19 Behavioral approaches to contract law

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1. Introduction
Legal scholars have increasingly used existing scholarship in both cognitive psychology and behavioral economics, which suggests that human behavior often deviates from rational choice in systematic and predictable ways, to explain legal phenomena and to argue for legal reforms. This behavioral approach to law has infiltrated the legal literature in such diverse areas as tax law, administrative law, environmental law, criminal law, civil procedure, corporate securities law, tort law, and contract law (Langevoort 1998). There now exists an increasingly rich literature which attempts to blend behavioral analysis and economic analysis of law into a ‘behavioral economic analysis of law’. This new movement within legal scholarship is called ‘behavioral law and economics’ (Sunstein 1997; Jolls et al. 1998) or ‘law and behavioral science’ (Korobkin and Ulen 2000) and builds on the core insights of law-and-economics scholarship, but seriously scrutinizes the shortcomings of rational choice theory. It asserts that legal scholars seeking to understand the incentive effects of law in order to propose efficacious legal policy should not be limited to rational choice theory, since people regularly make decisions that deviate from rational choice in predictable ways (Korobkin and Ulen 2000). Instead of a strict adherence to rational choice theory, this new movement adopts a more subtle and context-dependent view of how individuals behave for use in legal analysis (Korobkin 2004). The ultimate goal of behavioral economic analysis of law is to offer better predictions and prescriptions about law based on improved accounts of how people actually behave (Jolls 1998).

This chapter is a review of the literature on the central attributes of behavioral law and economics and its applications in the field of contract law. Section 2 presents some of the evidence of non-rational behavior on which scholars of behavioral law and economics have relied. Where possible, the general implications of the behavioral findings for the economic analysis of law will be shown. Section 3 summarizes the challenges and responses in the general debate over the role of behavioral economics in legal policy-making. An overview of the specific applications of the behavioral approach in the field of contract law is given in section 4. Conclusions on the value of the behavioral approach for the analysis of contract law follow in section 5.
2. Evidence of Non-rational Behavior and General Implications for the Economic Analysis of Law

Conventional law and economics assumes that people exhibit rational behavior: that people are self-interested utility maximizers with stable preferences and the capacity to optimally accumulate and assess information. However, a large body of social science literature, like cognitive psychology, behavioral decision theory, and behavioral economics, demonstrates that these assumptions are not always accurate and that deviations from rational behavior are often systematic. Based on this evidence, Jolls et al. (1998) claim that people exhibit bounded rationality, bounded self-interest, and bounded willpower. The focus of this section is on the evidence relating to bounded rationality.

The notion of ‘bounded rationality’ was introduced by Herbert Simon (1955) and refers to the fact that there are critical psychological limits on human cognition. In the past few decades, much has been learned about human cognitive limitations and their implications for behavior. Only a small part of the behavioral findings will be presented here.

First, there is evidence that cognitive limitations force actors to employ relatively simple decision-making strategies which may cause actors to fail to maximize their utility (see section 2.1). Second, numerous tests done by psychologists and experimental economists have shown that people often do not exhibit the kinds of reasoning ascribed to agents in rational choice models. People make reasoning errors, and more importantly, these errors are typically systematic. Psychologists hypothesize that subjects make systematic errors by using decision ‘heuristics’, or rules of thumb, which fail to accommodate the full logic of a decision. The systematic errors are often referred to as ‘biases’, and this general topic often carries the label ‘heuristics and biases’ (see section 2.2). Third, evidence from social science demonstrates that preferences are not as stable as typically assumed in rational choice theory, but instead depend on endowment, status quo, or default rule (see section 2.3).

2.1. The Use of Simplified Decision-making Strategies

An important early critic of the rational choice model’s descriptive adequacy was Herbert Simon. As an alternative to utility maximization, Simon (1955) introduced the notion of ‘bounded rationality’, which asserts that cognitive limitations force people to construct simplified models of the world in order to cope with it. In standard optimizing theory, agents act as if they perform exhaustive searches over all possible decisions and then pick the best. Simon (1955, 1987) hypothesizes that agents instead perform limited searches, accepting the first ‘satisfactory’ decision.

The plausible assumption is that because individuals are limited in
their information-processing capacity, they tend to simplify the cognitive requirements of the decision process. This tendency will be more pronounced as the decision increases in complexity. The most obvious component of complexity—information load—has typically been defined as $m$ (the number of alternatives) multiplied by $n$ (the number of attributes). Social science research reveals that as the alternatives become more numerous and/or vary on more attributes, people are more likely to reduce their information search and to adopt simplifying strategies which require less cognitive effort than a complete cost-benefit analysis of the available alternatives (Abelson and Levi, 1985). The key characteristic of simplified decision rules is that they ignore information that is potentially useful for selecting the best alternative. There is ample evidence that several choice rules, especially simple non-compensatory1 ones, can lead to suboptimal choices.

It has been argued that bounded rationality arising from the high costs of acquiring and processing information is entirely consistent with rationality, which does not presuppose zero costs of acquiring and processing information. Indeed, intentional ‘satisficing’ is often quite sensible in light of both the costs of obtaining and processing the information to make maximizing choices and the cognitive limitations on human beings. Korobkin and Ulen (2000, p. 1076) argue that although ‘satisficing’ behavior can be rational in a ‘global’ sense, it nonetheless violates rational choice theory because ‘satisficing’ causes actors to fail to maximize their utility in the particular decision-making situation at hand.

This finding, that decision-makers are likely to make choices that fail to maximize their expected utility in situations in which decisions are complex relative to the capacities of those making the choice, challenges the traditional law-and-economics conclusion that a well-functioning market ensures that contractual exchanges and contract terms that exist in the marketplace will maximize social value. The premises of economics underlying traditional law-and-economics analysis push in the direction of freedom of contract: if parties are rational, they will enter contracts only when it is in their self-interest, and they will agree only to terms that make them better off; otherwise, they would not have voluntarily agreed to them. Korobkin and Ulen (2000, p. 1081) argue that the traditional law-and-economics theory needs to be modified for situations in

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1 Non-compensatory decision rules do not allow trade-offs between alternatives. The non-compensatory category includes the conjunctive decision rule, the disjunctive decision rule, the lexicographic decision rule, and the elimination by aspects rule. Under a compensatory decision rule, negative scores on one attribute can be compensated by positive scores on another attribute.
which complexity and ambiguity create substantial barriers to optimizing behavior.

2.2. *Heuristics and Biases*

In the past few decades, much has been learned about human cognitive limitations and their implications for behavior, particularly with regard to decisions made in the face of uncertainty and risk. If people are to respond optimally to the risks they face, they must have reasonably accurate perceptions of the magnitude of those risks. However, numerous studies show that people (including experts) have great difficulty judging probabilities, making predictions and otherwise attempting to cope with uncertainty. Frequently these difficulties can be traced to the use of judgmental *heuristics*, which serve as general strategies for simplifying complex tasks. These heuristics are valid in many circumstances, but in others they lead to large and persistent *biases*, with serious implications for decision-making (Tversky and Kahneman 1974). The study of heuristics and biases tends to be dominated by attempts to expose systematic errors in human judgment and decision-making.

One persistent source of error relevant for risk perception arises from the *availability heuristic* (Tversky and Kahneman 1973). People using this heuristic judge the probability of a future event based on the ease with which instances can be brought to mind. Availability is a useful clue for assessing probability, but because availability is affected by factors other than probability, reliance on it leads to predictable biases. A pervasive fact about human judgment is that people disproportionately weight salient, memorable, or vivid evidence, even when they have better sources of information. The availability heuristic contributes to many specific further biases. One is *hindsight bias* (Fischhoff 1975). Because events that actually occurred are easier to imagine than counterfactual events that did not, people have a tendency to overestimate the probability they previously attached to events that later happened. In hindsight, people consistently exaggerate what could have been anticipated with foresight.

The *representativeness heuristic* (Tversky and Kahneman 1974) refers to the tendency to assess the probability that some process A will bring about some event B by the degree to which A is representative or similar to B. This approach to the judgment of probability leads to serious errors because similarity or representativeness is not influenced by several factors that should affect judgments of probability.

Another source of error is *anchoring and adjustment*, referring to a tendency to resist altering a probability estimate, once formed, when pertinent new information comes to light (Slovic and Lichtenstein 1971; Tversky and Kahneman 1974). Furthermore, even when actors know the actual probability distribution of a particular event, their predictions as
to the likelihood that that event will happen to them are susceptible to the overconfidence bias: the belief that good things are more likely than average to happen to them and bad things are less likely than average to happen to them. Overconfidence leads to over-optimism. Related to the overconfidence bias is the confirmatory or self-serving bias, the term to describe the observation that actors often interpret information in ways that serve their interest or preconceived notions.

The experimental evidence and empirical analysis suggest that people make consistent and systematic errors in risk assessment, which undermines the standard assumption of conventional law and economics that fully informed individuals employ expected utility analysis to accurately assess risk (Arlen 1998). Behavioral economic analysis of law scholars generally focus on evidence that people systematically underestimate many risks – particularly risks to themselves. The possibility that people are systematically overly optimistic has important implications for the economic analysis of law. It suggests that individuals operating in markets may underestimate the risk to which they are subject, and thus take actions that do not maximize their own utility. As a result, social welfare also will not be maximized.

2.3. The Endowment Effect, Status-quo Bias and Default Preference
The ‘endowment effect’ (Thaler 1980) stands for the principle that people tend to value goods more when they own them than when they do not. A consequence of the endowment effect is the ‘offer-asking gap’, which is the empirically observed phenomenon that people will often demand a higher price to sell a good that they possess than they would pay for the same good if they did not possess it at present. The paradigmatic experimental demonstration of this is the ‘mugs’ experiment of Kahneman et al. (1990).2 Another term – the ‘status-quo bias’ (Samuelson and Zeckhauser 1988) – refers to an exaggerated preference for the status quo.3 It is often used interchangeably with the endowment effect, but actually has a slightly

2 In their experiments, some subjects are endowed (randomly) with coffee mugs, and others are not. Those who are given the mugs demand a price about two to three times as large as the price that those without mugs are willing to pay, even though in economic theory these prices should be extremely close together.
3 When Harvard University added new health-care plan options, older faculty members who were hired previously when the new options were not available were allowed to switch to the new options. If one assumes that new and old faculty members have essentially the same preferences for health-care plans, then the distribution of plans elected by new and old faculty should be the same. However, Samuelson and Zeckhauser found that older faculty members tended to stick to their previous plans; compared with the newer faculty members, fewer of the old faculty elected new options.
broader connotation: individuals tend to prefer the present state of the world to alternative states; all else equal, they prefer to leave things as they are. Furthermore, people may have an exaggerated preference for whichever option is the default choice (Korobkin 1998a, 1998b).

All three phenomena (status-quo bias, default preference, and endowment effects) are routinely explained as a result of ‘loss aversion’, the element of prospect theory that losses from a reference point are valued more highly than equivalent gains (Kahneman and Tversky 1979; Tversky and Kahneman 1991). Making one option the status quo or default or endowing a person with a good seems to establish a reference point people move away from only reluctantly, or if they are paid a large sum. Thaler (1980) explains the endowment effect as the underweighting of opportunity costs. If out-of-pocket costs are viewed as losses and opportunity costs are viewed as foregone gains, the former will be more heavily weighted. Thus a person would be willing to pay more in opportunity costs to keep a good that he already possesses than he would be willing to spend in received income (out-of-pocket money) to acquire the good. In comparison to a world in which preferences are independent of endowment, the status quo, or the default rule, the existence of loss aversion produces an inertia in the economy because gains from trade are reduced and potential traders are more reluctant to trade than is conventionally assumed (Kahneman et al. 1990). This is not to say that Pareto-optimal trade will not take place. Rather, there are simply fewer mutually advantageous exchanges possible and so the volume of trade is lower than it otherwise would be.

The endowment effect, status-quo bias, and default preference – when they exist – undermine the central premise of conventional law and economics that fully informed individuals allowed to exercise free choice will maximize their own utility, and thus social welfare, when transaction costs are low. In such a case, legal regimes will not necessarily maximize social welfare simply by following the standard law-and-economics prescription to minimize transaction costs and allow markets to operate whenever possible.

3. From Behavioral Findings to a Renewed Analysis of Law: Difficulties and Opportunities

While the experimental literature presents a compelling case that people are not necessarily rational utility maximizers, some authors have questioned the usefulness of behavioral insights for legal analysis. Does behavioral research offer an alternative model of human behavior suitable for normative policy analysis, and if so, what exactly are the normative implications? This section summarizes the challenges and responses in the general debate on the role of behavioral economics in legal policy-making.
3.1. Do Individuals Act Rationally after All?

Conventional law-and-economics analysis assumes that people exhibit rational behavior: that people are self-interested utility maximizers with stable preferences and the capacity to optimally accumulate and assess information. Law-and-economics scholars do not claim that this rational choice model perfectly captures all human behavior, but they do claim that deviations from rational choice generally are not systematic, and thus generally will cancel each other out. These scholars thus assert that rational choice, while not a perfect description of human behavior, is the best workable approximation of human behavior. Spitzer and Hoffman (1980, p. 1191) state that observations that do not conform to the assumptions of the rational choice model do not necessarily constitute grounds for rejecting the model as an analytical tool:

If a model’s predictions are generally borne out in economic, political, or legal situations, the model is a useful policy tool because it is generally correct about outcomes, even though its behavioral assumptions are generally false. We say in using such a model that people behave ‘as if’ they conform to the assumptions of the model.

According to Epstein (2006, p. 113) ‘the right way to understand the theory of rational behavior cannot be to assume away . . . pervasive human frailties. Rather, it is to explore how people of limited capacities learn to cope with their own limitations and to succeed in spite of them, as they often do’. Real-world choices often are affected by market choices, expert advice, and individual experiences, which may alter, reduce, or even eliminate judgment errors and biases. Education may also reduce or eliminate some biases under certain circumstances. People operating in certain markets, where learning is possible and errors are punished, and people guided by experts who are repeat players, may act rationally after all.

Behavioral economic analysis of law scholars argue instead that the deviations from rational choice are systematic, not random. Most people are likely to exhibit certain biases, they assert, and thus these deviations from rational choice do not cancel each other out.

The argument that people have strong incentives to choose optimally because actors who fail to make rational decisions cannot survive in a competitive world carries lesser force for individuals than for firms. Firms may fail for lack of profits, but people usually do not die of sub-optimization (Conlisk 1996). Even with regard to business firms, Korobkin and Ulen (2000, p. 1071) state that ‘if it were true that competition drives imperfectly rational behavior out of business markets, such results would not occur instantaneously, and at any given moment in time a substantial number
of participants in markets would likely be imperfectly rational actors who have not yet learned their lessons’.

Moreover, some people need to make decisions in situations where the individual decision-maker is not a repeat player who will learn from errors. Even when people can learn from their errors, evidence suggests that people learn to reassess risks only in certain conditions. Learning is promoted by favorable conditions such as awards, repeated opportunities for practice, good feedback, unchanging circumstances, and a simple context. Conversely, learning is hindered or blocked by the opposite conditions (Conlisk 1996).

Although behavioral law and economics focuses on departures of rational choice theory, it does not intend to suggest that standard economic forces are unimportant or, as posited by Ulen (1998, p. 1763): ‘A new theory of human decision making is in the offing, one that captures the best of rational choice theory and supplements it with a subtle view of how and why and when humans make mistakes in judgment.’

3.2. A Model of Human Behavior Suitable for Normative Policy Analysis

The experimental literature presents a compelling case that people are not necessarily rational utility maximizers but instead may exhibit certain predictable, systematic biases. Posner (1998), however, states that describing, specifying, and classifying the empirical failures of rational choice theory is an important scholarly activity, but it is not an alternative theory of human behavior. Arlen (1998) argues that behavioral economics of law cannot serve as the basis for broad normative policy conclusions because it cannot provide a coherent alternative model of human behavior capable of generating testable predictions and policy conclusions in a wide range of areas. According to Arlen (1998), laboratory and empirical results are difficult to transform into a model of human behavior suitable for normative policy analysis. First, many biases exist in some circumstances but not in others, with the scope of the biases often being difficult to predict. Second, individuals making risky choices in the real world often are subject to more than one bias and employ multiple heuristics, with sometimes conflicting effects. Indeed, the cognitive theory seems to contain examples of all kinds of errors: for example, while availability may account for overestimation of a catastrophe, anchoring may explain under-reaction. According to Issacharoff (2002, p. 39), the concern with applying behavioral economics to law is that the empirical observations are either insufficiently robust or amenable to conflicting interpretations, thereby limiting their ability to offer reliable generalizations.

Korobkin and Ulen (2000, pp. 1057–58) respond to this type of critique by arguing that ‘one can analyze the appropriate legal command in any
given circumstance without a grand, overarching theory of behavior as long as one has a due regard for the relevant decision-making capabilities of the actors in that specific setting'. Moreover, these authors (Korobkin and Ulen 2000, p. 1072) state that 'most laws are geared toward specific portions of the population or to people who play specific roles.' Hence, even when behavioral economic analysis of law cannot yet provide a general framework applicable to many areas of law, it can be used to formulate specific normative policies. The project's goal is to develop a more nuanced understanding of behavior for use by legal policy-makers.

3.3. Normative Implications of Behavioral Findings

An important, but under-addressed, question in behavioral law and economics is how evidence of bounded rationality is relevant to the formulation of legal policy. It is somewhat unclear if and how legal intervention can address non-rational tendencies in decision-making.

Many authors have recognized that it is difficult to formulate normative policy which takes cognitive biases into account because legal regimes designed to address the biases and heuristics generally require the intervention of judges, legislators, or bureaucrats, who are themselves subject to various biases. Arlen (1998, p. 1769) posits that ‘interventions to “cure” bias-induced inefficiency may ultimately produce outcomes that are worse than the problem itself’.

One important finding of behavioral research is that values and preferences are not fixed, but depend on endowment, context, or the way in which choice is presented. However, the normative implications of these findings are far from clear. The behavioral research on the importance of context predicts, for example, that altering default rules and rules of presentation produces different outcomes, and it shows the unreliability of perceived behavior as a gauge of actual preferences or likely future behavior. However, according to Issacharoff (2002), behavioral research cannot contribute to normative conclusions about which outcome is desirable and should be pursued as a matter of public policy. This conclusion must be derived externally from broader economic and policy considerations. Posner (1998) is concerned that the behavioral findings that people’s preferences are unstable and manipulative will be used as a pretext for the intervention of a totalitarian government charged with determining the populace’s authentic preferences. That would clearly be an abuse of behavioral decision theory. Korobkin and Ulen (2000) admit that when policy-makers wish to use law as a means of promoting efficiency, behavioral economic analysis of law’s present recognition of the importance of context cannot yield normative implications that are clearly superior to those of conventional law and economics. They state
that ‘if an actor selects “choice A” because the choices are presented in a particular context, but he would have otherwise selected “choice B”’, it is often difficult to determine whether the law will enhance efficiency by reinforcing “choice A”, encouraging “choice B” in spite of the context, or changing the context so that the actor will select “choice C” (Korobkin and Ulen, 2000, p. 1104). However, Korobkin and Ulen (2000, p. 1104) argue that understanding the importance of context for decision-makers can enable policy-makers who want to use law as a means of achieving a pre-established goal to establish a closer fit between the means and ends than rational choice theory would permit.

The other important finding of behavioral research is that boundedly rational actors make judgment errors. The consequence of bounded rationality is that individuals make particular decisions in ways that are not utility maximizing for them (even though the time and effort saved by using simplified decision rules and heuristics might enable them to maximize their global utility). To the extent that the law can be used as a tool to help actors make decisions that better maximize their utility in those particular circumstances, law can improve efficiency. If cognitive illusions do lead parties to make errors, then the law might play a role in reducing them. However, most of the suggestions made in behavioral law and economics for legal reform are for devices of getting around rather than dispelling non-rational tendencies. The usual approach in behavioral law and economics work is to focus on designing legal rules and institutions ‘to curtail or even entirely block choice in the hope that legal outcomes do not fall prey to problems of bounded rationality’ (Jolls and Sunstein 2006, p. 200). In the existing behavioral law and economics literature, ‘bounded rationality might be, and often is, taken to justify a strategy of insulation, attempting to protect legal outcomes from people's bounded rationality’ (Jolls and Sunstein, 2006, p. 200). However, Jolls and Sunstein (2006, p. 200) state that a quite different possibility is ‘that legal policy may respond best to problems of bounded rationality not by insulating legal outcomes from its effects, but instead by operating directly on the boundedly rational behavior and attempting to help people either to reduce or to eliminate it.’ They describe legal policy in this category as ‘debiasing through law’. ‘Debiasing through law’ strategies can recognize human limitations, while at the same time avoiding the step of removing choices from people.

3.4. Paternalism

The presence of systematic biases poses a particular challenge to the strongest anti-paternalism arguments of conventional law and economics, many of which appear to depend on the assumption that individuals make rational choices. Sunstein (1997, p. 1178) asserts that the recent revisions
in understanding human behavior greatly unsettle certain arguments against paternalism in law. While these revisions do not make an affirmative case for paternalism, they support a form of anti-antipaternalism. According to Issacharoff (1998), it is true that the tools of psychology yield a richer understanding of human behavior, but this cannot possibly translate into a justification for greater constraints on individual decision-making through paternalistic interventions. In his view, ‘it would be ironic if greater insight into the complexity of human decision making became the justification for taking the freedom to decide, even if imperfectly, from those very individuals’ (Issacharoff 1998, p. 1745).

However, scholars of the behavioral approach claim that the errors identified by behavioral research lead people to behave against their best interests, in which case paternalism may prove useful. If, for example, parties to a contract suffer from cognitive limitations that prevent them from making wise commitments, then there is at least a prima-facie case for more paternalistic forms of judicial intervention rather than strict reliance on freedom of contract. Generally speaking, when the behavioral analysis identifies cognitive errors that parties are prone to making, it supports somewhat paternalistic doctrine. If people make systematic errors in judgment, then they will make bad choices even when they have the incentives and information needed to make good ones, and hence, do themselves harm if left to their own devices. This is the psychological argument for paternalism. Recognition of the fallibility of human judgment commonly inspires calls for imposing constraints on individual choice. Scholars of behavioral law and economics do recognize that such restrictions on individual choice would be costly for those individuals who are able to behave in their own best interest. Therefore, they have sought to develop non-intrusive forms of paternalistic intervention focusing on ways to allow individuals to make better choices, rather than restricting choices.

Camerer et al. (2003) propose an approach to evaluating paternalistic regulations and doctrines that they call ‘asymmetric paternalism’. A regulation is asymmetrically paternalistic if it creates large benefits for those people who make errors, while imposing little or no harm on those who are fully rational. Such regulations are relatively harmless to those who reliably make decisions in their best interest, while at the same time advantageous to those making suboptimal choices. The authors embrace cost-benefit analysis as a method of determining the desirability of paternalistic regulations: are the benefits of mistake prevention larger than the harms imposed on rational people? The authors review potential regulations such as default rules, framing issues, cooling-off periods, and limiting consumer choice, and describe circumstances under which each regulation may be asymmetrically paternalistic.
According to Rachlinsky (2003), the psychological case for paternalism should not depend only upon a comparison of the costs of a regulatory intervention with the benefits of saving people from their own choices, but depends on demonstrating that the cost of either learning to adopt a superior approach to a choice or relying on others to make a choice exceed the cost of the paternalistic intervention.

Sunstein and Thaler (2003) advocate ‘libertarian paternalism’, an approach that preserves freedom of choice, but encourages both private and public institutions to steer people in directions that will promote their own welfare. Libertarian paternalism is a relatively weak, soft, and non-intrusive type of paternalism because choices are not blocked, fenced off, or significantly burdened. The paternalistic aspect consists in the claim that it is legitimate for private and public institutions to attempt to influence people’s behavior in directions that will make people’s lives better; in other words, that it is legitimate to ‘nudge’ (Thaler and Sunstein 2008). One particular form of paternalism embodied in libertarian paternalism is ‘minimal paternalism’. It occurs whenever a planner (private or public) constructs a default rule or starting point with the goal of influencing behavior without forbidding any options (Sunstein and Thaler 2003, p. 1188). Libertarian paternalists also ask the question: how much choice should people be given? While libertarian paternalists want to promote freedom of choice, they need not seek to provide bad options, and among the set of reasonable ones, they need not argue that more is necessarily better (Sunstein and Thaler 2003, p. 1196).

4. Applications of Behavioral Law and Economics to Contract Law

This section presents an overview of the applications of behavioral law and economics in the field of contract law. The implications of the behavioral approach for the general rules of contract law will be mentioned first, followed by the implications for the specific rules governing consumer contracts.

4.1. General Rules of Contract Law

4.1.1. Contract default rules  Traditional law-and-economics analysis of contract ‘default’ rules – that is, legal rules that govern the relationship between contracting parties only if the parties do not explicitly agree to different terms – posits that (1) unless transaction costs are unusually high, the choice of default rules will have little effect on the contract terms because wealth-maximizing parties will contract around inefficient default terms, and (2) default terms should mirror the terms that the majority of contracting parties would choose (‘majoritarian’ defaults) to minimize the
transaction costs when contracting around inefficient defaults. Evidence of the status-quo bias suggests that revisions to both elements of the conventional wisdom are appropriate (Korobkin and Ulen 2000).

Korobkin (1998a and 1998b) has shown experimentally that default rules are more difficult to contract around than rational choice theory explanations suggest. This is because contracting parties are likely to see default terms as part of the status quo and, consequently, prefer them to alternative terms, all other things equal. If this is the case, default terms will be sticky and the choice of defaults may determine the terms that the parties adopt in many cases (Korobkin and Ulen 2000, p. 1112). Even if ‘majoritarian’ terms are selected as defaults, this stickiness will cause some of the parties in the ‘minority’ not to contract around the default rule even if it would be efficient for them to do so and transaction costs are low. Because the status-quo bias makes default terms sticky and reduces the number of parties expected to contract around defaults, it is particularly important to select default terms that maximize efficiency for most contracting parties (Korobkin 1998b). However, the status-quo bias highlights the difficulty that policy-makers face in attempting to determine which terms the majority of contracting parties would favor. At a minimum, the status-quo bias demands that lawmakers seeking to promulgate majoritarian default terms look for evidence other than what terms are adopted in a market with an existent default for indications as to what terms the majority would prefer (Korobkin and Ulen 2000). Hence, the status quo bias provides an argument against the role of trade or standard practices as a basis for determining the majoritarian default rule, because the fact that trade practices are widely adopted does not prove that they are optimal, even if transaction costs are low.

In the field of employment contract law, Millon (1998) argues that the current prevalence of at-will employment in the US does not necessarily indicate its superiority to job security when status-quo bias is taken into account. If the efficiency of observed behavior cannot be taken for granted, current arrangements do not deserve default-rule status simply because people tend to choose them.

Korobkin (1998b) proposes two default-rule policies to reduce the opportunities for parties to become biased in favor of the status-quo terms: tailored default rules and non-enforcement defaults. The ‘non-enforcement default’ announces that courts simply will refuse to enforce contracts with gaps. Such a default term creates a status-quo term (non-enforcement) which is so strongly disliked by all contracting parties that parties will affirmatively contract for a different term. Especially for contingencies that are highly salient to parties, such that they are unlikely to forget to negotiate terms to address them, it might be preferable not to
provide a default term at all, instead denying enforcement of contracts that fail to provide a term governing the contingency. ‘Tailored defaults’ leave the content of the default rule at the time of contracting unresolved. Tailored default terms are given content by judges after the parties complete their contract and a contingency occurs for which the contract does not explicitly provide. When determining the content of the default rule, judges will take into account the specific characteristics of the parties and the circumstances of the particular transaction. Because the exact content of tailored default terms is unknown to parties at the time of contracting, parties are unable to clearly perceive a status-quo term. Tailored default rules are typically formulated as a standard. Long-standing questions about the comparative virtues of rules versus standards might well take into account the behavioral insight that standards are likely to minimize the status-quo bias (Korobkin 2000).

4.1.2. Liquidated damages and the penalty doctrine  One of the puzzles of conventional law and economics is the courts’ reluctance to enforce penalty clauses. According to Eisenberg (1995), the special scrutiny of liquidated damages is justified because such provisions are systematically more likely to be the products of the limits of cognition than performance terms, that is, terms that specify the performance each party has to render. Eisenberg asserts that although parties can easily understand terms such as subject matter, quantity, and price, they cannot comprehend all scenarios of breach and the application of liquidated damages provisions to these scenarios. Because people accumulate, understand, and process only a limited amount of information about the future, contracting parties may fail to comprehend and focus on the prospect of breach. In addition, parties at the bargaining stage are generally overly optimistic about their ability to perform and will sacrifice the detailed bargaining necessary to achieve an effective liquidated damage provision. The consequence is that liquidated damages provisions, to the extent that parties intend them to serve as a proxy for expected actual damages, are likely to be quite erratic. The policy implication of this observation, according to Eisenberg, is that it is proper for courts to scrutinize these provisions more closely.

Korobkin and Ulen (2000) are less sanguine about this conclusion, because it implicitly assumes that parties are better served by accuracy in damages than by ex ante certainty as to what damages will be if a breach occurs – a position that is open to debate.

Hillman (2000) argues that behavioral decision theory cannot resolve the puzzle of liquidated damages. Although some phenomena like over-optimism support scrutiny of this provision, other cognitive heuristics and biases support strict enforcement of the provision. First, assuming that
parties consider default rules – here the award of expectation damages – as part of the status quo, contracting around this default and agreeing to liquidated damages suggests that the term must be very important for parties and that they bargained over the provision with care. Second, assuming that cognitively limited parties do not like ambiguity, they may prefer the safety of a liquidated damages provision over the uncertainty of expectation damages. Third, judges who exhibit hindsight bias will overestimate the parties’ ability to calculate at the time of contracting the actual damages that would result from breach. Because judges will believe that the parties’ remedial situation at the time of contracting was not ambiguous, judges will undervalue the importance the parties attach to the agreed-upon damages provision. For these behavioral reasons, courts should presume the enforceability of such provisions rather than making every effort to strike them.

Rachlinsky (2000) argues as a response to Hillman’s skepticism that biases that cause over-optimism justify scrutiny of liquidated damages provisions. The status quo bias does not justify deference because the increased effort to bargain around the damages rule does not necessarily eliminate the effects of over-optimism. Although aversion to ambiguity justifies deference to liquidated damages, courts actually use this insight under the penalty doctrine by giving more deference to liquidated damages clauses when damages are hard to calculate (and thus ambiguous).

Eric Posner (2003) states that the behavioral account of the penalty doctrine cannot explain why the biases justify judicial scrutiny of liquidated damages terms but not other terms. If parties overlook low-probability events, then any contractual term that makes obligations conditional on events that occur with a low probability could be defective on a behavioral account, but because they are not liquidated damages provisions, actual courts do not subject them to scrutiny. The behavioral approach does not seem to explain existing contract law. It may also not provide a solid basis for normative recommendations for reforming contract law. Monumental floodgate problems would be created if courts were to police potentially all contract provisions to account for parties’ irrationality in processing information. This would undermine contract law’s goal of certainty and predictability (Hillman 2000, p. 735).

4.1.3. Consequential damages

The traditional contract default rule protects the promisor against non-foreseeable consequential damages. Garvin (1998) argues that the cognitive literature favors, at some level, limits on even foreseeable consequential damages. He justifies attenuating the promisor’s liability as a means of correcting for its systematic under-pricing of risk. Generally, if individuals are overconfident about their own
ability to perform the terms of the contract, they would tend to under-
estimate the likelihood that they will be unable to perform. The remote
risks at play will be undervalued by contractual parties, particularly those
who seldom deal with these risks; as a result, they will make too small an
allowance for them in the contract price, and thus will not adequately
compensate the risk-bearing promisor. Garvin therefore supports a role
for a disproportionality test that focuses on the disparity between the size
of the risk and the size of the premium charged to bear it as part of the law
of consequential damages.

4.2. Consumer Contracts
A growing literature models consumer markets in which sophisticated
firms interact with boundedly rational consumers and consumers who
may have psychological biases. Absent legal intervention, the sophis-
ticated seller will often exploit the consumer’s behavioral biases. The
contract itself, commonly designed by the seller, will be shaped around
consumers’ systematic deviations from perfect rationality. Such biased
contracting is not the consequence of imperfect competition. On the con-
trary, competitive forces compel sellers to take advantage of consumers’
weaknesses (Bar-Gill 2004). Section 4.2.1 gives an overview of contractual
practices in consumer markets which are regarded in the behavioral law
and economics literature as responses to consumers’ boundedly rational
behavior, or even as conscious attempts by firms to exploit the cognitive
limitations of consumers. Section 4.2.2 lists some of the suggestions made
in the behavioral law and economics literature as strategies for improving
consumer choice.

4.2.1. Contractual exploitation of consumer biases

1. Inefficient contract terms in standard form contracts
Korobkin (2003) assumes that buyers, when confronted with standard
form contracts, compare only limited numbers of product and contract
attributes when contemplating purchase because they are boundedly rational rather than fully rational decision-makers. He claims that com-
petition between sellers will generate the efficient level of quality for the
attributes buyers consider (‘salient’ attributes), but low-quality terms
regarding ‘non-salient’ attributes (that is, attributes buyers do not con-
sider). The lynchpin of the theory is that sellers are unable to recoup the
costs of offering efficient non-salient terms and that this condition worsens
with increasing competition. Assuming that price is always a salient
product attribute for buyers, market competition actually will force sellers
to provide low-quality non-salient attributes in order to save costs that will
be passed on to buyers in the form of lower prices. According to Korobkin (2003), the problem is most sensibly addressed through a combination of market, ex ante legislative mandates, and judicial action, including a modification of the unconscionability doctrine to protect behaviorally biased consumers.

2. SHR O UDED ATT RIBUTES In many businesses, it is customary to advertise a base price for a product and to try to sell additional ‘add-ons’ at high prices at the point of sale. Add-on prices are not advertised and they would be costly or difficult to learn before one arrives at the point of sale (Ellison, 2005). Gabaix and Laibson (2006) present a model of consumer myopia that explains why firms often shroud the negative attributes of their products, particularly high prices for complementary add-ons. For example, hotels often shroud information on complementary add-ons like parking, phone calls, in-room movies, minibar items, dry cleaning, or meals in the hotel restaurant. In this setting, unsophisticated consumers fail to take the add-on into account when comparing products. Hence, they only compare the prices of base goods across firms, instead of comparing the total prices (base goods plus add-on). A ‘sophisticated’ consumer anticipates the marked up add-ons and avoids buying many of them (for example, she brings a cell phone instead of relying on the hotel phone; she takes a taxi instead of renting a car that requires parking, etc.). Gabaix and Laibson show that competition will not induce firms to reveal information that would improve market efficiency. Firms will not educate the public about the add-on market, even when unshrouding is free. The reason for this is a phenomenon which they call ‘the curse of debiasing’.

Debiasing improves consumer welfare, but no firm can capture or even partially share these benefits. Educating a consumer about competitors’ add-on schemes effectively teaches that consumer how to profitably exploit those schemes, thereby making it impossible for the educating firm to profitably attract the newly educated consumers. From a policy perspective, Gabaix and Laibson argue that regulators might compel disclosures or could warn consumers to pay attention to shrouded costs. The imposition of markup caps on shrouded attributes is mentioned as a possible regulatory response by the authors, but they reject it as a solution because it would distort markets.

3. MISPERCEPTION-BASED PRICING AND BUNDLING Oren Bar-Gill (2004, 2006, 2008) argues that consumers make persistent mistakes. Imperfect information and imperfect rationality lead to misperception of benefits and costs associated with the product. As a result, consumers might fail to maximize their preferences in product choice or product use. According to
Bar-Gill, the misperceptions can be traced back to a particular category of mistakes: use-pattern mistakes – mistakes about how the consumer will use the product. Bar-Gill argues that sellers respond strategically to use-pattern mistakes by redesigning their products, contracts, and pricing schemes. His proposed theory of seller reactions to consumer misperceptions builds on the multidimensionality of products and prices.

Multidimensional pricing and bundling can be seen as a strategic response to consumer mistakes. Examples discussed by Bar-Gill are rebates, credit card pricing, bundling of printers with ink, and inter-temporal bundling in subscription markets like health clubs. In these cases, consumers often misperceive their future use of the product. For example, consumers overestimate the likelihood of redeeming their rebate, they underestimate the likelihood of paying their credit card bills late, underestimate the amount of printing, and overestimate the number of times that they will visit the health club. With multidimensional pricing and bundling, such misperceptions drive a wedge between the actual price paid by the consumer and the perceived price, which may in turn lead to welfare-decreasing decisions made by consumers. From a policy perspective, focusing on disclosure regulation, Bar-Gill argues that the importance of use-pattern mistakes requires more, and better, use-pattern disclosure. In particular, sellers should be required to provide average or individualized use-pattern information. For example, a consumer who underestimates the likelihood of paying late and triggering a credit card late fee will not make a truly informed choice, even if she has perfect information about the magnitude of the late fee. The disclosure apparatus should therefore include the amount that an average consumer pays in late fees and how much the individual consumer has paid in late fees over the last year (Bar-Gill 2008).

4. SPECIFIC CONTRACT TERMS THAT EXPLOIT CONSUMER BIASES

Particular contract terms could be seen as conscious attempts by sellers to take advantage of consumer biases, such as the sunk cost fallacy, status-quo bias, or consumer inertia.

Economic theory implies that only incremental costs and benefits should affect decisions. Historical or sunk costs should be irrelevant. Thaler (1980) suggests instead that consumers often do not ignore sunk costs in their everyday decisions. This is called the ‘sunk cost effect’ or ‘sunk cost fallacy’. Sellers may design their contract in such a way as to take advantage of consumers’ commitments to sunk costs.

Korobkin and Ulen (2000, p. 1126) give the example that sellers often structure contracts such that the buyer is obligated to make monthly payments but can stop making payments and return the merchandise at any
time. Once the first monthly payment is made, the purchaser is unlikely to discontinue the contract and return the merchandise, even if the marginal cost of keeping the merchandise is higher than the marginal benefit he receives from it. To the extent that lawmakers believe that such contracts result in many consumers’ failing to maximize their utility, those lawmakers might consider implementing restrictions on the way consumer contracts may be structured (Korobkin and Ulen 2000, p. 1126).

The status-quo bias implies that individuals tend to prefer the present state of the world to alternative states; all else equal, they prefer to leave things as they are, creating some inertia in the economy. These forces imply that if, for a given choice, there is a default option – an option that the chooser will obtain if he or she does nothing – then we can expect a large number of people to end up with that option, whether or not it is good for them. Sellers could take advantage of the status-quo bias of consumers, for example, by adopting an automatic renewal clause in the contract. Such clauses are part of many subscription contracts. Automatic renewal clauses specify that the contract will be automatically renewed for a new term unless the consumer gives notice of his intent to terminate. If the consumer takes no action to cancel the agreement, he would be bound for another term. It turns out that many consumers fail to cancel their agreement even if the benefits from continuance are lower than the price that needs to be paid. This failure might be due to high transaction costs involved in canceling. In fact, sellers sometimes deliberately inflate transaction costs (Sovergn 2006), but with status-quo bias, the level of cancellation is expected to be suboptimal even when the transaction costs to cancel are low.

4.2.2. Strategies to improve consumer choice  When people choose a flavor of ice cream, they know what they will consume and what the price will be. Choosing among ice cream flavors is an easy task for consumers. But for many products, people may not understand all the ramifications of their choice. Often people have a hard time predicting how their choices will end up affecting their lives. In the words of Sunstein and Thaler (2003, p. 1198), it may be hard ‘to map from options to preferences’.

Thaler and Sunstein (2008, pp. 92–3) give an example of the mapping problem in choosing a digital camera: ‘Cameras advertise their megapixels, and the impression created is certainly that the more megapixels the better. . . . But what is really problematic for consumers is translating megapixels (not the most intuitive concept) into what they care about. Is it worth paying an additional hundred dollars to go from four to five megapixels?’

According to the authors, one way to help people to improve their ability to map and hence to select options that will make them better off is
to make the information about various options more comprehensible by providing information that translates more readily into actual use. As an example, Thaler and Sunstein (2008, p. 93) suggest that manufacturers of digital cameras could list the largest print size recommended for a given camera. Instead of being given the options of three, five, or seven megapixels, consumers might be told that the camera can produce quality photos at 4 x 6 inches, 9 x 12 inches, or ‘poster size’.

Thaler and Sunstein notice that people often have a problem in mapping products into money, especially when products have a complex pricing scheme, like credit cards, cell-phone calling plans, mortgages, and car insurance policies. For these and related domains, Thaler and Sunstein (2008, p. 93) propose a very mild form of government regulation, a species of libertarian paternalism that they call RECAP: Record, Evaluate, and Compare Alternative Prices. The government would not regulate how much sellers could charge for their services, but it would regulate their disclosure practices. RECAP regulation consists of a price disclosure part and a usage disclosure part. An example given by Thaler and Sunstein (2008, pp. 93–4) of usage disclosure in the cell-phone market would be that once a year, issuers would have to send their customers a complete listing of all the ways they had used the phone and all the fees that had been incurred.4

Thaler and Sunstein (2008, p. 173) suggest that RECAP regulation might also encompass ‘intelligent assignment’. An intelligent assignment system matches consumers with the product that best fits their needs. Such a system was, for example, used in Maine to match individuals with prescription drugs plans. Maine officials evaluated several plans according to three months of historical data on prescription use by eligible participants. Participants in plans covering fewer than 80 percent of their required drugs were switched automatically to better plans. Variants of this system are also conceivable for use by professional sellers or intermediaries to match consumers with the product or service that best suits their preferences.

5. Conclusions
The behavioral approach holds promise for analyzing contract law. If economic models of the law are undermined by their rationality assumptions, then psychologically accurate models of human cognition might fill in the gaps left by the economic analysis of law. The behavioral approach is successfully applied in the field of consumer contract law. A growing

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4 Note that the usage disclosure proposed by Thaler and Sunstein (2008) is similar to the use-pattern disclosure recommended by Bar-Gill (2008).
literature models contractual behavior, whereby sophisticated firms interact with boundedly rational consumers and consumers who may have psychological biases. Firms design contract terms as a strategic response to consumer biases and competitive markets do not cure the biases due to a phenomenon called the ‘curse of debiasing’. The behavioral models are used to justify legal reform of a non-intrusive kind, like asymmetric paternalism or libertarian paternalism. Innovative forms of information disclosure mandates, like use-pattern disclosure, are recommended by behavioral law and economics scholars to help boundedly rational consumers to make informed and better choices.

Whereas the behavioral approach provides a solid basis for explaining and reforming specific rules governing consumer contracts, the value of behavioral analysis for understanding the general rules of contract law is rather limited. The behavioral approach has not produced a behavioral theory of general contract law. The difficulty lies in developing a behavioral model of general contracting behavior capable of generating testable predictions and offering reliable generalizations. This is not to say that the behavioral approach has not produced any wisdom; for example, the empirical evidence that the status-quo bias makes contractual default rules sticky is valuable information for designing default-rule policy.

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20 The civil law of contract

Ejan Mackaay*


1.1. General Features of Codified Law

This chapter presents a brief survey of economic analyses performed on contractual institutions and doctrines that are specific to civil law – as opposed to common law – systems (for more detailed analysis, see Mackaay forthcoming). What sets civil law systems apart from common law systems, besides differences in vocabulary, is that their core rules are set out in codes drafted with the aim of covering in principle all relationships within the field of law they govern. All legal problems arising within that field are deemed to be soluble by reference to, and through interpretation of, one or more provisions of the code.

Whilst codes consolidate in their provisions the solutions found to a great many practical problems that have arisen over time, it would be illusory to expect them to provide ready-made solutions to all conceivable problems. To cope with novel or imperfectly foreseen problems, whilst yet maintaining the claim to complete coverage, the codes need to resort to a small number of open-ended concepts that can be used to fashion appropriate solutions to such problems. Good faith and abuse of rights are some of these concepts.

One of the main objectives of codification in civilian legal systems is to make law accessible: all the law for a given field is in principle to be found in one place – the code – rather than in a proliferation of individual judicial

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1 The following abbreviations are used in the chapter:

BGB – Bürgerliches Gesetzbuch – German Civil Code
CCF – Code civil des Français – French Civil Code
CCQ – Civil Code of Quebec