oren Bar-Gill & Omri Ben-Shahar, *Regulatory Techniques in Consumer Protection: A Critique of European Consumer Contract Law*, 50 COMMON MKT. L. REV. 109 (2013) (criticizing the use of mandatory rules, disclosure duties, cooling-off periods, and overly sticky default rules); Lucian A. Bebchuk & Richard A. Posner, *One-Sided Contracts in Competitive Consumer Markets*, 104 MICH. L. REV. 827 (2006) (highlighting the role of reputation in disciplining suppliers’ treatment of customers).

8. We follow this nomenclature in the Introduction and in Part I. However, in Parts II and III, which focus on substantive mandatory rules, we use “mandatory rules” as a shorthand for substantive mandatory rules.

9. See, e.g., *Ferguson v. Countrywide Credit Indus., Inc.*, 298 F.3d 778, 783 (9th Cir. 2002) (noting that under California law, “[i]n order to render a contract unenforceable under the doctrine of unconscionability, there must be both a procedural and substantive element of unconscionability”). But see Brian M. McCall, *Demystifying Unconscionability: An Historical and Empirical Analysis*, 65 VILL. L. REV. 773 (2020) (demonstrating that in most cases, courts do not require both procedural and substantive unconscionability).

10. Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (introducing the notion of penalty default rules).

11. See, e.g., Oren Bar-Gill & Oliver Board, *Product Use Information and the Limits of Voluntary Disclosure*, 14 AM. L. & ECON. REV. 235 (2012) (advocating the imposition of disclosure duties with regard to the expected use of products by customers); Richard Craswell, *Taking Information Seriously: Misrepresentation and Nondisclosure in Contract Law and Elsewhere*, 92 VA. L. REV. 565 (2006) (suggesting ways to improve contractual disclosures); George Loewenstein, Cass R. Sunstein & Russell Golman, *Disclosure: Psychology Changes Everything*, 6 ANN. REV.

construct nudges.¹² In contrast, relatively little scholarly attention has been given to the questions of when to deploy and how to design mandatory rules. With a few exceptions,¹³ only recently have scholars started to address questions associated with the design of such rules,¹⁴ and no attempt has been made to tackle the relevant issues in a comprehensive manner.

This gap in contract scholarship (broadly conceived) may stem from the law's fragmentation: scholars interested in U.S. contract law tend to disregard or only marginally address *statutory* state and federal material (with the exception of the Uniform Commercial Code), as well as topics such as real estate transactions.¹⁵ Since mandatory rules are often *statutorily*, rather than *judicially* made (and apply to specific transactions such as residential leases, rather than to contracts in general), they can easily be overlooked.¹⁶ Whatever causes this gap, this Article strives to fill it. The choice to make a contractual rule mandatory and the manifold choices, which we will analyze, in designing, implementing, and enforcing mandatory law, should be based on a sound theoretical and policy foundation.

To provide the necessary background, the Article opens with normative and descriptive overviews. The normative analysis (Part I) offers a typology of procedural and substantive mandatory rules and theorizes about the circumstances in which substantive mandatory rules are likely to be superior to merely setting defaults or using other procedural rules. The analysis establishes that substantive mandatory rules are sometimes the most

ECON. 391 (2014) (discussing the psychological factors that affect perception and use of information, and advocating simplified, standardized, and vivid disclosure).

12. See, e.g., THALER & SUNSTEIN, *supra* note 4 (discussing dozens of potential and already used nudges); Richard H. Thaler & Shlomo Benartzi, *Save More Tomorrow™: Using Behavioral Economics to Increase Employee Saving*, 112 J. POL. ECON. S164 (2004) (proposing a default savings plan whereby employees commit in advance to allocating a portion of their future salary increases to a retirement plan); Eyal Zamir, Daphna Lewinsohn-Zamir & Ilana Ritov, *It's Now or Never! Using Deadlines as Nudges*, 42 LAW & SOC. INQUIRY 769 (2017) (advocating the use of deadlines as an antidote to procrastination).

13. See, e.g., Spencer L. Kimball & Werner Pfennigstorf, *Legislative and Judicial Control of the Terms of Insurance Contracts: A Comparative Study of American and European Practice*, 39 IND. L.J. 675 (1964) (discussing mandatory regulation of insurance policies); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1247–90 (2003) (discussing *ex ante* legislative prescription and *ex post* judicial policing of contract terms).

14. See, e.g., Omri Ben-Shahar, *Fixing Unfair Contracts*, 63 STAN. L. REV. 869 (2011) (analyzing the optimal substitutes for invalid contract terms); Meirav Furth-Matzkin, *On the Unexpected Use of Unenforceable Contract Terms: Evidence from the Residential Rental Market*, 9 J. LEGAL ANALYSIS 1 (2017) (studying the use of unenforceable terms in residential leases).

15. On the causes and outcomes of the fragmentation of U.S. contract law, see Eyal Zamir, *Contract Law and Theory: Three Views of the Cathedral*, 81 U. CHI. L. REV. 2077, 2119–21 (2014).

16. See, e.g., E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS (3d ed. 2004). While Farnsworth devotes hundreds of pages to contract interpretation, construction, and supplementation, *id.* vol. 2, at 215–410, he only occasionally and very briefly mentions mandatory rules, e.g., *id.* vol. 1, at 40–41.

appropriate means of meeting the goals of contract law. Substantive mandatory rules can be appropriate when the law is trying to protect people outside or inside the contract (what we dub externality and internality concerns, respectively), especially where procedural mandatory rules are likely to be ineffective. Clarifying *when* such rules are necessary is essential to examining *how* to design them.

The descriptive analysis (Part II) then surveys existing substantive mandatory rules. It demonstrates that such rules are already ubiquitous in several fields, yet less prevalent in U.S. law than in most legal systems. While our survey is not exhaustive, we present sufficient evidence to conjecture that, contrary to common wisdom, virtually every area or field of U.S. law is a mixture of default rules, procedural mandatory rules, and substantive mandatory rules. The main purpose of this survey is to show that even if the use of substantive mandatory rules should not be expanded, studying the optimal design of these rules is important for reassessing—and possibly improving—the existing ones. Such a study is all the more important if further mandatory rules are called for, as we believe they are.

Having established that substantive mandatory regulation of the content of contracts is sometimes warranted, the main contribution of this Article lies in analyzing various issues surrounding the design of such rules. Thus, Part III focuses not on *whether*, but on *how*, the content of transactions should be regulated. To this end, it offers a systematic analysis of ten choices involved in the design of mandatory rules, concerning who imposes the mandate, the scope of mandate, the possible interaction with procedural mandatory rules, and the enforcement of the mandate. Specifically, mandatory regulation of contracts' content may be: (1) conducted by the legislature, administrative agencies, or courts; (2) formulated as rules or as standards; (3) applied to an untailed range of transactions (“one-size-fits-all”), or tailored to more specific categories of contracting parties, or even customized or “personalized” to individual cases. Mandatory rules may or may not (4) be opted out of or somewhat modified under more or less strict substantive or procedural conditions, and may (5) prohibit any deviation from them, or merely limit the types of possible deviations (e.g., *unidirectional* mandates only allow deviations that favor one party, but not the other). Another important choice is (6) whether to invalidate or impose certain substantive arrangements without prohibiting or requiring the inclusion of certain clauses in the contract document, or whether to prohibit or mandate such inclusion. Relatedly, the law should determine the outcomes of the inclusion of forbidden clauses or the noninclusion of required ones—in particular (7) whether to impose criminal, administrative, or other sanctions for such violations. Subtler choices then pertain to (8) the framing of mandatory rules, that is, whether to formulate the mandatory rule as *invalidating or prohibiting* a certain contractual arrangement or as *mandating*

or requiring the insertion of such a complementary arrangement. Finally, when invalidating or prohibiting certain arrangements, the law should determine (9) what arrangements should substitute the voided or prohibited ones, and (10) how the unenforceability of a given clause should affect the validity and content of the remainder of the contract.

While some of the abovementioned choices have been examined sporadically in the context of mandatory rules or in other contexts,¹⁷ most have not been studied in any detail. Discussing the various issues within a comprehensive framework, rather than in isolation, yields new insights. For example, once it is realized that substantive mandatory rules may be formulated as vague standards (whose application is subject to judicial discretion); that they may be unidirectional rather than bidirectional; and that they need not be absolute (that is, may offer some leeway for deviations)¹⁸—the assertion that substantive mandatory rules are ill-suited for the heterogeneity of parties' preferences loses much of its cogency.¹⁹ Similarly, a comprehensive examination reveals how various techniques may be used to attain a single goal. For example, the goal of deterring suppliers from using certain clauses in their contracts could be advanced by setting criminal, administrative, or civil sanctions for such inclusion; by replacing the invalid term with a term that favors the customer (rather than a balanced one); and by precluding the adjustment of the remainder of the contract after invalidating the errant clause.²⁰ Considering each measure in isolation may thus result in over- or under-deterrence.

In addition to providing criteria for an assessment of existing mandatory rules and guidelines for the design of new ones, the analysis in Part III will reflect back on the ongoing debate surrounding the desirability and legitimacy of mandatory rules, as reviewed in Part I. Once we realize that the choice is not dichotomous—i.e., substantive mandatory rules, yes or no—but rather covers a huge variety of rules that differ in numerous respects, blanket opposition to mandatory rules is hardly tenable. Thus, the inquiry into the

17. See Ben-Shahar, *supra* note 14 (analyzing the optimal substitutes for invalid contract terms); Omri Ben-Shahar & Ariel Porat, *Personalizing Mandatory Rules in Contract Law*, 86 U. CHI. L. REV. 255 (2019) (discussing personalized mandatory rules); Furth-Matzkin, *supra* note 14 (examining the use of unenforceable terms in residential leases); Eyal Zamir & Ori Katz, *Do People Like Mandatory Rules? The Impact of Framing and Phrasing*, 45 LAW & SOC. INQUIRY 1052 (2020) (experimentally testing the impact of framing and regulation of the wording of contracts on their judged desirability).

18. See *infra* sections III(A)(2), III(C)(2), and III(C)(1), respectively.

19. See *infra* notes 198–201 and accompanying text.

20. See *infra* sections III(D)(2), III(F)(1), and III(F)(2), respectively. A fourth deterrent comes in the form of applying the partial enforcement doctrine to terms that deviate from unidirectional mandatory rules in multiple respects—some to the detriment of the customers, and some in their favor. See *infra* note 224 and accompanying text.

question of *how* to regulate the content of transactions will shed new light on the question of *whether* to do so.

The Article focuses on transactions between commercial providers of products and services, including retailers, insurers, lenders, landlords, and employers (collectively labeled “suppliers”) and consumers, insureds, tenants, borrowers, employees, etc. (collectively labeled “customers”). However, the analysis is relevant to all spheres where mandatory rules govern contractual relations—be it commercial, consumer, or private. Furthermore, the analysis is applicable, *mutatis mutandis*, to other spheres where contractual or consensual relationships may be governed by mandatory rules, such as corporate and family law—although the normative landscape in those spheres is more complex. Finally, many of the arguments carry over to noncontractual spheres, such as mandatory restrictions on the freedom of disposition in the law of wills and testaments, as well.

I. Mapping the Normative Landscape

A. Procedure Versus Substance; Externalities Versus Internalities

Mandatory rules restrict freedom of contract either by imposing procedural requirements or by restricting the set of substantive provisions that can be obtained. Procedural mandatory rules establish prerequisites for achieving certain substantive contractual outcomes. Substantive mandatory rules limit the range of contractual arrangements that can be agreed upon (regardless of the contracting procedures).

Procedural and substantive mandatory rules aim to protect people either inside or outside the contract. These two groups span the entire space of humans who could be negatively impacted by unrestricted contractual freedom. As a matter of nomenclature, we will say that mandatory rules that strive to protect people outside the contract are driven by externality concerns. For example, mandatory rules prohibiting conspiracies to assassinate elected officials or prohibiting cartel agreements are easily justified by their negative external effects on the general public.²¹ The same is true of contracts imposing unreasonable costs on the judicial system, such as entitling the parties to specific performance, whatever the costs it entails for the state enforcement mechanism. In contrast, mandatory rules that attempt to protect people inside the contract are driven by concerns of internal protection (or *internality*). The nonwaivable option of a person to void any contract she entered as a child might, for example, be justified by internal-

21. For an example of external-protection mandatory rules in bankruptcy law, see Antonio E. Bernardo, Alan Schwartz & Ivo Welch, *Contracting Externalities and Mandatory Menus in the U.S. Corporate Bankruptcy Code*, 32 J.L. ECON. & ORG. 395 (2016).

protection concerns.²² Some mandatory rules might be justified by a mixture of externality and internality concerns. For example, mandatory bankruptcy rules that restrict the freedom of borrowers to use their craft tools as loan collateral not only benefit borrowers but also protect the general public from an increased risk of having to provide welfare support for default borrowers.²³

Paying attention to whether procedural mandatory rules aim at protecting people inside or outside the contract is important because procedural mandatory rules motivated by concerns of internal protection tend to rely on different methods than procedural mandatory rules motivated by externality concerns. Procedural mandatory rules motivated by internality concerns operate by helping contracting parties *protect themselves*. These forms of mandatoriness aim to improve rational decision-making by the contracting parties. For example, disclosure mandates often operate by trying to educate imperfectly informed people so that they can make better contracting choices.²⁴ Default and altering rules have a procedural mandatory aspect because the drafting party must procedurally do something—insert some additional words in the draft—to displace the default.²⁵ Contracting around the default is a kind of mandated disclosure that can educate the non-drafter about the substantive provisions of the contract. The information-forcing effect of penalty defaults might help non-drafters protect themselves by making them better informed. A host of procedural interventions that might help contracting parties overcome cognitive biases that lead to

22. See RESTATEMENT (SECOND) OF CONTRACTS § 14 (AM. LAW. INST. 1981) (“Unless a statute provides otherwise, a natural person has the capacity to incur only voidable contractual duties until the beginning of the day before the person’s eighteenth birthday.”).

23. See Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283, 285 (1995) (explaining generally how regulations preventing the use of certain types of collateral can be justified by their tendency to deter social behavior which increases welfare system costs). Another example of a mandatory rule that reacts to both externality and internality concerns is the Consumer Review Fairness Act of 2016 (15 U.S.C. § 45(b) (2018)), which prohibits suppliers from restricting the dissemination of information by customers, such as through customer reviews. This prohibition advances the interests of both the reviewers and future customers.

24. In exceptional cases—such as the graphical depiction of the negative health consequences of smoking on cigarette packing—the primary goal of the “disclosure” is not to facilitate informed deliberation, but rather to elicit disgust or other affective responses. For commentary on “System 1 disclosures,” see Ryan Bubb, *TMI? Why the Optimal Architecture of Disclosure Remains TBD*, 113 MICH. L. REV. 1021, 1026–39 (2015).

25. Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032, 2074 (2012) (“Specificity requirements in altering might also impose a kind of mandatoriness . . .”).

suboptimal decisions have been recently proposed by Richard Thaler, Cass Sunstein, and other behavioral-law-and-economics scholars.²⁶

These procedural mandates attempt to help people protect themselves by enhancing their ability to make better, more rational, contracting choices. But these rationality-enhancing interventions are likely to be ineffective when the central goal is to protect people outside the contract.²⁷ When the joint interests of the contracting parties diverge substantially from the external interests, increasing rationality is unlikely to negate externalities. Accordingly, when externalities are the primary concern, procedural interventions will more likely rely on methods that discourage harmful contracting. For example, simply setting public-regarding defaults (as recommended by § 207 of the Restatement (Second) of Contracts),²⁸ in some contexts, can dampen externalities.²⁹ The inertial effect of default settings can be enhanced with the use of altering rules that impede opt-out and make the default stickier.³⁰ However, the ambit and efficacy of procedural rules that respond to negative externalities are limited. The more the interests of the parties diverge from the interests of society, the more likely the parties are to contract for socially deleterious provisions. Table 1 provides a schema of the four different types of mandatory rules and the circumstances when they should be deployed.

26. See, e.g., THALER & SUNSTEIN, *supra* note 4 (analyzing various non-intrusive techniques, including the setting of defaults and using other choice-architecture devices, to improve people's decisions).

27. Enhancing rationality can be effective when a procedural intervention is supported by *both* internal- and external-protection concerns. For example, a mandated disclosure on the superior energy efficiency of a refrigerator might both reduce the consumer electricity bill and greenhouse gases. See C.A. Webber, R.E. Brown & J.G. Koomey, *Savings Estimates for the Energy Star® Voluntary Labeling Program*, 28 ENERGY POL'Y 1137, 1144 tbl. 4 (2000) (presenting estimates of energy savings).

28. RESTATEMENT (SECOND) OF CONTRACTS § 207 (AM. LAW INST. 1981) ("In choosing among the reasonable meanings of a promise or agreement or a term thereof, a meaning that serves the public interest is generally preferred.").

29. Cf. Eyal Zamir, *The Inverted Hierarchy of Contract Interpretation and Supplementation*, 97 COLUM. L. REV. 1710, 1723–24 (1997) (arguing that the rule that favors interpretation that serves the public interest does not aim to reveal the parties' actual intentions, but rather to advance social policies).

30. Ayres, *supra* note 25, at 2084–96 (discussing sticky defaults as quasi-mandatory rules); Zamir, *supra* note 29, at 1738–53, 1758–65 (discussing legal doctrines that blur the distinction between default and mandatory rules, and the behavioral effects of default rules).

Table 1: Typology of Mandatory Rules

		<i>Type of Intervention</i>	
		Procedural	Substantive
<i>Primary Rationale</i>	Externalities	Deter deleterious opt-outs with sticky defaults; make social norms salient	Prevent harm to third parties when non-compulsory means fail
	Internalities	Provide information; enhance rational decision-making	Protect contracting parties when contracting failures are intransigent

Mandatory procedural rules motivated by internalities are thus appropriate if they can usefully enhance rational, free, and informed decision-making, while mandatory procedural rules motivated by externalities may be appropriate if they can usefully deter deleterious opt-out.³¹ Substantive mandatory rules are appropriate when there are contracting failures that are intransigent to procedural interventions. Substantive mandatory rules are ordinarily justifiable in two circumstances: (1) when the rule is necessary to protect people outside the contract; and (2) when procedural mandatory rules are likely to be ineffective at helping contracting parties protect themselves because the costs of overcoming their information problems are prohibitive, their cognitive failures are intransigent, or their bargaining power is extremely unequal.

Neither proponents of freedom nor champions of efficiency oppose in principle mandatory rules motivated by externalities. Liberals generally recognize a moral constraint against harming other people (as those others, too, must be respected), and hence they would not oppose the invalidation of agreements that harm third parties. And economists accept that adversely affecting third parties is often inefficient because the negative externalities may exceed the parties' joint surplus.³² The main dispute—to which we now turn—therefore revolves around substantive mandatory rules whose justification is not primarily grounded in the protection of third parties.

31. One might also imagine mandatory disclosures that respond to externality concerns by making people more altruistic. *E.g.*, Ian Ayres, *Save a Grandma. Get Your Flu Shot*, L.A. TIMES (Nov. 12, 2018, 3:15 AM), <https://www.latimes.com/opinion/op-ed/la-oe-ayres-flu-shots-20181112-story.html> [<https://perma.cc/Y8PD-VW2T>].

32. *Cf.* Ayres & Gertner, *supra* note 10, at 88 (citing the protection of third parties as one of the two key justifications for mandatory rules).

B. *The Normative Debate*

This section maps the normative debate about substantive mandatory rules, beginning with the liberal perspective (or the *will theory* of contract), moving on to economic efficiency, and finally touching upon distributive and paternalist arguments.

1. *The Liberal Perspective.*—According to the liberal ideal, the law should respect the parties' freedom by letting them design their contractual rights and obligations as they see fit.³³ Advocates of substantive mandatory rules often endorse this ideal yet contend that standard-form contracts (SFCs), which are unilaterally drafted by suppliers,³⁴ do not reflect the free will and true intentions of customers.³⁵ This concern is further exacerbated by modern technologies that facilitate contracting without true consent of the customers to the content of contracts, coupled with judicial relaxation of the rules of contractual assent.³⁶ In the present economic and legal environment, therefore, substantive mandatory rules may actually reflect customers' expectations more accurately than the formal contract.³⁷

One response to this argument is that if the SFCs available in the market are sufficiently heterogeneous, the very fact that customers do not take part in their formulation does not negate the customers' choice.³⁸ Another response is that even if substantive mandatory rules reflect customers' intentions more accurately than SFCs, they do not reflect suppliers' preferences—and from a liberal perspective, there are no grounds for

33. See, e.g., STEPHEN A. SMITH, *CONTRACT THEORY* 59 (2004) (explaining that according to the notion of contracts as self-imposed promissory obligations, "the *content* of a contractual obligation is a matter for the parties, not the law").

34. While contracts between suppliers and customers may be individually negotiated, the vast majority of them (indeed, the great majority of *all* contracts nowadays) are standard-form contracts—hence a focus on SFCs is highly apposite.

35. See, e.g., Lewis A. Kornhauser, Comment, *Unconscionability in Standard Forms*, 64 CAL. L. REV. 1151, 1183 (1976) (explaining that while mandating minimum contractual provisions may appear to curtail freedom of contract, that freedom is illusory under modern market conditions). Another way to reconcile mandatory rules with the liberal ideal is to argue that some rights are simply inalienable. See Thomas L. Hudson, Note, *Immutable Contract Rules, the Bargaining Process, and Inalienable Rights: Why Concerns over the Bargaining Process Do Not Justify Substantive Contract Limitations*, 34 ARIZ. L. REV. 337, 337–38, 353 (1992) (explaining that the protection of inalienable rights is a superior justification for mandatory rules than paternalism). However, this argument only applies to a narrow subset of mandatory rules, such as the denial of specific performance of an obligation to provide personal service. See *infra* note 96 and accompanying text.

36. Restatement of the Law, Consumer Contracts, Rep. Mem. Discussion Draft (Apr. 17, 2017).

37. Relatedly, it has been argued that indiscriminate enforcement of SFCs transfers a quasi-legislative power from the legislature to suppliers. RADIN, *supra* note 2, at 33–51; W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 530, 533, 542 (1971).

38. Michael J. Trebilcock, *An Economic Approach to the Doctrine of Unconscionability*, in *STUDIES IN CONTRACT LAW* 379, 397–99 (Barry J. Reiter & John Swan eds., 1980).

prioritizing the former. According to a possible counterargument, whenever the supplier is a firm, liberalism does not rule out substantive mandatory rules because human rights (such as freedom and autonomy) do not extend to firms.³⁹ More fundamentally, the law need not content itself with respecting people's negative liberty by refraining from placing constraints on one's actions. Rather, it should arguably enhance people's positive liberty as well, by providing them with the means of taking control of their lives and realizing their fundamental purposes.⁴⁰ Hence, limiting the negative liberty of suppliers may be necessary to promote the positive liberty of the customers.

Finally, once people choose to make *legally enforceable* contracts, they are no longer engaging in a purely private activity, since enforcing contracts involves the exercise of the state's power. Hence, the real issue is not *whether* the state should interfere with private relationships—as such interference is inherent in legal enforceability—but rather what are the circumstances in which the state's authority should be put at the disposal of one party against the other.⁴¹

2. *Economic Efficiency*.—From an economic perspective, in a perfectly competitive market, unregulated contracts maximize aggregate social utility—but most markets are imperfectly competitive, and some are blatantly noncompetitive. Market failures may relate to the objective characteristics of a given market—such as the assumptions of full information, low transaction costs, and numerous sellers and buyers.⁴² Market failures may also stem from prevalent and systematic deviations from the premise that market players are rational in the economic sense.⁴³ In the light of traditional and behavioral market failures, enforcing unilaterally drafted SFCs is at times less efficient than subjecting them to mandatory regulation.

To be sure, the existence of market failures, in and of itself, does not warrant regulatory intervention, since the costs of intervention may surpass its benefits—and even if regulation is warranted, the most efficient regulation need not be through substantive mandatory rules. In a competitive market,

39. For conflicting arguments in this debate, see generally Peter Jones, *Group Rights*, STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Mar. 17, 2016), <https://plato.stanford.edu/entries/rights-group> [<https://perma.cc/VAZ7-9AK2>] and Symposium, *Rethinking Corporate Agency in Business, Philosophy and Law*, 154 J. BUS. ETHICS. 893 (2019).

40. On the distinction between negative and positive liberty, see Isaiah Berlin, *Two Concepts of Liberty*, in *FOUR ESSAYS ON LIBERTY* 118 (1969) and Ian Carter, *Positive and Negative Liberty*, in STANFORD ENCYCLOPEDIA OF PHILOSOPHY (Aug. 2, 2016), <https://plato.stanford.edu/entries/liberty-positive-negative> [<https://perma.cc/NBZ5-4ACE>].

41. Morris R. Cohen, *The Basis of Contract*, 46 HARV. L. REV. 553, 585–86 (1933).

42. See generally N. GREGORY MANKIW, *PRINCIPLES OF ECONOMICS* 289–358, 452–57 (8th ed. 2018).

43. See generally EYAL ZAMIR & DORON TEICHMAN, *BEHAVIORAL LAW AND ECONOMICS* 19–138 (2018) (surveying the literature on cognitive biases and heuristics).

suppliers who wish to maximize their profits would respond to customers' preferences. For instance, if the expected cost to the customer of bearing a given risk is higher than the expected cost to the supplier, rational suppliers would undertake the risk and charge a price for doing so, thereby making both parties better off. Even in a monopolistic market, it makes no sense for the supplier to allocate such risk to the customers. Rather, a profit-maximizing monopoly would bear the risk and exploit its monopoly power by charging a supracompetitive price for it.⁴⁴ Proponents of regulation concede this argument as long as the pertinent issue is something that customers are aware of. However, this argument does not apply to most contractual terms in SFCs, which are practically invisible for most customers.⁴⁵ Consequently, sellers may have an incentive to include shrouded terms that reduce the joint gains of trade but simultaneously increase the seller's profits.⁴⁶

In the past, law-and-economics scholars would respond to the latter claim by arguing that, even if most customers do not read SFCs, it is enough that some of them do for suppliers to respond to customers' preferences, since suppliers compete over the marginal customers.⁴⁷ However, this *informed minority* hypothesis rests on the questionable assumptions that customers' preferences are homogenous, and that suppliers cannot discriminate between readers and nonreaders.⁴⁸ Furthermore, the available empirical data indicates that even in transactions concluded online—where reading the SFC is particularly convenient—practically nobody reads SFCs before concluding

44. On this conventional economic wisdom and its limitations, see generally Albert Choi & George Triantis, *The Effect of Bargaining Power on Contract Design*, 98 VA. L. REV. 1665 (2012).

45. Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173 (1983) (drawing a distinction between visible and invisible terms in standard-form contracts, and proposing that the latter should be presumed unenforceable).

46. Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets*, 121 Q.J. ECON. 505, 505 (2006) (“[I]nformational shrouding flourishes even in highly competitive markets, even . . . when the shrouding generates allocational inefficiencies.”).

47. Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979); LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE 219–20 (2002); see also Clayton P. Gillette, *Pre-Approved Contracts for Internet Commerce*, 42 HOUS. L. REV. 975, 976–77 (2005); George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L. J. 1297, 1347 (1981).

48. Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WIS. L. REV. 679, 692–97 (highlighting the weaknesses of the informed-minority hypothesis); Zamir, *supra* note 15, at 2102–05 (same).

the transaction.⁴⁹ For all practical purposes, therefore, the informed-minority hypothesis may be disregarded, at least in routine transactions.⁵⁰

Another argument against the need for substantive restrictions on contracting relies on the market forces of competition and reputation. It has been argued that in a competitive market, suppliers are expected to inform clients about the excessive invisible terms in their competitors' SFCs.⁵¹ However, even in competitive markets suppliers may not have an incentive to spread this information,⁵² and one hardly sees such an effect in practice.⁵³

It has further been argued that even if customers do not read SFCs (or become informed about their content otherwise), and even if those contracts contain one-sided and oppressive terms, those terms are irrelevant as long as reputational forces ensure that suppliers treat their customers fairly.⁵⁴ While customers may not care much about their reputation, suppliers who are repeat players in the market do. Hence, customers sometimes behave opportunistically and make unreasonable complaints. In contrast, suppliers treat their customers fairly, regardless of the one-sided disclaimers that presumably allow them not to do so. They only rely on those disclaimers to handle opportunistic customers who make unreasonable complaints.

One response to this important argument is that even if suppliers do not ordinarily rely on oppressive contract terms, market forces are not perfect and hence courts do occasionally face the question of whether to enforce such

49. Yannis Bakos, Florencia Marotta-Wurgler & David R. Trossen, *Does Anyone Read the Fine Print? Consumer Attention to Standard-Form Contracts*, 43 J. LEGAL STUD. 1, 1 (2014) (empirically studying the clickstream data of tens of thousands of households and finding that fewer than 0.2% of software shoppers accessed the SFC page, and even those who did spent an exceedingly short time reading it).

50. Cf. Ian Ayres & Alan Schwartz, *The No-Reading Problem in Consumer Contract Law*, 66 STAN. L. REV. 545 (2014) (discussing the no-reading problem without mentioning the informed-minority hypothesis, originally put forward by Schwartz).

51. Lee Goldman, *My Way and the Highway: The Law and Economics of Choice of Forum Clauses in Consumer Form Contracts*, 86 NW. U. L. REV. 700, 716 (1992) ("If a seller includes unwanted terms in its contracts, a business offering the preferred higher price/easier terms option should inform consumers that although the competitor's price is lower, the real value that the competitor offers is less.").

52. Gabaix & Laibson, *supra* note 46 (showing that, even when disseminating information is costless, firms might not educate the public about the hidden costs of their competitors' products); Michael J. Trebilcock, *The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords*, 26 U. TORONTO L. J. 359, 372 (1976) (noting that since firms do not fully internalize the benefits of "justified disparagement" of competitors, they may avoid such disparagement even when it is socially optimal).

53. See also Florencia Marotta-Wurgler, *Competition and the Quality of Standard Form Contracts: The Case of Software License Agreements*, 5 J. EMPIRICAL LEGAL STUD. 447 (2008) (finding no significant correlation between the level of competition and the pro-seller bias in end-user licensing agreements).

54. See Bebchuk & Posner, *supra* note 7 (discussing the role of reputation in disciplining suppliers' treatment of customers); DOUGLAS G. BAIRD, *RECONSTRUCTING CONTRACTS* 127-30 (2013) (same).

terms to the detriment of customers. Legal norms may be important to instill commercial norms even if in most cases they are self-imposed by virtue of reputational forces. A greater difficulty with reliance on reputational forces is that they are much more likely to favor large, recurring, and sophisticated customers—whose goodwill the supplier values highly—than weak, occasional, and unsophisticated customers—whose goodwill is less appreciated.⁵⁵

Economists (and free-will proponents) tend to prefer procedural mandates (such as disclosure duties) over substantive mandatory rules, since the former aim to rectify the market without restricting the freedom of parties to contract for particular substantive provisions, while the latter replace the market with centralist decision-making.⁵⁶ Such regulation almost inevitably precludes certain mutually beneficial transactions.⁵⁷ It may also fail to maximize overall social utility because regulators are often captured by organized interest groups who induce self-interested government officials to advance the interests of those groups in return for various benefits.⁵⁸

These concerns militate against the use of substantive mandatory rules and in favor of procedural ones, primarily disclosure duties. However, there is a growing recognition—including by some law-and-economics scholars—that disclosure duties are often ineffective.⁵⁹ While disclosures make the

55. Cf. Ian Ayres, *Fair Driving: Gender and Race Discrimination in Retail Car Negotiations*, 104 HARV. L. REV. 817 (1991) (documenting price discrimination against blacks and women by car dealerships). On distributive considerations, see also *infra* notes 80–85 and accompanying text. See also Yonathan A. Arbel & Roy Shapira, *Theory of the Nudnik: The Future of Consumer Activism and What We Can Do to Stop It*, 73 VAND. L. REV. 929, 971 (2020) (arguing that the reputation mechanism may also be thwarted by suppliers' use of big data to screen out customers who tend to complain and post negative reviews). For further critique of the reputation argument, see Zamir, *supra* note 15, at 2100–01.

56. See, e.g., Stephen Breyer, *Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform*, 92 HARV. L. REV. 547, 580 (1979) (arguing that disclosure duties can be effective without overly constraining freedom of action); Howard Beales, Richard Craswell & Steven C. Salop, *The Efficient Regulation of Consumer Information*, 24 J. L. & ECON. 491, 513–14 (1981) (same).

57. For example, high liquidated damages may compensate the injured party for subjective harms and to serve as a signal of the promisor's ability and motivation to perform her obligations. ROBERT COOTER & THOMAS ULEN, *LAW & ECONOMICS* 321–22 (6th ed. 2012). Invalidation of such clauses as penalties may therefore adversely affect the parties' interests in some cases, even though it is desirable on the whole.

58. On regulatory capture, see generally MARVER H. BERNSTEIN, *REGULATING BUSINESS BY INDEPENDENT COMMISSION* (1955); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). On the inclination of well-intentioned officials to advance the interests of powerful groups due to automatic and mostly unconscious self-serving biases, see Eyal Zamir & Raanan Sulitzeanu-Kenan, *Explaining Self-Interested Behavior of Public-Spirited Policy Makers*, 78 PUB. ADMIN. REV. 579 (2018).

59. See, e.g., BEN-SHAHAR & SCHNEIDER, *supra* note 2 (critically discussing the overuse and limited efficacy of mandatory disclosures); Marotta-Wurgler, *supra* note 2 (arguing that increased

information available to customers, they cannot force customers to use it.⁶⁰ Given the multiple demands on people's time and attention, it is often rational to ignore the disclosed information, especially if it pertains to low-probability risks. To avoid *information overload* (the deterioration of the quality of decisions once the amount of information people try to perceive and process surpasses their cognitive abilities),⁶¹ people adaptively ignore most of the information available to them. Other causes for ignoring information are the *herd effect* (if others purchase the product without heeding the additional information, why shouldn't I?);⁶² and *escalation of commitment* and the *confirmation bias* (once one has spent time and effort on choosing a product, one tends to seek information supporting that decision and avoid unfavorable information about the product or the contract terms).⁶³ Additional reasons include the *availability heuristic* (which prompts people to underestimate the probability of events that they do not easily recall);⁶⁴ *self-serving biases* (which make people overly optimistic about future contingencies);⁶⁵ and people's *myopia* (which causes them to excessively discount future risks and rewards).⁶⁶

disclosures are unlikely to change current contracting practices); Doron Teichman, *Too Little, Too Much, Not Just Right: Seduction by Contract and the Desirable Scope of Contract Regulation*, 9 JERUSALEM REV. LEGAL STUD. 52, 54–60 (2014) (discussing the failure of disclosure duties).

60. See, e.g., George S. Day, *Assessing the Effects of Information Disclosure Requirements*, 40(2) J. MKTG., April 1976, at 42, 51 (1976) (concluding that even when information is available to consumers, they are not necessarily aware of it or comprehend it—nor does it appear to affect their behavior); Jeff Sovern, *Preventing Future Economic Crises Through Consumer Protection Law or How the Truth in Lending Act Failed the Subprime Borrowers*, 71 OHIO ST. L.J. 761, 769–97 (2010) (analyzing previous evidence and providing new evidence about the failure of the Truth in Lending Act's disclosure duties).

61. See, e.g., Jacob Jacoby, Donald E. Speller & Carol Kohn Berning, *Brand Choice Behavior as a Function of Information Load: Replication and Extension*, 1 J. CONSUMER RES., June 1974, at 33, 33 (1974) (describing information overload); Kevin Lane Keller & Richard Staelin, *Effects of Quality and Quantity of Information on Decision Effectiveness*, 14 J. CONSUMER RES. 200 (1987) (studying the relationship between information overload and the effectiveness of consumer decisions); Korobkin, *supra* note 13, at 1222–25 (discussing the strategies buyers use to minimize the costs of decision-making given the abundance of information); Ellen Peters, Nathan Dieckmann, Anna Dixon, Judith H. Hibbard & C.K. Mertz, *Less Is More in Presenting Quality Information to Consumers*, 64 MED. CARE RES. & REV. 169, 169 (2007) (finding that consumers make better choices when information presented “was designed to ease the cognitive burden and highlight the meaning of important information”).

62. See generally Abhijit V. Banerjee, *A Simple Model of Herd Behavior*, 107 Q. J. ECON. 797 (1992) (analyzing a sequential decision model showing that people will do what others are doing instead of using their own information); Yi-Fen Chen, *Herd Behavior in Purchasing Books Online*, 24 COMPUTERS IN HUM. BEHAV. 1977 (2008) (examining the effectiveness of star ratings, sales volume, and different recommendation sources on online book purchasing).

63. Shmuel I. Becher, *Behavioral Science and Consumer Standard Form Contracts*, 68 LA. L. REV. 117, 125–33 (2007). On *escalation of commitment*, see generally EYAL ZAMIR, LAW, PSYCHOLOGY, AND MORALITY: THE ROLE OF LOSS AVERSION 29–31 (2015).

64. Becher, *supra* note 63, at 144.

65. *Id.* at 147.

66. *Id.* at 150.

Yet another reason for skepticism about disclosures is the sheer complexity of many transactions. Making an optimal transaction often requires professional expertise that customers—including commercial ones—lack, and is typically prohibitive to acquire.⁶⁷ Even customers who understand the meaning of a given contract term may fail to make a rational decision if they do not know the probability that the contingency triggering the term would occur, the probability that the supplier would actually rely on the term, the probability that a court would enforce that term, or the expected loss to themselves from that contingency if the term is enforced.⁶⁸ Another difficulty with disclosure duties is that suppliers may display the information and design the transaction in a manner that maximizes their profits, rather than optimize customers' decision-making.⁶⁹ Behaviorally informed, smart disclosures may overcome some of these difficulties,⁷⁰ but the impact of disclosure duties often remains limited.⁷¹

To be clear, our argument regarding the necessity of substantive mandatory rules does not hinge on the claim that disclosure duties are generally futile. Disclosure duties serve important goals, and their effectiveness varies from one context to another.⁷² For our purpose, suffice it to acknowledge that disclosures are often ineffective. Just as regulators set minimal standards for the safety of physical products—such as toys, drugs, and cars—rather than content themselves with the imposition of disclosure

67. For example, even customers who are aware of the existence of a standard arbitration clause are likely to misunderstand its full legal implications. See Jeff Sovern, Elayne E. Greenberg, Paul F. Kirgis & Yuxiang Liu, "Whimsy Little Contracts" with Unexpected Consequences: An Empirical Analysis of Consumer Understanding of Arbitration Agreements, 75 MD. L. REV. 1 (2015).

68. Eyal Zamir & Yuval Farkash, *Standard Form Contracts: Empirical Studies, Normative Implications, and the Fragmentation of Legal Scholarship*, 12 JERUSALEM REV. L. STUD. 137, 156–58 (2015).

69. See Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 6–25 (2008) (arguing that firms have clear incentives, magnified by market competition, to exploit customers' lack-of-information and cognitive biases).

70. Sunstein, *supra* note 3, at 727–33; ZAMIR & TEICHMAN, *supra* note 43, at 171–73, 314–316. The government can facilitate the dissemination of information in two additional ways. First, it may provide a simple rating of complex products and services, such as health-care plans. See Russell Korobkin, *Comparative Effectiveness Research as Choice Architecture: The Behavioral Law and Economics Solution to the Health Care Cost Crisis*, 112 MICH. L. REV. 523 (2014) (proposing a "relative value" rating system for medical treatments that would assess the costs and benefits of different treatments and thus enable customers to more knowledgeably contract with insurers for different treatments). Second, it can prevent suppliers from restricting the dissemination of information by customers, such as through consumer online reviews. See Consumer Review Fairness Act, 15 U.S.C. § 45(b) (2018).

71. ZAMIR & TEICHMAN, *supra* note 43, at 173–77, 316–18.

72. See generally Richard Craswell, *Static Versus Dynamic Disclosures, and How Not to Judge Their Success or Failure*, 88 WASH. L. REV. 333 (2013) (discussing possible purposes of disclosure duties and the criteria for evaluating their success).

duties, they should set such standards for the safety of contractual products, which may be just as risky.⁷³

Along with disclosure duties, other choice-preserving means rely on behavioral insights to steer customers' decisions in the desirable direction—for their own good and for the good of society. Such nudges include altering the default, forcing people to make choices, setting deadlines, and informing people about other people's behavior (thereby triggering social norms).⁷⁴ However, while nudges are effective in other contexts—such as the default effect in the promotion of posthumous organ donations—they tend to be ineffective with regard to market transactions whenever suppliers are able and motivated to contract around defaults,⁷⁵ and to counteract other nudges.⁷⁶ Indeed, suppliers regularly employ behavioral insights to take advantage of customers' heuristics and biases.⁷⁷

To be sure, while the drawbacks of disclosures and nudges make substantive mandatory rules more attractive, the latter are also not free of difficulties. In addition to the concern about regulatory capture mentioned above, legal policymakers, like customers, may be vulnerable to information problems and all sorts of cognitive biases.⁷⁸ However, that claim appears to be overstated: while policymakers may have incomplete information and are susceptible to cognitive biases, legislators and administrative agencies can rely on objective data and professional expertise that are unavailable to individuals, and typically consider the options in a calmer and less hasty manner.⁷⁹ For all these reasons, the very need and the appropriate design of substantive mandatory rules must be examined very carefully, and be subject to oversight and review.

73. See, e.g., Bar-Gill & Warren, *supra* note 69 (calling for the regulation of consumer credit products along the lines of the regulation of physical consumer products); Zamir & Farkash, *supra* note 68, at 163–64 (making the same argument regarding SFCs in general).

74. See *supra* notes 3–4 and accompanying text.

75. See Willis, *supra* note 6.

76. Michael S. Barr, Sendhil Mullainathan & Eldar Shafir, *Behaviorally Informed Regulation*, in *THE BEHAVIORAL FOUNDATIONS OF PUBLIC POLICY* 440 (Eldar Shafir ed., 2012) (distinguishing between contexts in which firms seek to overcome customers' bias and contexts in which they seek to exploit it).

77. ZAMIR & TEICHMAN, *supra* note 43, at 285–306 (surveying marketing, pricing, drafting, and other techniques suppliers use to exploit consumers' heuristics and biases); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: Some Evidence of Market Manipulation*, 112 HARV. L. REV. 1420, 1428–553 (1999) (surveying evidence of consumer manipulation by firms); Stern, *supra* note 6.

78. See generally Edward L. Glaeser, *Paternalism and Psychology*, 73 U. CHI. L. REV. 133 (2006) (arguing that bounded rationality militates against governmental regulation, rather than in its favor); W. Kip Viscusi & Ted Gayer, *Behavioral Public Choice: The Behavioral Paradox of Government Policy*, 38 HARV. J. L. & PUB. POL'Y 973 (2015) (same).

79. Jeremy A. Blumenthal, *Expert Paternalism*, 64 FLA. L. REV. 721, 732–56 (2012).

3. *Redistribution and Paternalism.*—Respect for free will and the maximization of aggregate social utility are not the only conceivable goals of contract law and market regulation. Mandatory rules may also be attractive for their distributive effects. Admittedly, as means of redistributing wealth, tax-and-transfer mechanisms are superior to substantive mandatory private-law rules,⁸⁰ and the latter may actually have a regressive effect.⁸¹ However, the very existence of the tax-and-transfer welfare system induces people to take excessive credit risks, which may in turn justify substantive mandatory rules that deter such risk-taking (such as usury laws).⁸² Moreover, redistributive private-law rules are superior to tax-and-transfer mechanisms in two important respects. First, they can promote the welfare of the underprivileged by giving them entitlements that objectively improve their well-being—such as fair and respectful treatment by lenders, landlords, and insurers—even if these are not the entitlements they would have purchased otherwise.⁸³ Second, by setting the “rules of the game,” redistributive private-law rules empower customers, whereas redistribution of money through tax-and-transfer mechanisms implicitly conveys a message of failure, or even humiliation.⁸⁴ Moreover, compared with tax-and-transfer mechanisms, setting decent norms of conduct in contractual relationships is much less likely to arouse resentment among the privileged, as they are unlikely to feel that something is being taken from them.⁸⁵

Another possible, though controversial, justification for substantive mandatory rules lies in protecting people from imprudent decisions due to their limited cognitive abilities and biases.⁸⁶ Elsewhere, one of us (Zamir) has argued that given people’s bounded rationality, legal paternalism is sometimes economically efficient,⁸⁷ and consistent with respect for people’s

80. See Louis Kaplow & Steven Shavell, *Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income*, 23 J. LEGAL STUD. 667 (1994) (arguing that redistribution through private-law rules is less efficient than redistribution through tax-and-transfer mechanisms). *But see* Chris William Sanchirico, *Taxes Versus Legal Rules as Instruments for Equity: A More Equitable View*, 29 J. LEGAL STUD. 797 (2000) (arguing that redistribution through private-law rules, even though possibly less efficient than redistribution through tax-and-transfer mechanisms, is warranted under certain circumstances).

81. See Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer–Seller Relationships*, 43 STAN. L. REV. 361, 377–80, 395–98 (1991) (analyzing the variables affecting the distributional effects of private-law rules).

82. See Posner, *supra* note 23.

83. See Daphna Lewinsohn-Zamir, *In Defense of Redistribution Through Private Law*, 91 MINN. L. REV. 326, 340–53 (2006) (pointing to the advantages of private-law rules over tax-and-transfer schemes as means of redistribution).

84. *Id.* at 353–74.

85. *Id.* at 331–32, 369.

86. On the exploitation of consumers’ heuristics and biases by suppliers, see generally OREN BAR-GILL, *SEDUCTION BY CONTRACT: LAW, ECONOMICS, AND PSYCHOLOGY IN CONSUMER MARKETS* (2012) and ZAMIR & TEICHMAN, *supra* note 43, at 281–306.

87. Eyal Zamir, *The Efficiency of Paternalism*, 84 VA. L. REV. 229, 237–54 (1998).

freedom and autonomy.⁸⁸ But, of course, there are powerful countervailing arguments, which we could not discuss in detail here.

To sum up, while there are weighty considerations for and against substantive mandatory rules, sometimes they are the only effective—or the most appropriate—means of overcoming market failures, promoting customers' freedom, and achieving other important goals. Concomitantly, the costs and limitations of such rules must be heeded when deciding whether to lay down such rules and when designing them, as further elaborated in Part III.

II. The Absolute Prevalence and Relative Paucity of Mandatory Rules

Having highlighted the main arguments for and against mandatory rules, this Part demonstrates that substantive mandatory rules (hereinafter, for brevity's sake, *mandatory rules*) are already prevalent in many spheres, although they may be used much more extensively. To begin with, several general doctrines authorize courts to invalidate contract clauses that are deemed oppressive, unconscionable, or contrary to public policy. These include the unconscionability doctrine embodied in § 2-302 of the Uniform Commercial Code,⁸⁹ and the exclusion of terms in SFCs when the drafter has reason to believe that the other party would not have assented to the contract had she known that it contained them.⁹⁰ Excessive contract terms might also be found “unfair and deceptive” under federal and state Unfair and Deceptive Acts and Practices (UDAP) statutes.⁹¹ Similar results are often attained through less overt techniques, such as preventing people's reliance on a given contract term on the grounds that they have not acted in good faith;⁹² and strictly construing certain types of terms, such as disclaimers in consumer

88. EYAL ZAMIR & BARAK MEDINA, LAW, ECONOMICS, AND MORALITY 313–47 (2010) (analyzing legal paternalism from a threshold-deontology perspective). There is also some support for the claim that the public-at-large does not object to governmental paternalism. See Blumenthal, *supra* note 79, at 728–29 (noting that citizens prefer to defer most political decisions to government officials).

89. On this doctrine, see generally 1 FARNSWORTH, *supra* note 16, at 577–99; JAMES J. WHITE & ROBERT S. SUMMERS, UNIFORM COMMERCIAL CODE 217–44 (6th ed. 2010).

90. RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (AM. LAW INST. 1979). See also Robert A. Hillman & Jeffrey J. Rachlinski, *Standard Form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429, 458–59 (2002) (describing the rule).

91. See CAROLYN L. CARTER & JONATHAN SHELDON, UNFAIR AND DECEPTIVE ACTS AND PRACTICES 305–20, 345–47 (9th ed. 2016). For example, the Federal Trade Commission (FTC) declared that contractual “waiver of the right to notice and the opportunity to be heard in the event of suit” is unfair and deceptive within the meaning of Section 5 of the Federal Trade Commission Act. 16 C.F.R. 444.2(a)(1) (2019). See also *infra* note 115 and accompanying text. Another example is courts' rulings that under some circumstances, charging unconscionably high prices may be considered a UDAP violation. CARTER & SHELDON, *supra*, at 315–16.

92. Zamir, *supra* note 29, at 1743–44 (exemplifying the use of this technique).

contracts, forfeiture clauses, and limitations of liability for negligence.⁹³ More specific rules of contract law render unenforceable unreasonable restraints of trade;⁹⁴ invalidate unreasonably large liquidated damages as penalty;⁹⁵ deny specific performance of an obligation to provide personal service;⁹⁶ and more. An even more specific rule invalidates contractual restrictions of the dissemination of information by customers, such as through customer reviews.⁹⁷ At the most general level, while parties may determine the standards by which their obligations are measured, the basic duty to perform contractual duties in good faith is immutable.⁹⁸

Many more mandatory rules apply to specific types of contractual transactions. Plausibly, the most heavily regulated contracts are insurance policies. In part, this is due to the complexity of insurance contracts, the legal or practical necessity of purchasing certain types of insurance, the special vulnerability of the insureds to insurers' opportunism (given that the latter handle insurance claims after they have already collected the premiums), and the great risk of insurers' insolvency.⁹⁹ However, the prevalence and general acceptability of mandatory rules in insurance contracts may also have to do with the fact that, at least initially and at least in New York, the impetus for standardizing fire insurance policies came from the insurance companies themselves in the wake of their difficulties in settling claims involving several insurers.¹⁰⁰ This legislation then served as a model for other states.¹⁰¹

Mandatory regulation of the content of insurance policies takes various forms. At the extreme, the entire policy is mandated by the law (sometimes allowing for extended coverage)¹⁰² or subject to approval by the pertinent

93. *Id.* at 1725–26.

94. RESTATEMENT (SECOND) OF CONTRACTS § 186 (AM. LAW INST. 1979).

95. *Id.* § 356.

96. *Id.* § 367; *see also id.* § 365 (denying specific performance if the act that would be compelled or the very compulsion are contrary to public policy).

97. Consumer Review Fairness Act, 15 U.S.C. § 45b (2018).

98. RESTATEMENT (SECOND) OF CONTRACTS § 205 (AM. LAW INST. 1979); U.C.C. § 1-302(b) (AM. LAW INST. & UNIF. LAW COMM'N 2009); 2 FARNSWORTH, *supra* note 16, at 355–56; Ayres & Gertner, *supra* note 10, at 87.

99. On these and other rationales for insurance regulation, see generally ROBERT H. JERRY II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW 59–62 (6th ed. 2018); Peter Kochenburger & Patrick Salve, *An Introduction to Insurance Regulation*, in RESEARCH HANDBOOK ON INTERNATIONAL INSURANCE LAW AND REGULATION 221, 221–23 (Julian Burling & Kevin Lazarus eds., 2011).

100. Kimball & Pfennigstorf, *supra* note 13, at 691–95.

101. *See, e.g.*, CAL. INS. CODE § 2071 (West 2018) (California Standard Form Fire Insurance).

102. *See, e.g.*, N.Y. INS. LAW § 3404 (Consol. 2010) (Standard Fire Insurance Policy of the State of New York).

regulatory agency.¹⁰³ Such standardization offers various advantages to the insureds (who can more easily compare between insurers based on price and service)¹⁰⁴ and the insurers (who, among other things, benefit from the increased certainty generated by judicial interpretation of the uniform clauses).¹⁰⁵ Rather than dictating the entire policy, the regulator may require that it include specific provisions,¹⁰⁶ or—less intrusively—prohibit the inclusion of other clauses.¹⁰⁷ Finally, the regulator (including the courts) can refrain from supervising the wording of the policy, while enforcing mandatory rules that override any conflicting contractual clauses.¹⁰⁸ While the regulation of insurance policies varies across jurisdictions, time, and type of insurance, it involves almost all aspects of the contract, including scope of coverage and premium rates.¹⁰⁹ A notable example is the requirement of minimum liability coverage in auto insurance, as mandated by state legislatures.¹¹⁰ Some of these mandatory provisions protect third-party beneficiaries.¹¹¹

Moving from the field of insurance to consumer credit, even after the subprime mortgage crisis, the scope of regulation of the content of loan contracts in the United States is rather limited. Thus, while state usury laws set caps on interest rates, they have been rendered largely ineffective by the

103. See, e.g., Tom Baker & Kyle D. Logue, *Mandatory Rules and Default Rules in Insurance Contracts*, in RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW 377, 402–08 (Daniel Schwarcz & Peter Siegelman eds., 2015) (describing various forms of administrative approval of insurance policies).

104. Daniel Schwarcz, *Reevaluating Standardized Insurance Policies*, 78 U. CHI. L. REV. 1263, 1272 (2011).

105. *Id.* at 1272–73.

106. See, e.g., N.Y. INS. LAW § 3412(g) (Consol. 2020) (“All policies providing automobile physical damage coverage shall include a provision authorizing the insurer to take the insured motor vehicle into custody for safekeeping, when notified that the motor vehicle reported stolen . . . has been located.”); MICH. COMP. LAWS ANN. § 500.3006 (2020) (requiring liability insurance policies to state that the insured’s insolvency must not release the insurer from its liability); *id.* § 500.3008 (requiring inclusion of a provision that any notice given by the insured to any authorized agent of the insurer shall be deemed to be a notice to the insurer).

107. See, e.g., N.Y. INS. LAW § 3215(d) (2020) (“No [life insurance or contract of deferred annuity] shall provide that the face amount of life insurance shall be reduced because of any disability benefits paid . . .”). Such statutory prohibitions need not be absolute. See, e.g., *id.* § 3411(j) (“The superintendent may approve policy forms for physical damage coverage . . . which exclude coverage for specified items of personal property located in or upon the automobile.”).

108. For instance, under California law, provisions in life and disability insurance policies, which give discretionary authority to the insurer to determine eligibility for benefits or coverage, are unenforceable. CAL. INS. CODE § 10110.6 (2012).

109. For an overview, see generally JERRY & RICHMOND, *supra* note 99, at 59–161.

110. Baker & Logue, *supra* note 103, at 385–86. For an overview of compulsory automobile insurance, see JERRY & RICHMOND, *supra* note 99, at 805–56.

111. For example, many states require that life and disability insurance contracts include “incontestability clauses” that preclude insurers from contesting the validity of a policy after one or two years even if the insured intentionally misrepresented that she was a nonsmoker. See, e.g., DEL. CODE ANN. tit. 18, 3306(a)(2) (2020).

ruling that banks are subject to the usury laws of the state where their headquarters—rather than the borrowers—reside (and direct federal preemption undermines state regulation of other aspects of loan contracts, as well).¹¹² Apart from interest rates, mandatory rules apply to specific aspects of consumer-credit transactions. Thus, the federal legislation on residential mortgage loans prohibits the inclusion of terms that require the borrower to pay a penalty for prepayment,¹¹³ and the same holds for private educational loans.¹¹⁴ The FTC further declared that a nonpossessory security interest in household goods, other than a purchase money security interest, is unfair and deceptive within the meaning of § 5 of the Federal Trade Commission Act.¹¹⁵ Another example can be found in the California statute pertaining to lenders and providers of consumer credit who have been involved in the arrangement of *credit disability insurance* to the debtor. Such creditors must not invoke any remedy against the debtor because of nonpayment during the disability claim period.¹¹⁶

Various mandatory rules apply to credit-card agreements pursuant to the Credit Card Accountability, Responsibility, and Disclosure Act of 2009.¹¹⁷ Here are three examples: While credit-card issuers may increase the annual percentage rate upon the expiration of a specified period of time, the increased rate must not apply to transactions that were executed prior to the increase.¹¹⁸ Then, an over-the-limit fee may be imposed only once during a billing cycle.¹¹⁹ Finally, issuers cannot, as a rule, charge a violation fee (primarily for late payment) of more than \$25—or \$35 for a recurring violation.¹²⁰

A variety of mandatory rules apply to employment contracts. Most notably, federal and state (and occasionally even local) laws set minimum

112. KATHERINE PORTER, *MODERN CONSUMER LAW* 204–13 (2016) (concluding that states' usury laws "have a sharply limited reach"); Bar-Gill & Warren, *supra* note 69, at 79–83 (describing the erosion of state power in this regard).

113. 15 U.S.C. § 1639c(c) (2012).

114. *Id.* § 1650(e).

115. 16 C.F.R. § 444.2(a)(4) (2019).

116. CAL. CIV. CODE §§ 1812.400–410 (1983).

117. Credit CARD Act of 2009, Pub. L. No. 111-24, 123 Stat. 1734 (2009) (codified in various sections of 5, 11, 15, 16, 20, and 31 U.S.C. (Supp. IV 2010)).

118. 15 U.S.C. §§ 1666i-1(a), (b)(1)(C) (2012).

119. *Id.* § 1637(k)(7). This rule, and the requirement that consumers expressly opt to permit such extension of credit (*id.* § 1637(k)(1)), resulted in a dramatic decline of over-the-limit charges. Oren Bar-Gill & Ryan Bubb, *Credit Card Pricing: The Card Act and Beyond*, 97 CORNELL L. REV. 967, 986–90 (2012).

120. 12 C.F.R. § 226.52(b)(1)(ii)(A)–(B) (2011). On the dramatic decrease of late-payment fees following the enactment of the CARD Act, see Bar-Gill & Bubb, *supra* note 119, at 991–92.

wages.¹²¹ The Family and Medical Leave Act of 1993 requires employers to provide employees with job-protected and unpaid leave for qualified medical and family reasons.¹²² Title VII prohibits discrimination upon a number of grounds with regard to the terms and conditions of employment.¹²³ Another example is state laws that invalidate non-compete clauses—namely, contractual provisions that prohibit employees from working for a competitor after the end of the employment relationship.¹²⁴ In the absence of such legislation, courts use general doctrines to police noncompete clauses.¹²⁵

In the sphere of residential leases, all states apply mandatory rules. The most important doctrine is the *warranty of habitability*, first developed in the celebrated case of *Javins v. First National Realty Corp.*,¹²⁶ and then incorporated in the Uniform Residential Landlord and Tenant Act (URLTA) of 1972 and in dozens of state acts. According to this doctrine, landlords are subject to immutable obligations to maintain the premises in habitable conditions and to comply with the applicable housing codes. The doctrine further entitles tenants to withhold rent when this obligation is breached.¹²⁷ In the same spirit, landlords cannot disclaim their liability for personal injury or property damage resulting from their negligence.¹²⁸ Also, to protect tenants' rights to complain to governmental agencies about violations of housing codes and to organize or join tenants' unions, landlords must not retaliate for such actions by increasing rent, decreasing services, or threatening to repossess.¹²⁹ Many other mandatory rules offer further protection of tenants' rights.¹³⁰

121. See, e.g., 29 U.S.C. § 206 (2012) (setting the federal minimum wage); CAL. LAB. CODE § 1182.12 (2017) (setting the state minimum wage for California); S.F. ADMIN. CODE § 12R.4 (2014) (setting the city minimum wage for San Francisco).

122. 29 U.S.C. §§ 2601–54 (2012).

123. Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e-2 (2012).

124. E.g., CAL. BUS. & PROF. CODE § 16600 (2020); N.D. CENT. CODE § 9-08-06 (2020).

125. See Norman D. Bishara, *Fifty Ways to Leave Your Employer: Relative Enforcement of Covenants Not to Compete, Trends, and Implications for Employee Mobility Policy*, 13 U. PA. J. BUS. L. 751 (2011) (analyzing the statutory and judicial regulation of noncompete clauses across the United States).

126. 428 F.2d 1071 (D.C. Cir. 1970).

127. For a recent review of the judicial and statutory rules, see Donald E. Campbell, *Forty (Plus) Years After the Revolution: Observations on the Implied Warranty of Habitability*, 35 U. ARK. LITTLE ROCK L. REV. 793 (2013). For varying assessments of the success of the implied warranty of habitability, see Paula A. Franzese, Abbott Gorin & David J. Guzik, *The Implied Warranty of Habitability Lives: Making Real the Promise of Landlord-Tenant Reform*, 69 RUTGERS U. L. REV. 1 (2016); David A. Super, *The Rise and Fall of the Implied Warranty of Habitability*, 99 CAL. L. REV. 389 (2011).

128. UNIF. RESIDENTIAL LANDLORD AND TENANT ACT § 1.403(a)(4) (UNIF. LAW COMM'N 1972) (“A rental agreement may not provide that the tenant . . . agrees to the exculpation or limitation of any liability of the landlord arising under law . . .”).

129. *Id.* § 5.101.

130. For a brief overview, see Furth-Matzkin, *supra* note 14, at 9–10.

Yet another sphere in which several states have introduced detailed regulation of suppliers' liability is builders' liability for defects in new homes. In some instances, this statutory liability is fully mandatory; in others, disclaiming it is subject to formal and substantive requirements.¹³¹ A number of state laws impose a mandatory obligation on sellers of new manufactured homes that the homes materially comply with the applicable statutory standards of safety or quality, and with implied warranties of merchantability.¹³²

In the legal services market, statutory and judicial mandatory norms apply to lawyers' contingent fees. Many states set statutory caps on the rates of such fees; and in the absence of statutory caps, courts review the reasonableness of such fees on a case-by-case basis.¹³³

Like any other transaction, consumer contracts are subject to the general doctrines of contract law that facilitate the policing of contracts, such as unconscionability. Beyond these doctrines and the specific regulation of particular types of contracts mentioned above, relatively few mandatory rules apply to consumer transactions in goods and services. With very few exceptions, Article 2 of the U.C.C. (dealing with the sale of goods) comprises default rules.¹³⁴ The Magnuson–Moss Warranty Act does restrict the ability of sellers to disclaim liability for the quality of consumer goods;¹³⁵ but these restrictions pertain only to the formulation and saliency of the disclaimers—thus allowing sellers to avoid any liability whatsoever, provided that they comply with the pertinent *procedural* mandatory rules.¹³⁶ More to the point, so-called state Lemon Laws give purchasers of defective new vehicles an unwaivable right to rescind the contract and receive a full refund, or a

131. *See, e.g.*, Louisiana New Home Warranty Act of 1986, LA. STAT. ANN. §§ 9:3141–3150 (2020) (according to § 9:3144.C, if the home “is a single or multiple family dwelling to be occupied by an owner as his home,” the statutory warranty cannot be waived); New York Warranties on Sale of New Homes Act of 1988, N.Y. GEN. BUS. LAW §§ 777–777-b (McKinney 2019) (§ 777-b contains a long list of formal and substantive limitations on the exclusion of the statutory liability). For a general discussion of warranties in the sale of new homes, see Jeff Sovern, *Toward a Theory of Warranties in Sales of New Homes: Housing the Implied Warranty Advocates, Law and Economics Mavens, and Consumer Psychologists under One Roof*, 1993 WIS. L. REV. 13 (1993).

132. *See, e.g.*, MINN. STAT. § 327B.02 (2020) (mandating that every new home sale complies with applicable federal and state standards and carries with it an implied warranty of merchantability); WASH. REV. CODE § 46.70.132 (2018) (same). On these and comparable state laws, see CAROLYN L. CARTER, JON W. VAN ALST & JONATHON SHELDON, *CONSUMER WARRANTY LAW: LEMON LAW, MAGNUSON–MOSS, UCC, MANUFACTURED HOME, AND OTHER WARRANTY STATUTES 700–01* (5th ed. 2015).

133. *See generally* ROBERT L. ROSSI, *ATTORNEY’S FEES 2-22–2-31* (3d ed. 2001).

134. *See* U.C.C. § 1-302(a) (AM. LAW INST. & UNIF. LAW COMM’N 2009). Exceptions include §§ 2-719(3) (limiting consequential damages for injury to the person in the case of consumer goods presumed to be unconscionable) and 2-725(1) (stating that the period of statute of limitations cannot be reduced to less than one year or extended to more than four years).

135. 15 U.S.C. §§ 2301–2312 (2012).

136. U.C.C. § 2-316 lays down comparable rules.

comparable replacement vehicle (as well as indemnification for their reasonable costs), if a specified number of attempts (e.g., four) to repair the defect have failed, or if the vehicle has been out of service for repairs for a minimal number of days (e.g., thirty) in the first year after delivery.¹³⁷ Then, on the borderline of contract and torts, sellers' liability for harm caused by defective products under the products-liability doctrine is nondisclaimable.¹³⁸

Finally, some mandatory rules apply to commercial transactions. For example, the Automobile Dealers' Day in Court Act imposes a mandatory duty of good faith in the termination and nonrenewal of a franchise and allows the franchisee to sue the manufacturer for breach of that duty wherever the latter has an agent.¹³⁹ Even when a franchise contract prescribes arbitration for dispute settlement, arbitration may be used only if all parties consent to it once the dispute has arisen.¹⁴⁰

Although far from complete, this list of examples is sufficient to demonstrate the prevalence of mandatory rules in U.S. contract law. The existence of such rules in the contractual sphere should not come as a surprise. Vast swaths of U.S. law can be described as combinations of default and mandatory rules. Scholars have extensively analyzed the default/mandatory mixture with regard to corporate law,¹⁴¹ environmental law,¹⁴² civil procedure,¹⁴³ property,¹⁴⁴ intellectual property,¹⁴⁵

137. *E.g.*, Michigan New Vehicles Warranties Act, MICH. COMP. LAWS ANN. §§ 257.1401–257.1410 (West 2019). For a detailed analysis of lemon laws, see CARTER ET AL., *supra* note 132, at 559–608.

138. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 18 (AM. LAW INST. 1998).

139. 15 U.S.C. § 1222 (2012).

140. *Id.* § 1226.

141. *See, e.g.*, Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989) (including thirteen contributions debating the appropriate “mandatory/enabling balance in corporate law”).

142. *See, e.g.*, Bradley C. Karkkainen, *Adaptive Ecosystem Management and Regulatory Penalty Defaults: Toward a Bounded Pragmatism*, 87 MINN. L. REV. 943, 965–70 (2003) (discussing the mandatory/default makeup of environmental regulation).

143. *See, e.g.*, Kevin E. Davis & Helen Hershkoff, *Contracting for Procedure*, 53 WM. & MARY L. REV. 507 (2011) (reviewing the practice of contracting out of the rules of civil procedure and suggesting procedural and substantive limitations to this practice).

144. *See, e.g.*, HANOCH DAGAN, PROPERTY VALUES AND INSTITUTIONS 34 (2011) (describing the trend from mandatory to default rules in marital property and servitudes law); Adam S. Hofri-Winogradow, *The Stripping of the Trust: From Evolutionary Scripts to Distributive Results*, 75 OHIO ST. L.J. 529 (2014) (criticizing the trend of transforming various characteristics of trusts into mere defaults); John Langbein, *Mandatory Rules in Law of Trusts*, 98 NW. U. L. REV. 1105, 1105 (2004) (analyzing mandatory and default rules in trust law); Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 641–46 (2004) (accounting for the mixture of default and mandatory rules in donative trusts).

145. *See, e.g.*, Niva Elkin-Koren, *Copyright Policy and the Limits of Freedom of Contract*, 12 BERKELEY TECH. L.J. 93, 110 (1997) (criticizing contractual expansion of copyright).

torts,¹⁴⁶ and conflicts of interest in attorney–client relationships.¹⁴⁷ Indeed, while an exhaustive examination is beyond the scope of this Article, we conjecture that every area of law is a combination of default and mandatory rules. Areas that are thought of as primarily consisting of default rules have some mandatory rules, and areas that are thought of as primarily mandatory are found to have some default rules.¹⁴⁸ The prevalence of default and mandatory rules in so many different domains counsels toward pedagogic attention to whether particular rules are contractible or not.

It should be emphasized, however, that the relative proportions of mandatory and default rules do vary substantially in different substantive areas of law as well as in different geographic areas. Mandatory rules are significantly less common in the United States than in many other countries. This relative paucity is particularly evident in the area of labor and employment law, where U.S. law provides employees with considerably fewer immutable rights than European and other legal systems.¹⁴⁹ Similarly, other countries regulate the content of loan contracts considerably more extensively than U.S. law.¹⁵⁰ More generally, U.S. law still largely addresses

146. Thus, while liability for assault is routinely waived by patients who consent to medical treatment and boxers who participate in boxing matches (on the assumption-of-risk defense and the effect of consent, see RESTATEMENT (SECOND) OF TORTS §§ 496A–496G (AM. LAW INST. 1965) and 892A (AM. LAW INST. 1979), respectively), product liability is mandatory (*see supra* note 138 and accompanying text).

147. *See, e.g.*, Richard W. Painter, *Advance Waiver of Conflicts*, 13 GEO. J. LEGAL ETHICS 289, 293 (2000) (analyzing advance waivers by clients of their conflict-of-interest rights).

148. Even the United States Constitution and the judicial decisions interpreting it include default as well as mandatory provisions. *See, e.g.*, Ian Ayres, *First Amendment Bargains*, 18 YALE J.L. & HUMAN. 178, 190–96 (2006) (discussing default interpretation of *New York Times v. Sullivan*); John A. Ferejohn & Barry Friedman, *Toward a Political Theory of Constitutional Default Rules*, 33 FLA. ST. U. L. REV. 825 (2006) (examining various constitutional rules and doctrines as default rules and explaining how they can be contracted around).

149. Juan Botero and his colleagues constructed an *Employment Laws Index*, which quantified and measured “the protection of labor and employment laws as the average of (1) Alternative employment contracts, (2) Cost of increasing hours worked, (3) Cost of firing workers, and (4) Dismissal procedures.” Across the eighty-five countries compared in their study, the mean and median of the index were 0.4876 and 0.4749, respectively. The index for the United States was 0.2176—lower than all but eight countries. A similar pattern was found in the *Collective Laws Index*: mean: 0.4451; median: 0.4749; United States: 0.2589; only nine countries with a lower index. Juan C. Botero, Simeon Djankov, Rafael La Porta, Florencio Lopez-De-Silanes & Andrei Shleifer, *The Regulation of Labor*, 119 Q. J. ECON. 1339, 1346–56, 1362–63 (2004).

150. For example, the Israeli Fair Credit Law, 1993, as revised in 2017, sets mandatory rules about various aspects of the contract—including interest rates, default interest rates, prepayment, and collection procedures. Much regulation has previously been done by the Israeli Banking Supervisor. For example, in 2004, “well before the global subprime crisis, the Bank of Israel banned the practice of short-term teaser rates in mortgage loans altogether.” *See* Eyal Zamir & Tal Mendelson, *Three Modes of Regulating Price Terms in Standard-Form Contracts—The Israeli Experience*, in CONTROL OF PRICE RELATED TERMS IN STANDARD CONTRACT TERMS 429, 445–48 (Yeşim M. Atamer & Pascal Pichonnaz eds., 2019) (discussing the Israeli Fair Credit Law and describing Israel’s banking regulations before the mortgage crisis).

unfair clauses in SFCs through general, vague, and not very effective doctrines, such as unconscionability and interpretation against the drafter. In contrast, other Western countries have long since enacted special laws for SFCs that establish *black lists* of invalid provisions in such contracts, and *gray lists* of provisions that are presumed to be invalid, pending judicial (or sometimes administrative) scrutiny.¹⁵¹

Against the backdrop of the key arguments for and against intervention in the content of contracts (as discussed in Part I), this Part has demonstrated the absolute prevalence—yet relative scarcity—of mandatory rules in American law. The upshot is that mandatory rules are often necessary to attain the fundamental goals of contract law—including respect for people’s liberties and the maximization of social welfare—and that given their relative scarcity compared to other countries, mandatory rules might plausibly be used even more extensively. However, one need not agree with these conclusions to acknowledge the importance of theoretically informed guidelines for the design of mandatory rules. For even if no new rules as such are promulgated, the vast body of existing mandatory rules calls for reassessment based on systematic and sound policy analysis.

III. Designing Mandatory Rules

This Part examines various dimensions of the design of mandatory rules. This examination provides guidelines for assessing and reforming existing rules and for formulating new ones. As elaborated below, designing mandatory rules involves a long list of issues, including the identity of the regulator and the choice between rules and standards; determination of the incidence of rules, the degree to which they are immutable, and whether to impose bidirectional or unidirectional immutability; the decision whether to complement substantive rules with duties and prohibitions about the wording of contracts (and determining the outcomes of noncompliance with said duties and prohibitions); the use of positive or negative formulations of the legal norms; and determining which arrangement should substitute invalid contractual clauses, and how such invalidity should affect the remainder of the contract. Optimal design often requires considering many of these dimensions simultaneously.

While this examination is more comprehensive than any previous examination of the design of mandatory rules that we are aware of, it is still

151. Notable examples include the pioneering Israeli Standard Contracts Law of 1964 (reenacted in 1982), the German Standard Contracts Act (Gesetz zur Regelung des Rechts der Allgemeinen Geschäftsbedingungen) of 1976 (subsequently incorporated into the German Civil Code, Bürgerliches Gesetzbuch, §§ 305–10), and the European Directive 93/13/EEC on Unfair Terms in Consumer Contracts (1993). See, e.g., Larry Bates, *Administrative Regulation of Terms in Form Contracts: A Comparative Analysis of Consumer Protection*, 16 EMORY INT’L L. REV. 1, 55–67, 79–90 (2002) (discussing German and Israeli law).

incomplete because it does not cover indirect means that may be used to undermine the immutable nature of mandatory rules. These include “choice of law” clauses that subject transactions to a more lenient legal regime than would otherwise apply;¹⁵² the restructuring of transactions (for example, of employment contracts as the hiring of an independent contractor, or the creation of security interest as a lease or a sale) to bypass mandatory rules;¹⁵³ and the inclusion of arbitration clauses that potentially shield the supplier from judicial enforcement of mandatory rules.¹⁵⁴ Such attempts to circumvent mandatory rules (which under existing law are sometimes successful) are troubling. However, to keep the discussion manageable, we shall not discuss them here.¹⁵⁵

A. *Functionaries and Forms*

This section addresses the interrelated questions of which functionaries—legislative, executive, or judicial—should be entrusted with the creation of mandatory norms, and what should be the form of these norms: rules or standards. These two choices determine the division of labor among governmental branches in this sphere and may thus have considerable practical implications.

1. *The Regulator.*—Mandatory rules may be established by the legislature, by the courts, or by administrative agencies. This tripartite distinction partially overlaps with the distinction between legislative and

152. See William J. Woodward Jr., *Constraining Opt-Outs: Shielding Local Law and Those It Protects from Adhesive Choice of Law Clauses*, 40 LOY. L.A. L. REV. 9 (2006) (considering possible solutions to the problem).

153. See, e.g., Guy Davidov, Mark Freedland & Nicola Kountouris, *The Subjects of Labor Law: “Employees” and Other Workers*, in RESEARCH HANDBOOK IN COMPARATIVE LABOR LAW 115 (Matthew Finkin & Guy Mundlak eds., 2015) (discussing the distinction between employee and independent contractor); WHITE & SUMMERS, *supra* note 89, at 1155–65 (discussing the distinction between security interest and lease); Meredith Jackson, *Contracting Out of Article 9*, 40 LOY. L.A. L. REV. 281, 283–91 (2006) (discussing the restructuring of secured transactions as leases or sales).

154. See generally Andrew T. Guzman, *Arbitrator Liability: Reconciling Arbitration and Mandatory Rules*, 49 DUKE L.J. 1279 (2000) (analyzing the dilemma, and suggesting that it be solved by making arbitrators liable for failure to apply the mandatory law); Stephen J. Ware, *Default Rules from Mandatory Rules: Privatizing Law Through Arbitration*, 83 MINN. L. REV. 703 (1999) (showing that arbitration facilitates the privatization of law creation and calling to reverse the ruling that claims arising under mandatory rules are arbitrable).

155. Two additional issues are left out of the present discussion. One is the ability of contracting parties to waive their rights under a mandatory rule *ex post* (which basically exists, unless the aim of the rule is not to protect that party, but rather external ones). See, e.g., U.C.C. § 9-602 cmt. 3 (AM. LAW INST. & UNIF. LAW COMM’N 2009) (clarifying that the immutability of the provisions listed in this section does not restrict the parties’ ability to settle claims for past conduct); *id.* § 9-624 (allowing for waiver of debtors’ rights after default). The other is the possibility of using temporary mandatory rules. See generally Tom Ginsburg, Jonathan S. Masur & Richard H. McAdams, *Libertarian Paternalism, Path Dependence, and Temporary Law*, 81 U. CHI. L. REV. 291 (2014) (advocating the “case for temporary law”).

judicial lawmaking, where administrative bodies may fulfill both legislative and quasi-judicial functions. This distinction is, however, schematic since there are various possible combinations of legislative, administrative, and judicial elements. For example, throughout the United States, insurers are required to submit policies for approval by insurance regulators, which may actively approve, reject, or merely fail to disapprove, policies or specific terms therein.¹⁵⁶ In such cases, the question arises as to what impact an administrative authority's active approval or passive failure-to-disapprove a policy might have on the authority or discretion of a law court to invalidate policy clauses that are unconscionable or at odds with the reasonable expectations of the insured.¹⁵⁷ Plausibly, the more rigorous the scrutiny applied by the regulator, the more the court should defer to the regulator's decision—especially if it is an active approval (in part because people feel greater responsibility for active decisions than for passive ones).¹⁵⁸ However, the assumption that active approval is the product of greater scrutiny of the policies in question by the regulator compared with a failure-to-disapprove, is debatable.

At times, nongovernmental organizations adopt mandatory terms that apply to the contractual relations between their members and their customers. For example, in the 1970s, the National Association of Home Builders (NAHB) launched a voluntary program for builders—the Home Owners Warranty—which obliged construction firms who joined the program to provide purchasers with warranties for building defects for a period of up to ten years, depending on the type and severity of the defect.¹⁵⁹ Similarly, in the sharing economy, internet platforms such as Uber and Airbnb, which intermediate contracting between buyers and sellers, often mandate contractual provisions used in such agreements.¹⁶⁰ Strictly speaking, while such arrangements are not mandatory rules, one can imagine circumstances in which they would function as such—which further complicates the map of possible lawmakers.

Focusing on governmental lawmaking, a preliminary question has to do with the legitimacy of judicial lawmaking, given that judges are not democratically elected. Delving into this question exceeds the scope of the

156. BAKER & LOGUE, *supra* note 103, at 402.

157. *Id.* at 403–08.

158. See generally Johanna H. Kordes-de Vaal, *Intention and the Omission Bias: Omissions Perceived as Nondecisions*, 93 ACTA PSYCHOLOGICA 161 (1996) (demonstrating that people perceive the outcomes of omissions as being less intended than those of commissions); Mark Spranca, Elisa Minsk & Jonathan Baron, *Omission and Commission in Judgment and Choice*, 27 J. EXPERIMENTAL SOC. PSYCHOL. 76 (1991) (experimentally showing that people tend to rate harmful omissions “as less immoral, or less bad as decisions, than harmful commissions”).

159. On this program, see Sovern, *supra* note 131, at 21–22; Jonathan L. Kempner, Note, *The Home Owners Warranty Program: An Initial Analysis*, 28 STAN. L. REV. 357 (1976).

160. See generally Orly Lobel, *The Law of the Platform*, 101 MINN. L. REV. 87 (2016).

present discussion.¹⁶¹ Suffice it to say that, besides the fact that judges in state courts *are* usually elected,¹⁶² the alleged illegitimacy of judicial lawmaking primarily refers to constitutional and statutory interpretation, rather than to the development of the common law—which is generally perceived as the province of courts.¹⁶³

Putting aside the question of legitimacy, the main issue is one of institutional competence. Some mandatory rules reflect deeply held moral values, such as respect for human dignity and honesty. Examples include the unavailability of specific performance of an obligation to provide personal service and liability for fraudulent behavior. In designing rules of this sort, legislators (including administrative agencies engaged in legislation) have no particular advantage over the courts. Professional judges—who regularly make normative judgments in interpersonal disputes—may even have an advantage in this regard. In contrast, mandatory rules that aim to tackle market failures may require macroeconomic data and economic expertise, and rules that aim to mitigate people’s cognitive biases require expertise in human psychology. Potentially, at least, legislators and their supporting apparatus can collect and analyze such economic and psychological data better than courts. For example, issues such as determining which competition-reducing clauses should be invalidated, setting a minimum wage, and capping interest rates in consumer loans, should presumably be the preserve of the legislature.¹⁶⁴ Similarly, determining which terms in standard-form contracts are affected by market competition, and which are not, requires empirical investigations that courts cannot pursue. While judges are presented with the facts of particular disputes, legislators can see the broader picture.¹⁶⁵ The flipside of the coin is that legislative regulation might be overinclusive, while courts can tailor their decisions to the specific circumstances of the case at hand.¹⁶⁶

Admittedly, however, legislators do not always take advantage of the available empirical data, and when empirical analyses already exist, the

161. See, e.g., A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW (Amy Gutmann ed., 1997) (featuring an essay by Antonin Scalia and critical responses on the courts’ role in constitutional and statutory interpretation).

162. See Aaron-Andrew P. Bruhl & Ethan J. Leib, *Elected Judges and Statutory Interpretation*, 79 U. CHI. L. REV. 1215 (2012) (discussing the significance of the fact that, unlike federal judges, most state judges are elected, for their approach to statutory interpretation).

163. Even Justice Scalia, who adamantly objected to judicial activism in constitutional and statutory interpretation had “no quarrel with the common law and its process.” See Antonin Scalia, *Common-Law Courts in a Civil-Law System: The Role of United States Courts in Interpreting the Constitution and Laws*, in A MATTER OF INTERPRETATION, *supra* note 161, at 3, 13.

164. See, e.g., Bar-Gill & Warren, *supra* note 69, at 74–75 (discussing the institutional competence of legislators and courts in the sphere of consumer credit).

165. Korobkin, *supra* note 13, at 1249.

166. See also *infra* subpart III(B).

courts—with the help of expert testimonies—may overcome at least some of their limitations in this regard. In fact, when it comes to mandatory regulation in spheres involving specific expertise, such as the language of insurance policies, professional agencies may have an advantage over generalists—be they judges or legislators.¹⁶⁷ Professional agencies are also much more qualified than the legislature to closely follow market innovations and respond to them quickly.¹⁶⁸ Establishing specialized courts can mitigate the expertise problem, but not the other limitations of judicial lawmaking.

Compared with elected policymakers, one important advantage that the courts have in regulating the content of contracts is that they are typically less susceptible to lobbying by powerful interest groups and other forms of regulatory capture. Various studies have demonstrated that the policies adopted by the legislature reflect the preferences of organized interests, rather than those of the general public.¹⁶⁹ However, here, too, there is no bright line distinction between elected politicians and judges—especially when the latter are appointed by the former, or must stand for reelection. Courts may also cater to the interests of powerful stakeholders when they compete with one another.¹⁷⁰

These and other institutional differences between the governmental branches¹⁷¹ also affect the form and substance of regulation—hence the present distinction is closely associated with some of the choices discussed below. Specifically, given the considerable costs of adjudication, judicial oversight of the content of contracts is more appropriate for low-probability,

167. See, e.g., Kimball & Pfennigstorf, *supra* note 13, at 729 (opining that in the context of insurance “judges tend to intervene in complex matters about which they know very little”).

168. Bar-Gill & Warren, *supra* note 69, at 84–85.

169. See, e.g., LARRY M. BARTELS, *UNEQUAL DEMOCRACY: THE POLITICAL ECONOMY OF THE NEW GILDED AGE* (2d ed. 2016) (demonstrating that U.S. policymakers cater to the interests of affluent constituents much more than to those of middle-class and low-income constituents); KAY LEHMAN SCHLOZMAN, SIDNEY VERBA & HENRY E. BRADY, *THE UNHEAVENLY CHORUS: UNEQUAL POLITICAL VOICE AND THE BROKEN PROMISE OF AMERICAN DEMOCRACY* 9, 22 (2012) (arguing that the voices of organized interests perpetuate existing biases); Martin Gilens & Benjamin I. Page, *Testing Theories of American Politics: Elites, Interest Groups, and Average Citizens*, 12 *PERSP. ON POL.* 564, 564 (2014) (demonstrating that economic elites and organized groups representing business interests have much greater influence on U.S. government policy than average citizens and mass-based interest groups).

170. See Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 *YALE J. ON REG.* 209 (2006) (finding that the competition for corporate charters has made both the Delaware legislature and Delaware courts sensitive to the interests of corporations).

171. On additional differences, see, for example, Jeffrey J. Rachlinski & Cynthia R. Farina, *Cognitive Psychology and Optimal Government Design*, 87 *CORNELL L. REV.* 550 (2002) (analyzing the issue from a judgment-and-decision-making perspective); Daphna Lewinsohn-Zamir, Ilana Ritov & Tehila Kogut, *Law and Identifiability*, 92 *IND. L.J.* 505 (2017) (demonstrating that people react differently to identified individuals than to unidentified ones; and arguing that since legislators typically design rules for unidentified people, while judges deal with identified ones, the outcomes of those two forms of lawmaking may differ).

high-magnitude harms and losses than for high-probability, low-magnitude ones.¹⁷² In the latter case, legislative regulation—coupled with administrative or criminal sanctions for noncompliance—appears to be more appropriate.¹⁷³ More generally, the legislature can use any combination of rules and standards (the latter delegating some of the lawmaking task to those who implement the standards, primarily the courts); determine the precise incidence of its norms; and bring about major changes at once. In contrast, the meaning and incidence of judicial precedents are often unclear; judge-made law develops more incrementally; and courts may use various doctrines and techniques to police the content of contracts without openly declaring that they do so (thereby attracting less opposition).¹⁷⁴

2. *Rules Versus Standards.*—Mandatory rules may be formulated as rules or standards. Rules typically make legal outcomes contingent upon the existence of a limited number of easily ascertainable facts. Conversely, standards embody substantive objectives and values, and their implementation requires consideration of the entire set of circumstances of the case, and assessing these in light of the values that the standard embodies.¹⁷⁵ A mandatory norm may provide nothing more than a very general standard. Pertinent examples include the unenforceability of unconscionable contract terms,¹⁷⁶ the exclusion of terms in standardized agreements that the drafter “has reason to believe” that the other party would not have assented to “if he knew that the writing contained” those terms;¹⁷⁷ and the interpretation of contracts in a manner that is unfavorable to the drafter.¹⁷⁸ More concrete mandatory norms may use bright-line rules (e.g., a

172. Bar-Gill & Warren, *supra* note 69, at 77 (making this point in the context of consumer-credit products, such as credit cards).

173. On such sanctions, see *infra* section III(D)(1).

174. See Zamir, *supra* note 29, at 1719–53 (analyzing courts’ use of interpretation and construction rules, evidence law, and various other doctrines to transform default rules into quasi-mandatory ones).

175. See Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1687–88 (1976) (describing the distinction).

176. U.C.C. § 2-302, 2A-108 (AM. LAW INST. & UNIF. LAW COMM’N 2002); RESTATEMENT (SECOND) OF CONTRACTS § 208 (AM. LAW INST. 1979). For notable discussions of the doctrine, see, for example, Arthur A. Leff, *Unconscionability and the Code—The Emperor’s New Clause*, 115 U. PA. L. REV. 485 (1967); M.P. Ellinghaus, *In Defense of Unconscionability*, 78 YALE L.J. 757 (1969); Korobkin, *supra* note 13, at 1255–90. On courts’ use of the doctrine to invalidate warranty disclaimers, see Michael J. Phillips, *Unconscionability and Article 2 Implied Warranty Disclaimers*, 62 CHI.-KENT L. REV. 199 (1985).

177. See RESTATEMENT (SECOND) OF CONTRACTS § 211(3) (AM. LAW INST. 1979); *Berkson v. Gogo LLC*, 97 F. Supp. 3d 359, 391, 403–04 (E.D.N.Y. 2015) (applying this rule to misleading terms of use in an in-flight Wi-Fi service agreement).

178. See generally RESTATEMENT (SECOND) OF CONTRACTS § 206 (AM. LAW INST. 1979) (articulating the principle that a contract will generally be interpreted against the drafter); 2 FARNSWORTH, *supra* note 16, at 300–04 (same).

construction firm's liability for construction defects that become apparent within 24 months) or vaguely worded standards (such as liability for construction defects that become apparent within "a reasonable time"). Rules and standards may be used not only to delineate the substantive norm, but also to prescribe its incidence¹⁷⁹ and the conditions under which the parties may opt out of it, if at all.¹⁸⁰ In fact, mandatory norms that regulate the content of contracts can lie anywhere on a spectrum between very vague standards and very concrete rules, and may include any combination of the two.¹⁸¹

Rules and standards differ in terms of the costs of their *ex ante* formulation and *ex post* implementation,¹⁸² influence on future behavior,¹⁸³ impact on legal certainty and predictability,¹⁸⁴ risk of under- and over-inclusiveness,¹⁸⁵ adaptability to changed circumstances,¹⁸⁶ and the relationships between form and substance.¹⁸⁷ Rather than abstractly restating these well-known (if sometimes controversial) differences, we focus on their implications for mandatory regulation of the content of transactions.

Compared with standards, rules are relatively more costly to formulate *ex ante*, but easier to implement *ex post*. In fact, given the endless variety of contracts and contract clauses, regulating the content of contracts exclusively through concrete statutory rules is practically impossible. This is particularly true of unique and constantly changing contract terms.¹⁸⁸ Hence, no matter how detailed statutory mandatory rules might be, there would always be a need to complement them with standards such as unconscionability.¹⁸⁹

179. See, e.g., Baker & Logue, *supra* note 103, at 408–10 (discussing the question in the context of insurance).

180. See *infra* section III(C)(1).

181. See also Gideon Parchomovsky & Alex Stein, *Catalogs*, 115 COLUM. L. REV. 165 (2015) (analyzing norms that comprise a specific enumeration of items that share a salient common denominator and a residual category—denoted by words such as “and the like”).

182. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 568–86 (1992) (analyzing the costs associated with rules and standards).

183. *Id.* at 571–77; Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379, 384–85 (1985) (analyzing the deterrence effect of rules and standards).

184. See Kennedy, *supra* note 175, at 1688 (“It has been common ground, at least since Ihering, that the two great social virtues of formally realizable rules, as opposed to standards or principles, are the restraint of official arbitrariness and certainty.”). *But see infra* note 197 and accompanying text.

185. Kennedy, *supra* note 175, at 1689–90.

186. Kaplow, *supra* note 182, at 616–17 (arguing that standards are more adaptable to changes in circumstances and value judgments).

187. See Kennedy, *supra* note 175, at 1737–38, 1740 (arguing that rules tend to be associated with individualism while standards with altruism); Schlag, *supra* note 183, at 418–22 (criticizing Kennedy's account).

188. Kaplow, *supra* note 182, at 562–64, 568–77 (concluding that “the greater the frequency with which a legal command will apply, the more desirable rules tend to be relative to standards”).

189. Korobkin, *supra* note 13, at 1244–55 (advocating a combination of mandatory rules and standards).

Standard economic analysis ordinarily assumes that individuals are risk averse. On the one hand, since rules presumably produce greater certainty and predictability than standards, it follows that the contracting parties, and society at large, are better off under a rule-based regime.¹⁹⁰ On the other hand, it may be argued that if the goal is to deter the use of unfair and oppressive clauses by suppliers, the uncertainty involved in vaguely worded standards can be more effective in deterring risk-averse suppliers—perhaps even overly so.¹⁹¹ However, the latter argument is doubtful in the present context, for several reasons. First, more often than not, the addressees of mandatory rules are commercial firms, which may or may not be risk averse. Second, in addition to rendering certain clauses unenforceable, the law may or may not impose civil, administrative, or criminal sanctions for their very inclusion in the contract.¹⁹² Imposing such sanctions requires that the norms prescribing these duties be as clear and concrete as possible. Third, it is doubtful that suppliers—or, more precisely, the people who make decisions on their behalf—are perfectly rational in the economic sense. Empirical evidence suggests that self-serving biases are likely to distort the incentives created by legal norms: it is easier to convince oneself that one is complying with vague standards even when one is not, compared with bright-line rules.¹⁹³ Consequently, vague standards are more likely to produce underdeterrence rather than overdeterrence.

Another behavioral factor that arguably militates against the use of standards in the present context is that legal rights that are defined by a simple, bright-line rule are likely to produce a stronger sense of entitlement, and hence to induce a higher valuation of the rights by customers due to the *endowment effect*.¹⁹⁴ A lower sense of entitlement, and the difficulty of ascertaining one's legal position, likely decrease consumers' inclination to stand up for their rights. These concerns exacerbate other causes for the

190. See, e.g., Bates, *supra* note 151, at 9 (supporting administrative regulation of SFCs on this ground).

191. See, e.g., Parchomovsky & Stein, *supra* note 181, at 179 (pointing to the chilling effect of standards).

192. See *infra* section III(D)(2).

193. See, e.g., Yuval Feldman & Alon Harel, *Social Norms, Self-Interest and Ambiguity of Legal Norms: An Experimental Analysis of the Rule vs. Standard Dilemma*, 4 REV. L. & ECON. 81, 100–08 (2008) (finding that self-interest triggers noncompliance to a greater extent when the norms are formulated as standards); see also Laetitia B. Mulder, Jennifer Jordan & Floor Rink, *The Effect of Specific and General Rules on Ethical Decisions*, 126 ORG. BEHAV. & HUM. DECISION PROC. 115, 115 (2015) (demonstrating that “specifically-framed rules elicited ethical decisions more strongly than generally-framed rules” due to “reductions in people’s moral rationalizations”).

194. Russell B. Korobkin, *Behavioral Analysis and Legal Form: Rules vs. Standards Revisited*, 79 OR. L. REV. 23, 51–53 (2000). On the endowment effect—the tendency to place a higher value on objects or entitlements that one already possesses, compared with objects and entitlements that one does not—see generally Richard H. Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 43–47 (1980).

under-enforcement of consumer law—both rational (such as the small losses typically caused by suppliers' breach, compared with the high costs of litigation), and less rational (such as the *omission bias*).¹⁹⁵ Furthermore, inasmuch as people's behavior is influenced by social norms and their educational effect, and by the *conformity effect*, clear and simple rules are more likely than general standards to shape social norms, and thereby to affect behavior.¹⁹⁶

The advantages of rules over standards in terms of their certainty and predictability—and hence their stronger influence on people's behavior and the more effective enforcement by customers—should be qualified, however, when it comes to highly complex rules. When the system of rules is complex, involving numerous reservations, distinctions, exceptions, etc., its complexity likely diminishes rather than enhances the law's clarity and predictability.¹⁹⁷ That said, it remains true that concrete mandatory rules are generally more effective than flexible standards in influencing the formulation of contracts and their subsequent performance.

B. *Degree of Tailoring*

Along with the choice of “who is the best regulator,” design of mandatory rules requires choosing “who is to be regulated.” General contract law applies to innumerable types of private, commercial, and consumer contracts pertaining to goods, services, real property, and intellectual property. While specific rules apply to particular contracts, the general doctrines of contract law apply to all types of contracts. This is possible because much of contract law consists of default rules, which are subject to trade usages and to the agreement between the parties. In contrast, strictly mandatory rules apply irrespective of conflicting usages or agreements. Unsurprisingly, one major critique of mandatory norms is that they apply an untailored, “one-size-fits-all” regulation to diverse transactions between people and firms with heterogeneous needs and preferences—thus

195. On the omission bias—the tendency to prefer omission to commission—see generally ZAMIR & TEICHMAN, *supra* note 43, at 48–50.

196. Korobkin, *supra* note 194, at 53–56.

197. ZAMIR & TEICHMAN, *supra* note 43, at 557–59 (describing empirical findings that demonstrate “that systems of elaborate legal rules do not yield more certain and predictable outcomes than do systems of vague standards”); Kaplow, *supra* note 182, at 593–96 (explaining that rules may be as complex to operate as standards—if not more so); Korobkin, *supra* note 194, at 26–27 (“The more qualifications and exceptions a rule has . . . the more likely it will be applied unpredictably.”); Schlag, *supra* note 183, at 400–18 (deconstructing the notion that rules enhance predictability).

undermining efficiency and fairness, leading to perverse distributional outcomes, and inhibiting creativity.¹⁹⁸

However, there is no necessary correlation between the incidence of legal norms and whether they are mandatory or merely default rules. Just like defaults, the incidence of mandatory rules may be broad or narrow. Some mandatory norms—such as the denial of specific performance of personal services, and the right not to be defrauded—apply across a broad range of transactions. Yet, even mandatory norms with a broad incidence are not necessarily uniform and rigid. Vague standards are hardly vulnerable to these charges because their application in specific cases is discretionary.¹⁹⁹ And non-absolute rules, by their very nature, are less rigid than absolute ones, since they allow for some deviations when certain conditions are met.²⁰⁰ Given the diverse degrees of immutability of mandatory rules, there is no clear demarcation—if any—between partly mutable mandatory rules and so-called *sticky defaults*.²⁰¹

Moreover, even mandatory rules that are concrete, bidirectional, and preclude any contracting around them, vary in terms of their incidence. Mandatory rules are often tailored to specific transactions, such as insurance and residential leases. Similarly, they distinguish between standard-form and individually negotiated contracts, between consumer and non-consumer transactions, and so forth. Theoretically, at least, just as it is possible to create personalized default rules,²⁰² mandatory rules may even be personalized.²⁰³ Designing a complex set of rules can mitigate the problem of overinclusiveness (although it involves higher formulation costs and decreased predictability).

Unless one adheres to an extreme libertarian position, the very fact that mandatory rules sometimes apply to transactions that ideally should have been left out of their incidence does not mean that they are undesirable. It

198. See, e.g., Stephen M. Bainbridge, *Dodd-Frank: Quack Federal Corporate Governance Round II*, 95 MINN. L. REV. 1779, 1796–1819 (2011) (criticizing various provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act on the grounds that they directly or indirectly—i.e., through shaming disclosures—promote a uniform corporate governance that runs counter to companies’ diversity); Bar-Gill & Ben-Shahar, *supra* note 7, at 113–15 (criticizing mandatory arrangements in European consumer law for failing to accommodate consumers’ heterogeneity); Korobkin, *supra* note 13, at 1249–52 (arguing that “ex ante mandatory terms cannot be perfectly tailored to the efficiency requirements of context-specific market circumstances”).

199. On this distinction, see *supra* section III(A)(2).

200. On this distinction, see *infra* section III(C)(1).

201. Cf. Ayres, *supra* note 25, at 2084–96 (explaining how the rules about opting out of sticky defaults may be designed so as to handle parties’ heterogeneity).

202. See Ariel Porat & Lior Jacob Strahilevitz, *Personalized Default Rules and Disclosure with Big Data*, 112 MICH. L. REV. 1417 (2014) (explaining how the rise of Big Data facilitates the personalization of default rules and disclosure).

203. See Ben-Shahar & Porat, *supra* note 17 (exploring the implications of personalizing the scope of protection and prices in consumer contracts).

may well be that the benefits of mandatory rules in the great majority of cases to which they apply outweigh the costs in the minority of cases in which they result in inefficient, unfair, or regressive distributional outcomes. That said, legal policymakers should pay close attention to the incidence of mandatory rules, as well as to the possibility of leaving some leeway for flexibility in their application.

C. *Strictness of Regulation*

Mandatory norms vary in terms of their strictness. Specifically, they sometimes set substantive or procedural conditions under which the parties may opt out of them, and they may either prohibit any deviation from them, or merely limit the types of possible deviations. We discuss these two choices in turn.

1. *Degree of Immutability.*—The dichotomy between default rules and mandatory rules is somewhat misleading, since absolutely mandatory rules and absolutely default rules lie at either end of the same spectrum. Elsewhere, one of us (Zamir) has surveyed a long list of contract-law doctrines that make it difficult to contract around seemingly nonmandatory rules, thereby blurring the line between default and mandatory rules.²⁰⁴ This list includes umbrella doctrines such as unconscionability and public policy; “motivated” implementation of the rules of duress and mistake, offer and acceptance, and the requirement of consideration; strict enforcement of formal requirements; and purposive implementation of various interpretative devices (such as interpretation against the drafter and interpretation favoring the public). These legal tools enable courts “explicitly and tacitly, to avoid contractual terms that are inconsistent with legal rules and trade usages, thus turning the latter into quasi-mandatory norms.”²⁰⁵ These tools are examples of “altering rules” that impede the ability of the parties to achieve disfavored contractual outcomes.²⁰⁶

Turning from legal doctrine to the parties’ actual behavior, a large body of economic and behavioral literature has offered various explanations for the notable “stickiness” of presumably default rules. These include the costs of contracting around default rules; the role that default rules play in shaping people’s preferences; the *endowment effect* created by default rules; the parties’ fear of misunderstandings and uncertainty when contracting around

204. Zamir, *supra* note 29, at 1738–53.

205. *Id.* at 1752.

206. Ayres, *supra* note 25.

established rules; and the gap between the formal contract and the parties' subsequent behavior.²⁰⁷

From the other direction, many mandatory rules actually contain built-in leeway that makes it possible to contract around them, subject to various substantive or procedural requirements. For example, § 9-602 of the U.C.C. contains a long list of Article 9 sections that “the debtor or obligor may not waive or vary” to the extent that they give them rights or impose duties on the secured party.²⁰⁸ This section, however, is followed by § 9-603(a), which states that the parties “may determine by agreement the *standards measuring the fulfillment*” of said rights and duties “if the standards are *not manifestly unreasonable*.”²⁰⁹ To cite another example from state law, the Connecticut Landlord and Tenant Act details the landlord's duties concerning repair and maintenance of dwelling units.²¹⁰ While these duties are mandatory, the Act allows the parties to agree that some of them will be performed by the tenant. In the case of multiple family residences, such an agreement is valid if it pertains to “*specified* repairs, maintenance tasks, alterations or remodeling” and “if (1) the agreement of the parties is entered into *in good faith*; (2) the agreement is *in writing*; (3) the work is not necessary to cure noncompliance with [the relevant housing codes and the warranty of habitability]; and (4) the agreement does not diminish or affect the obligation of the landlord to other tenants in the premises.”²¹¹

As these examples demonstrate, default rules are often quasi-mandatory, and mandatory rules are sometimes quasi-default. Policymakers can therefore set the degree of immutability in each particular case, taking into account the aims of the rule and the typical characteristics of the parties, the transaction, and the contracting process.

Thus, if the primary goal of the altering rules (that is, the rules governing the conditions for opting out of a default rule) is to overcome typical flaws in the contracting process, it would make sense to set procedural requirements that guarantee the informed and considered consent of both parties. Such requirements may foster thoughtful decision-making²¹² and clearer

207. ZAMIR, *supra* note 63, at 101–09; Zamir, *supra* note 29, at 1753–68; see also Omri Ben-Shahar & John A. E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651, 660–70 (2006) (arguing that the very proposal by one party to opt out of the default may raise suspicions about the proposer's characteristics and motives); Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998) (experimentally demonstrating the endowment effect created by default rules).

208. U.C.C. § 9-602 (AM. LAW INST. & UNIF. LAW COMM'N 2009).

209. *Id.* § 9-603(a) (emphasis added). On the courts' implementation of § 9-603, see, for example, Jackson, *supra* note 153, at 293.

210. CONN. GEN. STAT. § 47a-7(a)–(b) (2005).

211. *Id.* § 47a-7(d) (emphasis added).

212. Ayres, *supra* note 25, at 2061–63, 2069–71.

communication of information.²¹³ In contrast, if the main goal of a rule is to protect the interests of third parties, improving the contracting process does not make much sense.

One notable hybrid arrangement is *safe harbors*—an altering rule which assures that a particular contractual outcome is achievable if particular conditions are followed. Any deviation from the safe harbor conditions triggers enhanced scrutiny, thus strengthening its mandatory nature.²¹⁴ For example, the U.S. Consumer Financial Protection Bureau has issued guidelines for lenders, which, if followed, provides them with a presumption of compliance with the statutory requirement to make a reasonable, good-faith determination of borrowers' ability to repay loans that are secured by a dwelling.²¹⁵

There are important interrelations between the degree of immutability and other aspects of designing mandatory norms, including the identity of the regulator and the form of the norm. Statutory mandatory rules may have any degree of immutability, including an absolute one. In contrast, judge-made rules tend to be less conclusive, since courts retain the power to distinguish past rulings. Vague standards, by their very nature, allow for flexibility in their implementation, while concrete rules may or may not be absolutely compulsory. The trade-off between certainty and predictability on the one hand, and consideration of the circumstances of the particular case in light of the pertinent values on the other—as discussed in the context of the choice between rules and standards²¹⁶—is relevant here too: the greater the leeway to evade a rule, the less predictable its implementation.

2. *Bidirectional Versus Unidirectional Immutability.*—Some mandatory rules impose bi- or omni-directional restrictions, such that no deviation from them in any direction is allowed. Other mandatory rules, however, only impose unidirectional restrictions—that is, they let the parties deviate from them in favor of one party (e.g., the tenant or employee) but not the other (e.g., the landlord or employer).²¹⁷ Unidirectional immutability is an inherent

213. *Id.* at 2072–74. Thus, for example, under the Magnuson-Moss Warranty Act, sellers of consumer products who wish to detract from the *federal minimum standards for warranty* set forth in the Act must do so clearly and conspicuously, using the designation “limited warranty.” 15 U.S.C. § 2303(a)(2), 2304 (2012).

214. See Oren Bar-Gill, *Consumer Transactions*, in THE OXFORD HANDBOOK OF BEHAVIORAL ECONOMICS AND THE LAW 465, 484 (Eyal Zamir & Doron Teichman eds., 2014) (“This enhanced regulatory scrutiny can be viewed as the price of opt-out; it is what makes the default rule sticky.”).

215. Ability-to-Repay and Qualified Mortgage Standards under the Truth in Lending Act (Regulation Z), 78 Fed. Reg. 6408, 6408 (Jan. 30, 2013) (to be codified at 12 C.F.R. pt. 1026).

216. See *supra* notes 184, 190–193, 197 and accompanying text.

217. A third, rather rare, possibility is a range of valid arrangements with a mandatory floor and ceiling. See, e.g., U.C.C. § 2-725(1) (AM. LAW INST. & UNIF. LAW COMM'N 2002) (setting a

feature of mandatory standards (as opposed to rules) that set minimal—rather than maximal—standards of conscionability, reasonableness, good faith, and the like. But many concrete rules are unidirectionally immutable, as well. Thus, for example, the Family and Medical Leave Act of 1993 explicitly states that “[n]othing in this Act . . . shall be construed to diminish the obligation of an employer to comply with any collective bargaining agreement or any employment benefit program or plan that provides greater family or medical leave rights”²¹⁸ Similarly, § 9-602 of the U.C.C. lists more than twenty sections in Chapter 9 that the debtor and obligor may not waive or vary, to the extent that they give them rights or impose duties on the secured party (although, according to § 9-603, the parties may agree on the standards for measuring the fulfillment of those rights and duties).²¹⁹ These rules set minimum *floors*. At other times, unidirectional rules establish maximum *ceilings*—for example, concerning the maximum allowable duration for a covenant not to compete.²²⁰

As these examples demonstrate, the distinction between bidirectional and unidirectional immutability intersects with other aspects of the design of mandatory rules, such as the degree of immutability, its scope of incidence, and its framing.²²¹ Unidirectional immutability—be it in the form of vague standards or bright-line rules—somewhat mitigates concerns about the overinclusiveness of mandatory norms, because it allows for deviations from the minimal legal standard. Unidirectional immutability therefore leaves some room for innovation and for tailoring contractual arrangements to heterogeneous and changing transactions and preferences.

Unidirectional restrictions may be well suited to respond to internal-protection concerns as they preclude one-sided—unfair and possibly inefficient—clauses. Even if they do not ensure desirable distributive effect in terms of wealth, they may level the playing field in terms of power, dignity, and more.²²² In contrast, when mandatory rules are prompted by externality concerns, bidirectional immutability may be warranted. For example, it has been argued that the rule that excludes insurance coverage when the insured

minimal period of statute of limitations of one year, presumably to protect customers, and a maximum period of four years, presumably to promote the general goals underlying the statute of limitations).

218. 29 U.S.C. § 2652(a) (2012). By the same token, the minimal coverage required by the Patient Protection and Affordable Care Act does not preclude health plans from providing broader coverage. 42 U.S.C. § 18022(b)(5) (2012).

219. U.C.C. § 9-602 (AM. LAW INST. & UNIF. LAW COMM’N 2009); *id.* § 9-603(a).

220. *See, e.g.*, FLA. STAT. § 542.335(1)(d)–(e) (2013) (establishing rebuttable presumptions that, depending on context, covenants not to compete with durations longer than two, three, seven, or ten years are unreasonable).

221. *See supra* sections III(C)(1), subpart III(B), and *infra* subpart III(E), respectively.

222. *See* Lewinsohn-Zamir, *supra* note 83, at 340–53, 379–96 (advocating an objective-list theory of human welfare and analyzing its implications for redistribution through private law).

has committed suicide within a certain period from buying life insurance belongs to this category.²²³

One drawback of unidirectional immutability is that it may adversely affect the norm's certainty because it is not always clear whether a given divergence from a mandatory rule positively or adversely affects the protected party. This may be the case, for example, when a contractual clause is multidimensional, and it benefits the protected party in some respects, but adversely affects her in others. Imagine a rule that imposes a mandatory two-year liability for building defects on the seller of new residential units, provided that the purchaser notifies the seller about the defects within four months of their discovery. Does a contractual clause that extends the liability to six years, but requires notifications within two months, favor the purchaser? Should it be allowed? The answer may depend on the rule's rationale. If the rationale is primarily distributive, one might conclude that the contractual clause is valid, since by and large it benefits the purchaser more than it burdens her. If, however, a primary goal of the rule is paternalistic—that is, there is a real concern that the purchaser might miscalculate the costs and benefits of deviations from the rule *ex ante*, and miss the notification deadline *ex post*—one might conclude that any deviation whatsoever from the rule to the detriment of the protected party—in the present example, the shortening of the notice period from four to two months—renders the clause invalid. In that case, a further question arises, which is whether it is possible to use the doctrine of partial enforcement—namely, to uphold the extension of liability from two to six years but annul the shorter notice requirement. While employing the doctrine in such circumstances may be regarded as unfair to the seller, it may be justified as a means of deterring the use of such contract clauses.²²⁴

The rule's certainty is particularly important when the regulator is not content with merely setting substantive rules, but also mandates that certain terms should, or should not, be included in the contract—and backs this directive with administrative or criminal sanctions.²²⁵ Such sanctions are likely to be less effective if drafters can reasonably claim (or sincerely believe) that their contracts do not violate the law.

Compared to unidirectional immutability, bidirectional immutability enhances the uniformity of contracts in a given market. Such uniformity may appear undesirable, since it prevents the tailoring of the contract to the parties' particular needs. However, it may be a second-best solution to certain problems. For one thing, when customers suffer from acute information and expertise problems—which limit their ability to compare between contracts

223. Kimball & Pfennigstorf, *supra* note 13, at 730.

224. On deterrence considerations, see also *infra* sections III(D)(2) and III(F)(1).

225. See *infra* subpart III(D).

that vary on numerous dimensions—limiting the number of aspects in which such variations exist may improve customer choice, thereby enhancing market competition.²²⁶ Enhanced uniformity may also be beneficial when the performance of several (or many) contracts and the resolution of disputes pertaining to them affect—or are affected by—other contracts. Thus, one key motivation for unifying fire-insurance policies has been the need to resolve insurance claims that stem from a single event involving several property owners, insurance policies, and insurers.²²⁷ Similarly, uniformity may be beneficial when a construction firm sells apartments in a single condominium project to many purchasers whose rights and remedies vis-à-vis the firm are interrelated, or when an insolvent debtor owes money to several contractual creditors.²²⁸

D. Regulation of the Contract's Wording

Some mandatory rules merely lay down substantive arrangements, while others require or prohibit the inclusion of certain clauses in the contract document. When the regulator does not content itself with substantive rules, but interferes with the wording of the contract as well, a secondary question arises, namely what sanctions to impose, if at all, for violating those rules. This section tackles these two issues.

1. Substantive Rules and Wording Rules.—The designer of mandatory rules should decide whether to merely specify the substantive law that governs the transaction, irrespective of the contractual terms, or rather supervise the wording of the contract as well—either by prohibiting the inclusion of invalid clauses, or by mandating the inclusion of valid ones. The unconscionability doctrine exemplifies the former option—that is, a substantive rule that does not interfere with the wording of the contract.²²⁹ An example of the latter option—interference in contract wording—can be found in the Consumer Review Fairness Act of 2016, which prohibits the use of SFCs containing a provision that restricts customers' right to publicly

226. See Eyal Zamir, Barak Medina & Uzi Segal, *Who Benefits from the Uniformity of Contingent Fee Rates?*, 9 REV. L. & ECON. 357 (2013) (arguing that the uniformity of lawyers' contingent fee rates serves the interests of uninformed clients); Bar-Gill & Ben-Shahar, *supra* note 7, 115–16, n.18 (pointing out the advantages of simplifying the multidimensional decision problem consumers face when choosing between different products, suppliers, and prices by establishing a fixed regime).

227. Kimball & Pfeningstorf, *supra* note 13, at 691–95.

228. See Jackson, *supra* note 153, at 281 (pointing out the importance of the mandatory rules of Article 9 of the U.C.C. not only for debtors, but also for third parties who might rely on those rules).

229. U.C.C. § 2-302(1) (AM. LAW INST. & UNIF. LAW COMM'N 2002) (if the court finds a contract clause unconscionable, it “may refuse to enforce” the clause).

review goods, services, or the conduct of people.²³⁰ Wording rules are also common in the regulation of insurance contracts.²³¹

Analytically, wording rules are a hybrid of substantive and procedural mandatory rules, as they not only interfere with the content of the contract, but also strive to ensure that customers get accurate information about the content of their rights and obligations.²³² Moreover, even if customers do not ordinarily read SFCs in advance, they may well read them once a dispute with the supplier arises. Since customers are often unaware of the legal regime, they tend to submit to the contractual provisions, on the assumption that they are legally valid (or that trying to challenge them may be overly difficult and costly).²³³ From the supplier's perspective, "if the worst thing that will happen is that the term will get thrown out, there is no reason not to include it and hope for the best."²³⁴ Similarly, when a contract fails to mention the customer's rights or the supplier's obligations, customers may jump to the conclusion that these rights and obligations do not exist.²³⁵ Given such ignorance and biases on the part of customers, mandating that certain clauses must be included in the contract may have a much greater impact than merely establishing substantive rules, or even just banning the inclusion of invalid terms in the contract. While the availability of legal information on the Web somewhat mitigates this concern, customers may fail to look for information online, fail to find the accurate information, or misunderstand it. It thus remains true that laypeople draw much of their knowledge about contractual rights from the contract itself. This claim has been substantiated

230. 15 U.S.C. § 45b(c) (2018).

231. See *supra* notes 106–107 and accompanying text.

232. An interesting question that lies beyond the scope of our discussion is what role the parties' intentions should play in interpreting contractual clauses dictated by mandatory wording rules. On this question, see Gregory Klass, *Boilerplate and Party Intent*, 82 LAW & CONTEMP. PROBS. 105, 116–19 (2019).

233. See, e.g., Warren Mueller, *Residential Tenants and Their Leases: An Empirical Study*, 69 MICH. L. REV. 247, 272–74 (1970) (providing empirical support for the claim that tenants tend to believe that contract clauses are valid even when they are not); Kurt E. Olafsen, Note, *Preventing the Use of Unenforceable Provisions in Residential Leases*, 64 CORNELL L. REV. 522 (1979) (discussing the problem and possible solutions); Bailey Kuklin, *On the Knowing Inclusion of Unenforceable Contract and Lease Terms*, 56 U. CIN. L. REV. 845, 845 (1988) (same); Charles A. Sullivan, *The Puzzling Persistence of Unenforceable Contract Terms*, 70 OHIO ST. L.J. 1127, 1129 (2009) (same); David A. Hoffman & Anton Strezhnev, *Mapping the Contracts of the Dispossessed* (Working Paper, Oct. 18, 2019), https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=CELS2019&paper_id=192 [<https://perma.cc/YEN5-TVUR>] (documenting prevalent unenforceable clauses in leases).

234. Tess Wilkinson-Ryan, *The Perverse Consequences of Disclosing Standard Terms*, 103 CORNELL L. REV. 117, 171 (2017).

235. Furth-Matzkin, *supra* note 14, at 35–40 (providing survey-based evidence that "residential leases play an important role *ex post*, both as an informational source and as a benchmark for the solution of the problem"); Meirav Furth-Matzkin, *The Harmful Effects of Unenforceable Contract Terms: Experimental Evidence*, 70 ALA. L. REV. 1031 (2019) (providing experimental support for the same proposition).

in survey and experimental studies.²³⁶ Indeed, arguably the best evidence of the practical impact of unenforceable terms and the absence of terms on customers' rights in SFCs lies in the fact that suppliers continue to use these techniques.²³⁷

Why would a regulator allow for the inclusion of unenforceable contractual clauses or fail to require the inclusion of details about customers' rights in the contract? While this may seem like a license to cheat, there are practical and principled considerations against laying down such prohibitions and duties. Practically speaking, not only customers, but suppliers as well, may be unaware of the existence or the precise content of mandatory norms. This is particularly true when the norm is in the form of a vague standard whose meaning and implications for any given case can be clarified only in an *ex post* judicial or administrative decision—and even then, judicial precedents on such matters may be unclear, inconsistent, and wavering. Moreover, inasmuch as the legal precedents are not well-established, suppliers may include questionable terms, in the hope that future courts will determine that they are valid—and even when the precedents are clear, a supplier may legitimately wish to challenge them—or so one may argue.

Another reason to avoid wording requirements and prohibitions concerns the costs of compliance—especially when the rules are complex. This is particularly apposite when a contract is made between private individuals (such as a person who rents out her apartment and the tenant), or is drafted by small firms. Nonetheless, more often than not it seems fair and efficient to incentivize suppliers, rather than customers, to bear the costs of eliminating misleading clauses from their contracts, even if this entails the need to get legal advice about the applicable laws.²³⁸

Beyond the practical considerations, there may be a principled objection to interventions in the drafting of contracts. Arguably, such interference, especially in the form of requirements to include certain clauses in the contract (as opposed to merely prohibiting certain clauses), is more detrimental to the parties' autonomy than merely setting substantive rules—especially if these duties are backed up by administrative or criminal sanctions.²³⁹ Drafting rules may even raise a concern about their adverse effect on suppliers' freedom of speech.²⁴⁰

236. Furth-Matzkin, *supra* note 14, at 35–40; Furth-Matzkin, *supra* note 235.

237. Cf. Bar-Gill & Warren, *supra* note 69, at 27 (making this claim in the context of consumer-credit products).

238. Kuklin, *supra* note 233, at 847–69 (analyzing the ethical and economic dimensions of unenforceable contract terms).

239. See *infra* subpart III(D).

240. See *Expressions Hair Design v. Schneiderman*, 137 S. Ct. 1144, 1151 (2017) (holding that regulating the communication of prices rather than prices themselves is a regulation of speech); Annie P. Anderson, Comment, *Why Anti-Surcharge Laws Do Not Violate a Merchant's Freedom of Speech*, 66 AM. U. L. REV. 1459 (2017) (criticizing the ruling in *Expressions Hair Design*).

Ultimately, it appears that, at least when it comes to sophisticated commercial suppliers, achieving the goals of mandatory rules requires the use of rules concerning wording, as well as substantive ones. Some scholars have indeed proposed to extend the use of such rules beyond the sphere of insurance, for example to residential leases.²⁴¹ Others have speculated that when legal policymakers set out only rules about substantive content, they are not really aiming at deterring the inclusion of invalid terms in contracts (or the non-inclusion of valid ones), but merely ensuring “that courts are not complicit in the prohibited agreements.”²⁴² Interestingly, an empirical study conducted with a representative sample of U.S. adults found that people tend to view wording rules as more desirable than merely substantive ones.²⁴³

2. *Outcomes of Noncompliance with Wording Rules.*—As the above analysis has shown, merely setting substantive mandatory rules may be considerably less effective than overseeing the wording of contracts. Once a regulator decides to impose prohibitions or duties regarding the wording of a contract, the question arises as to what sanctions should be imposed for violating those norms.²⁴⁴ Merely invalidating a prohibited clause, or resolving the dispute between the parties based on the substantive rule—without any sanction for disobeying the wording rule—essentially eliminates the legal incentive to comply with the rule. It is similar, therefore, to contenting oneself with a substantive rule.

The necessary additional sanctions may be civil, administrative, or even criminal. One type of a civil sanction is punitive damages. Thus, § 1.403(b) of the Uniform Residential Landlord and Tenant Act not only renders prohibited provisions in rental agreements unenforceable, but states that if the landlord knowingly uses an agreement with such provisions, the tenant may recover an amount equivalent to up to three months’ periodic rent plus

241. See, e.g., Allen R. Bentley, *An Alternative Residential Lease*, 74 COLUM. L. REV. 836, 876–80 (1974) (cautiously advocating the enactment of a mandatory statutory lease); David Vance Kirby, *Contract Law and the Form Lease: Can Contract Law Provide the Answer?*, 71 NW. U. L. REV. 204, 235–37 (1976) (espousing a statutory form lease); Furth-Matzkin, *supra* note 235, at 1062–63 (discussing the imposition of a duty to use pre-approved leases by landlords).

242. Sullivan, *supra* note 233, at 1132.

243. Zamir & Katz, *supra* note 17.

244. Criminal, administrative, and other sanctions may be imposed not only for violations of wording rules, but for violations of substantive rules as well. For example, a lender may be sanctioned for charging excessive interest, regardless of whether or not the loan contract authorizes it to do so. However, this is not a case of trying to contract around a mandatory rule, but of breaching the contract. Likewise, we do not discuss instances in which the supplier follows the mandate concerning the wording of the contract, but does so with no intention of performing. Cf. IAN AYRES & GREGORY KLASS, *INSINCERE PROMISES: THE LAW OF MISREPRESENTED INTENT* (2005) (discussing promises that the promisor never intended to perform).

reasonable attorney's fees, in addition to actual damages.²⁴⁵ Another type of civil sanction is to replace the invalid term with a substitute rule that deviates from the default rule or usage of trade in favor of the customer. For example, an excessive interest rate may be substituted with a zero-interest rate, rather than the prevailing rate in the relevant market.²⁴⁶ This measure is discussed in section III(F)(1). A third type of civil sanction, which may be appropriate when it does not compromise the interests of the customer, is to render the entire contract unenforceable.²⁴⁷

An example of an administrative sanction is to revoke the supplier's license to engage in the relevant commercial activity. For example, under Alabama law, engaging in the business of lending small amounts of money requires a license,²⁴⁸ and this license may be suspended or revoked for violating the law's provisions²⁴⁹—including those regarding the maximal interest rate, charges, and fees.²⁵⁰ Governmental authorities may also impose monetary sanctions for violations of wording rules. For example, in Massachusetts the Attorney General may bring an action against landlords for engaging in unfair or deceptive practices, including the use of certain types of invalid clauses in their rental agreements.²⁵¹ If the court finds that the landlord “knew or should have known” that such inclusion constituted a violation, the court may require the landlord to pay the commonwealth a civil penalty of up to \$5,000 for each violation.²⁵² Finally, in New York, any violation of the Insurance Law—including violations of the provisions concerning the formulation of insurance policies²⁵³—is a criminal offense,²⁵⁴ and willful violations may result in monetary penalties.²⁵⁵ Currently, however, criminal or administrative sanctions for the use of unenforceable terms in contracts, or failing to include mandatory ones, appear to be relatively rare,²⁵⁶ and the same is true for civil sanctions.

245. UNIF. RESIDENTIAL LANDLORD AND TENANT ACT § 1.403(b) (UNIF. LAW COMM'N 1972). Rather than imposing a sanction for the very (deliberate) inclusion of an unenforceable term in the contract, the Alabama statute sets the sanction (of one month's rent) only for attempts to enforce the invalid term. ALA. CODE § 35-9A-163 (2020). However, the practical difference between the two formulations appears to be negligible, since litigation is unlikely to ensue unless the landlord actually tries to rely on the invalid term.

246. N.C. GEN. STAT. § 24-2 (2020).

247. See *infra* notes 288–290 and accompanying text.

248. ALA. CODE § 5-18-4 (2020).

249. *Id.* § 5-18-9.

250. *Id.* § 5-18-15.

251. MASS. GEN. LAWS ANN. ch. 93A § 4 (West 2020); 940 MASS. CODE REGS. § 3.17(3).

252. MASS. GEN. LAWS ANN. ch. 93A § 4 (West 2020).

253. See, e.g., *supra* notes 102–103, 106–107 and accompanying text.

254. N.Y. INS. LAW § 109(a) (McKinney 2019).

255. *Id.* § 109(c). See also 15 U.S.C. § 45b(m) (2012); CAL. CIV. CODE § 1670.8(c–d) (2020).

256. Sullivan, *supra* note 233, at 1165–66 (stating that there are only “scattered instances” of statutes that treat the very inclusion of unenforceable clauses in contracts as illegal).

On the face of it, even without a special sanction, the very inclusion of an invalid clause in a contract—often with a view to mislead customers about their legal rights—constitutes a misrepresentation by the drafter, which renders the contract voidable.²⁵⁷ However, this is not ordinarily the case because only misrepresentation that induced the deceived party to enter into the contract renders it voidable.²⁵⁸ Ordinarily, there is no causal connection between the misrepresentation created by an invalid clause (or the absence of a valid one) and the customer's decision to enter into the contract: the invalid clause (or absence of a valid one) presents the customer's legal position as *worse* than it really is—which means that if she knew the truth, she would have been all the more interested in the contract. Only in very rare cases, if ever, might the customer claim that the very inclusion of an invalid clause indicates that the supplier is dishonest, and that had she known that this was the case she would not have entered into the contract. More realistically, a customer who settles a complaint because she was misled by the contract to believe that she has no legal right against the supplier may argue that *the settlement agreement* is the product of misrepresentation. However, the prospects of such an argument are unclear. Courts that strive to encourage out-of-court settlements (that reduce the docket) may be reluctant to allow the validity of such settlements to be questioned.²⁵⁹

Insofar as customers submit to invalid terms because they are ignorant of their rights, relying on customers' enforcement of civil sanctions may be unsatisfactory.²⁶⁰ Moreover, unless the civil sanctions are extremely high, suppliers may find it worthwhile to continue using the invalid terms, which most (ignorant) customers comply with—even if occasionally they encounter a customer who enforces those sanctions. Criminal and administrative enforcement measures are not a panacea either, because violations of wording rules may not feature highly on the priority list of enforcement agencies. A combination of privately and publicly enforced sanctions may thus be more effective than either variety on its own.

257. Misrepresentation may refer not only to facts, but also to the law. *See* RESTATEMENT (SECOND) OF CONTRACTS § 170 (AM. LAW INST. 1979).

258. *Id.* § 164(1) (“If a party’s manifestation of assent *is induced* by . . . misrepresentation”) (emphasis added).

259. On the various courses of action a customer might wish to use against a supplier who uses invalid clauses, see Kuklin, *supra* note 233, at 885–913. Kuklin concludes that “the problem has fallen within the interstices of the most readily apparent common law actions (deceit and prima facie tort) as well as all others.” *Id.* at 915. Sullivan reaches the same conclusion, *supra* note 233, at 1162–65.

260. Furth-Matzkin, *supra* note 14, at 44.

E. Positive Versus Negative Framing

Whether legal policymakers content themselves with laying down substantive mandatory rules, or regulate the wording of the contract document as well, they can often choose whether to express the rule in positive or negative terms. This seemingly trivial choice may have practical effects.

There is an entrenched moral conviction that the prohibition of harming other people is stronger than the duty to benefit others.²⁶¹ For example, it is much worse to actively kill a person than not to save one. However, when there is a well-defined range of collectively exhaustive possibilities, prohibiting part of that range may be logically tantamount to mandating the complementary range. For example, the rule “An agreement that exempts a contractor from liability for bodily injury caused by its negligence is void” is equivalent to the rule “Notwithstanding any agreement to the contrary, a contractor is liable for bodily injury caused by its negligence.”

These are different formulations of the same substantive rule—one negative and the other positive. The negative formulation states what the supplier cannot do (exempt itself from liability) while the positive one what the supplier must do (bear liability). This distinction applies, *mutatis mutandis*, to wording rules, that is, rules that intervene with the wording of the contract²⁶² as well.

Clearly, choosing between negative and positive formulations that differ in substance should be based primarily on the rule’s desired content. However, the choice between them must also take into account linguistic and psychological considerations. From a linguistic perspective, the implicature of the rule—i.e., the meaning it conveys beyond the literal meaning of the words that it uses—may depend on whether it is framed in a positive or negative manner.²⁶³ Compare, for example, the following two formulations: (1) “The buyer’s right to return the goods within one week may not be waived, unless the waiver is reasonable in the circumstances”; (2) “The buyer’s right to return the goods within one week may be waived, if the waiver is reasonable in the circumstances.” Strictly speaking, the two rules are equivalent. However, a judge may reasonably conclude that the seller’s burden of persuasion that the waiver was reasonable is heavier under the former rule, because its point of departure is that the waiver is *not* allowed.

261. A key feature of deontological and commonsense morality, this distinction is closely associated with the contrasts between doing harm and merely allowing it, and between intending harm and merely foreseeing it. ZAMIR & MEDINA, *supra* note 88, at 41–56. It resonates with the fundamental psychological phenomenon of *loss aversion* and with basic characteristics of the law. ZAMIR, *supra* note 63.

262. See *supra* section III(D)(1).

263. On the notion of implicature, see Yan Huang, *Implicature*, in THE OXFORD HANDBOOK OF PRAGMATICS 155 (Yan Huang ed., 2017).

As for the psychological perspective, it has been demonstrated that comprehension of information presented in negative terms involves first constructing the counterfactual (affirmative) meaning.²⁶⁴ Positive and negative formulations may therefore differ in terms of their *fluency*—the subjective experience of ease or difficulty with which people process information—and fluency, in turn, affects people’s judgments and decisions, beyond the content of the information. People tend to believe that more fluent statements are truer.²⁶⁵ Since negative statements include the negation element that does not exist in affirmations, the former tend to be less fluent.

These linguistic and psychological insights give rise to the hypothesis that subtle differences between negative and positive formulations of mandatory rules may have practical effects. Specifically, they may bear on a rule’s desirability in the eyes of legal policymakers and the public at large; affect the drafting of contracts by suppliers or their legal advisors; impinge on the decisions made by contracting parties once a dispute arises (e.g., whether to file a lawsuit); and influence judges’ discretion in applying the norm. A recent experimental study has shown that laypeople tend to judge positive formulations of mandatory rules (both merely substantive and wording rules) as more desirable than negative formulations.²⁶⁶ But we lack direct empirical evidence about other possible effects of this choice, so it is difficult to come up with policy recommendations. Nonetheless, some tentative suggestions may be possible. One suggestion is that people who oppose regulation of the content of transactions may find negative formulations less objectionable, since prohibiting inappropriate conduct by suppliers sounds less intrusive than prescribing appropriate conduct. Concomitantly, people who believe that the government should offer vigorous protection of customers may prefer positive formulations to negative ones. In the same vein, judges who resent judicial activism may feel more comfortable invalidating errant contractual arrangements than mandating complementary arrangements. More generally, advocates of mandatory rules may endorse more fluent formulations, both because they may gain greater public support and because it may be easier for customers to rely on them. These considerations may support the use of positive formulations.²⁶⁷

264. Uri Hasson & Sam Glucksberg, *Does Understanding Negation Entail Affirmation? An Examination of Negated Metaphors*, 38 J. PRAGMATICS 1015 (2006). See also Ken Ramshøj Christensen, *Negative and Affirmative Sentences Increase Activation in Different Areas in the Brain*, 22 J. NEUROLINGUISTICS 1 (2009) (investigating negation through a cognitive neuroscience lens).

265. For an overview of studies of fluency, see Norbert Schwarz, *Metacognitive Experiences in Consumer Judgment and Decision Making*, 14 J. CONSUMER PSYCHOL. 332 (2004).

266. Zamir & Katz, *supra* note 17.

267. The analysis in this subpart has focused on the framing of *mandatory rules*. A closely related question pertains to the framing of *contractual terms*, whenever the law mandates the

F. Outcomes of Clauses' Unenforceability

The direct outcome of a mandatory rule is that the parties cannot contract around it (subject to qualifications of the sort discussed in subpart III(C)). However, there are two additional questions that the law must answer: What arrangements should substitute the voided/prohibited ones? and How should the unenforceability of a given clause affect the validity and content of the remainder of the contract? We consider these questions in turn.

1. Substitute Arrangements.—When the law lays down a specific mandatory rule, it is legally binding notwithstanding any divergent contractual clause. But often the law contents itself with setting a minimal standard (that is, with unidirectional immutability)²⁶⁸—such as invalidating unreasonably large liquidated damages, or (in employment contracts) noncompete clauses in excess of one year. In these cases, the question arises as to what arrangement should substitute a given invalid term.

Schematically, there are three possible answers to this question: *penalty*, *moderate*, or *minimally tolerable* substitutionary arrangement.²⁶⁹ A penalty arrangement substitutes the invalid term with an arrangement that favors the party whose interests the law seeks to protect. For example, if a lender charges an interest rate in excess of a statutory cap, it may be replaced by 0% interest.²⁷⁰ The primary advantage of this option is that it deters the inclusion of overreaching clauses in contracts. This is particularly appropriate when the restriction is motivated by internal-protection concerns and the drafter in question is a repeat player, as in typical consumer and many commercial (but not private) contracts. Such a drafter is more likely to know the law and should be incentivized to acquire information about the law. Furthermore, the greater gains that accrue from repeated use of the invalid clause by suppliers call for greater sanctions to deter that practice.²⁷¹ Indeed, from an incentives perspective, it may be a good idea to tailor the substitute to the supplier's

inclusion of such terms in the contract. *See supra* section III(D)(1). Given that the framing of contractual terms may affect the behavior of the contracting parties in various ways, *see ZAMIR & TEICHMAN, supra* note 43, at 46–48, 277–78, 286–87, legal policymakers should carefully consider the wording of the mandated terms—possibly dictating not only their substance, but also their exact formulation.

268. On the distinction between unidirectional and bidirectional immutability, *see supra* section III(C)(2).

269. Ben-Shahar, *supra* note 14, at 876–78.

270. *Id.* at 877. For example, under North Carolina's statutory law, knowingly charging interest in excess of the statutory cap results in forfeiture of the entire interest; and if a greater rate has already been paid, the borrower "may recover back twice the amount of interest paid." N.C. GEN. STAT. § 24-2 (2020). Under California law, for some loans, if excessive rate is charged "for any reason other than a willful act," the lender forfeits all interest; and if any excessive amount is charged willfully, the lender does not recover even the principal. CAL. FIN. CODE § 22751 (West 2020); CAL. FIN. CODE § 22750 (West 2020).

271. Ben-Shahar, *supra* note 14, at 904.

expected gains from the invalid term: the greater the expected gains, the larger the penalty.²⁷² A penalty arrangement may replace, or be coupled with, administrative or criminal sanctions for including invalid clauses in the contract.²⁷³ However, penalty arrangements are troubling where neither party knew or had reason to know that a given contractual term was invalid, and they may create inefficient incentives for the parties' behavior.

A second option is to apply the default rule that would apply in the absence of any contractual arrangement, that is, a *moderate* arrangement.²⁷⁴ Thus, if a contract unconscionably denies the customer's entitlement to any remedy for breach of contract by the supplier, the customer would be entitled to the remedies ordinarily available to the injured party. Such default rules are typically deemed fair and reasonable. In addition, they usually reflect the expectations of most parties to the relevant type of contract, and as such are presumably efficient.²⁷⁵ However, while this option may be the fairest and most efficient, it may not effectively deter suppliers because it assures them that even if customers exercise their legal rights (which is often unlikely), the supplier's position would be no worse than in the absence of any clause.

The third possibility is to replace the invalid clause with a *minimally tolerable arrangement* (MTA)—namely, one that favors the drafter to the greatest possible extent, and yet may still be deemed enforceable. For example, assume that, under the default remedy rules, the drafter is entitled to \$10,000 in damages for the other party's breach; that liquidated damages of up to \$15,000 would have been considered tolerable; and that the contract sets a penalty of \$25,000. Under an MTA regime, the drafter would be entitled to liquidated damages of \$15,000. MTAs entail the least restriction of the parties' freedom of contract.²⁷⁶ Their greatest drawback is the "perverse incentives" they create for suppliers to include unenforceable terms in contracts.²⁷⁷

While this tripartite taxonomy of possible substitutionary rules is elegant and illuminating, the reality is often more complex. For one thing, it

272. See Mitchell Chervu Johnston, Note, *Reflection Remedies*, 129 YALE L.J. 1148 (2020). Johnston advocates *reflection penalties* to calibrate the size of the penalty to the expected illicit gains. *Id.* For example, if the drafter sets liquidated damages at \$25,000 when \$15,000 is the highest tolerable amount, the reflection principle would suggest only enforcing liquidated damages of \$5,000 ($(\$15,000 - (\$25,000 - \$15,000))$). *But see infra* note 280.

273. See *supra* section III(D)(2).

274. See, e.g., LARY LAWRENCE, LAWRENCE'S ANDERSON ON THE UNIFORM COMMERCIAL CODE § 1-102:294 (3d. ed. updated by David Frisch, 2017) (arguing that when objectionable clauses are removed, they should be replaced by reasonable standards).

275. Zamir, *supra* note 29, at 1753–55 (explaining why—similarly to trade usages and judicially developed *implied terms*—statutory default rules “express prevalent conceptions of what is fair, reasonable, and efficient in the relevant transactions”).

276. Ben-Shahar, *supra* note 14, at 879–80; see Sullivan, *supra* note 233, at 1158–59 (discussing partial enforcement of noncompete clauses in employment contracts).

277. Sullivan, *supra* note 233, at 1162.

is sometimes unclear whether a given solution should be considered a moderate arrangement or a penalty one. This may be the case when a trade usage is more favorable to the supplier than the statutory or judge-made default rule. Take, for example, an unfair arbitration clause. When a court strikes down such a clause, and substitutes it with no compulsory arbitration—is it an instance of a moderate substitute (in accordance with the default rules), or of a penalty (given that reasonable arbitration clauses are prevalent in the trade)?²⁷⁸ Alternatively, consider a case in which a contract first sets the supplier's liability in broad terms, then provides a list of exclusions to this liability—some of which are deemed unconscionable. Striking down an exclusionary clause while leaving the broad liability intact may be described as a moderate solution,²⁷⁹ but may actually be a penalty if the remaining liability is broader than the default arrangement.²⁸⁰

Omri Ben-Shahar has advocated MTAs for purely distributive clauses (such as the price), provided that the drafter has not deliberately included the unenforceable term in the contract (to take advantage of the customer's ignorance of the law, her disinclination to stand for her rights, etc.).²⁸¹ However, since most mandatory rules pertain to issues that affect the size of the surplus of the transaction rather than merely its distribution, and apply to contracts in which the drafter is a repeat player who may reasonably be assumed to know the legal regime (or should be incentivized to get that information), there are relatively few instances in which MTAs would appear to be appropriate. For example, liquidated damages, arbitration clauses, and noncompete clauses are not purely distributive, since they create incentives for the parties' contractual behavior. In fact, according to standard economic analysis, when the impact of a rule is purely distributive, there is arguably no justification for the mandatory rule in the first place, as standard economic analysis focuses on maximization of overall social utility rather than its distribution.²⁸²

Finally, when considering the incentive effects of possible substitute arrangements, one should not limit the examination to the expected impact

278. Ben-Shahar, *supra* note 14, at 876–77.

279. *Id.* at 876 (applying this analysis to exclusionary clauses in insurance policies).

280. Further complexity is introduced by the notion of reflection penalties mentioned in *supra* note 272. As demonstrated there, reflection penalties may substitute the invalid term with an arrangement that is more favorable to the protected party than the moderate arrangement. However, this is not always the case. Thus, if under the default remedy rules the drafter is entitled to \$10,000 in damages, the highest tolerable amount is \$15,000, and the contract sets liquidated damages of \$16,000, under a reflection penalty the drafter would be entitled to damages of \$14,000 ((\$15,000 – (\$16,000 – \$15,000)), which is considerably higher than the moderate substitute (\$10,000).

281. Ben-Shahar, *supra* note 14, at 896–905.

282. For a discussion of this topic in greater detail, see Ori Katz & Eyal Zamir, *Substituting Invalid Contract Terms: Theory and Preliminary Empirical Findings* 6–7 (Hebrew Univ. of Jerusalem Legal Research Paper 19–22, Sept. 26, 2019), <https://ssrn.com/abstract=3457893> [<https://perma.cc/DFA4-ZXEQ>].

of the possible substitutes on the wording of contracts or the parties' contracting behavior. Rather, one should also examine the impact of different substitutionary rules on customers' inclination to challenge questionable clauses, and on the courts' inclination to invalidate them—when invalidation is discretionary.²⁸³ Thus, for example, if the difference between the invalid contract term and the MTA is small, while the gaps between the contract term and the moderate and penalty arrangements are large, then customers might refrain from challenging the term in the first place under the MTA. There is less point in challenging a term if the substitute is not very different. As for judges, on the one hand they might be less inclined to invalidate an errant arrangement when the difference between it and the MTA is small, because such interference would not make much practical difference. On the other hand, such a small difference may possibly increase their willingness to invalidate the term because the outcome is not overly dramatic. Whether or not any of these effects of the choice between substitutionary arrangements is desirable may vary from one context to another and depend on one's normative perspective.²⁸⁴

2. *Remainder of the Contract.*—Sometimes, the law invalidates certain transactions altogether. One example is self-enslavement.²⁸⁵ Another is payday loans, which are banned in a considerable number of states.²⁸⁶ A third example is pyramid promotional schemes, in which consumers pay for the opportunity to receive compensation that is derived primarily from the introduction of other consumers into the scheme rather than from the sale or consumption of products—which are banned under specific statutes or found “unfair and deceptive” under state UDAP laws.²⁸⁷ More often, the law merely renders certain clauses unenforceable—in which case one should determine how this unenforceability affects the rest of the contract.

One extreme possibility is that the inclusion of an unenforceable clause renders the entire contract unenforceable (or at least voidable by the non-drafter). This is, for example, one of the options available to a court under

283. *See id.* at 8–25 (theoretically and empirically examining these issues).

284. Furthermore, in contexts where MTA is *inappropriate*, a further question arises, namely whether to enforce a contractual *severability clause* that states that if any contractual term is deemed unenforceable, it would be replaced by the minimally tolerable arrangement. On such clauses, see Ben-Shahar, *supra* note 14, at 885–87. *See also infra* note 291 and accompanying text.

285. Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763 (1983); Margaret Jane Radin, *Market-Inalienability*, 100 HARV. L. REV. 1849 (1987).

286. Some states prohibit this kind of consumer credit altogether, while others only ban repetitive payday loans, whose ramifications for lenders may be particularly damaging. On the payday loan industry and on these prohibitions, see, for example, PORTER, *supra* note 112, at 335–52; Ronald J. Mann & Jim Hawkins, *Just Until Payday*, 54 UCLA L. REV. 855 (2007); Paige Marta Skiba, *Regulation of Payday Loans: Misguided?*, 69 WASH. & LEE L. REV. 1023 (2012).

287. CARTER & SHELDON, *supra* note 91, at 605–07.

the unconscionability doctrine.²⁸⁸ While such result may create a strong deterrent against the inclusion of unenforceable terms in contracts,²⁸⁹ it often does not serve the interests of the party protected by the mandatory rule—hence this is seldom the case under modern contract law.²⁹⁰ Two other possibilities are to leave the rest of the contract intact²⁹¹ or to make suitable adjustments to the rest of the contract following the annulment of the errant clause. Imagine that a contract purports to present someone who does certain work for someone else as an independent contractor—rather than an employee—thereby depriving the worker of mandatory benefits and protections that are afforded by employment law, such as minimal annual vacation and maximal weekly working hours. If a court determines that, notwithstanding the contrary agreement, the relationship between the two parties is one of employment—and hence the worker is entitled to those benefits or their monetary equivalent—should the employer be entitled to reduce the agreed remuneration on the grounds that had the parties known that their relationship would be subject to labor laws, they would, in all probability, have fixed a lower remuneration?

Without purporting to offer a complete answer to this question—which may well vary across different contexts—we posit that one key consideration should be whether the parties knew, or should have known, of the (potential) unenforceability of the clause *ex ante*. Whenever only the party which is favored by the invalid clause—paradigmatically, the supplier who drafted the contract—knew, had reason to know, or had superior means of becoming aware of the (potential) unenforceability of the agreed arrangement, the remainder of the contract should, as a rule, remain intact. This claim rests on both fairness and efficiency considerations. From a fairness perspective, the drafter bears exclusive or at least primary responsibility for the inclusion of the invalid term, while the other party may be unaware of the contractual

288. Under the U.C.C., “[i]f the court as a matter of law finds the contract or any clause of the contract to have been unconscionable at the time it was made *the court may refuse to enforce the contract*, or it may enforce the remainder of the contract without the unconscionable clause” U.C.C. § 2-302(1) (AM. LAW INST. & UNIF. LAW COMM’N 2002) (emphasis added).

289. *See* Baierl v. McTaggart, 629 N.W.2d 277, 279 (Wis. 2001) (ruling that the inclusion of an unenforceable clause in a lease agreement with a view to intimidate tenants renders the entire lease unenforceable because merely ignoring the clause would eliminate landlords’ incentive to remove such clauses); Wilkinson-Ryan, *supra* note 234, at 172 (noting that a firm risks much more by including an unconscionable clause in a contract when such inclusion voids the entire contract rather than just the specific clause).

290. Ben-Shahar, *supra* note 14, at 875.

291. For example, the legislation on health insurance in Connecticut bans the inclusion of clauses that prohibit certain types of disclosure in contracts between a health care provider and a health carrier, clarifies that such provision shall be void, and adds that the invalidity of any contract provision under this rule “shall not affect any other provision of the contract.” CONN. GEN. STAT. § 38a-477f (2020). This is also one of the options available to the court under the unconscionability doctrine, as cited in *supra* note 288.

term, the legal regime, or both. From an efficiency perspective, assuming that the invalidation of the contractual arrangement is justified, leaving the rest of the contract intact creates a desirable deterrence against attempts to frustrate the goals of the mandatory law.

Arguably, the outcome should be different if neither of the parties knew, or should have known, about the discrepancy between the agreement and the mandatory legal regime, or if both of them similarly knew, or should have known, about it. In such cases, when the invalidation of the clause substantially distorts the contractual equivalence, the party who loses from the invalidation should arguably be entitled to restoration of the contractual equivalence. This would be achieved by setting the remuneration that the parties would have agreed upon had they known that their chosen arrangement is invalid.²⁹² In such cases, both parties are deemed equally responsible for incorporating an invalid arrangement in the contract, so there is presumably no good reason to let one of them get a substantial windfall while the other suffers considerable loss.

As previously noted, since adapting the remainder of a contract following the invalidation of a given clause reduces the incentive to refrain from including invalid clauses in the contract, it is particularly suited in cases where *neither* party knew, or should have known, about the discrepancy between the agreement and the mandatory legal regime (because in such cases, deterrence is less relevant). It is less obviously appropriate when *both* parties knew, or should have known, about said discrepancy. In such cases, the weight of the deterrence consideration may depend on the rationale for the mandatory rule: if the justification for the mandatory rule primarily concerns negative externalities, then perhaps it may be preferable to leave the remainder of the contract intact, on grounds of deterrence.

In some instances, the parties agree in advance that invalidation of a clause will result in suitable adjustment of the remainder of the contract. Interestingly, the mandatory nature of the primary rule (such as the rule invalidating penalty clauses, or the rule securing employees' annual vacation) does not necessarily imply that the secondary rule (about the ramifications of invalidation on the remainder of the contract) should be mandatory as well. If, however, all things considered, the desirable rule is that invalidation of the errant clause should not affect the rest of the contract for reasons of deterrence, this secondary rule should be mandatory as well.²⁹³

This analysis highlights an interaction between the present issue and other issues discussed above. Specifically, the weight of the consideration of

292. This is an extension of the notion of restoration of the contractual equivalence, which has been proposed as a possible goal of remedies for breach of contract. See Eyal Zamir, *The Missing Interest: Restoration of the Contractual Equivalence*, 93 VA. L. REV. 59 (2007) (addressing the value and implications of the restoration of the agreed equivalence for contract remedies).

293. See also *supra* note 284 and accompanying text.

deterrence depends on the extent to which the invalidity of the contractual arrangement was predictable *ex ante*, which in turn depends on whether the pertinent norm is formulated as a vague standard or as a concrete rule.²⁹⁴

G. Summary

This Part systematically analyzed a number of institutional, procedural, and substantive issues that pertain to the design of norms regulating the content of transactions. It went beyond the question of whether such regulation is legitimate and desirable, to inquire how mandatory rules should be designed. It demonstrated that mandatory rules differ in many respects, thus making their design a complex task. Ultimately, while the categories of default and mandatory rules remain useful, it transpires that a simple dichotomy does not stand up to scrutiny. It has further been shown that, just as default rules can serve various functions—including saving transaction costs and incentivizing parties to share information—so, too, can careful design of mandatory rules. For example, rules governing the wording of contracts not only constrain the substance of contractual arrangements but also simplify the contracting process and induce the provision of information to customers about their legal rights (when a dispute arises). Thus, while mandatory rules directly regulate the content of contracts, they indirectly affect the contracting process and the resolution of contractual disputes. Given the great diversity of contracts to which mandatory rules apply, the range of goals such rules can serve, and the variety of design options, it should come as no surprise that this analysis can offer no simple recipe for legal policymakers. However, it does provide a clearer roadmap for more rational, systematic, and informed consideration of the various options. Concomitantly, it demonstrates that many of the concerns raised by opponents of mandatory rules, as discussed in Part I, may be alleviated through well-thought-out formulation of such rules.

Conclusion

This Article has discussed the normative legitimacy of regulating the content of transactions, and argued that such regulation is often warranted. It demonstrated the current prevalence of substantive mandatory restrictions in federal and state, statutory and judge-made law—yet suggested that, in comparison with other legal systems, mandatory rules are an underutilized policy tool. Most importantly, it offered a comprehensive and systematic analysis of the choices facing the designers of mandatory rules—including the division of labor between branches of government; the use of standards and rules; the degree of immutability; the decision on whether to regulate

294. *See supra* section III(A)(2).

only substantive law or the wording of contracts by suppliers as well; and the effect of invalidation of contract terms on the remainder of the contract.

Analysis of the decisions that must be made when designing mandatory rules brings together issues that have already been discussed in the legal literature, as well as those that have only recently attracted the attention of legal scholars—including some that have never been tested empirically. It was therefore based, in part, on implicit assumptions about how varying designs of mandatory rules may gain the support of legal policymakers and the public at large; how they may affect the behavior of suppliers and customers when they draw up and execute contracts, and resolve disputes about them; and how they may influence judicial decision-making. Future research should examine these issues empirically—ideally, by combining qualitative and quantitative methods, and experimental and observational ones.

Establishing a detailed research agenda exceeds the scope of the present study, but a couple of examples may prove useful.²⁹⁵ Generally speaking, it would be worthwhile to empirically examine the public opinion about the use of mandatory rules, compared to alternatives such as disclosure duties, default rules, and other nudges. It would also be useful to empirically test how the various choices described in Part III might affect the formulation of contracts by suppliers, the inclination of customers to challenge excessive terms, and judicial decision-making in contractual disputes.

In conclusion, while there is still much to be learned about mandatory rules, the above analysis hopefully dispels some of the doubts and misconceptions about them, thereby opening the door to an open-minded consideration of their adoption and design.

295. Notable existing empirical studies include Furth-Matzkin, *supra* note 14 (studying the inclusion of invalid clauses in a sample of rental agreements); Furth-Matzkin, *supra* note 235 (experimentally examining the effect of invalid clauses on tenants' behavior once a dispute arises); Zamir & Katz, *supra* note 17 (studying the effect of framing and phrasing on the judged desirability of mandatory rules); Katz & Zamir, *supra* note 282 (experimentally studying the effect of the substitute rule on customers' inclination to challenge excessive terms and judges' inclination to invalidate them).