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Freedom of Choice and Paternalism
in Contract Law: a Law and
Economics Perspective

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Freedom of choice and paternalism in contract law: a law and economics perspective

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Abstract

In this paper I discuss the conceptual and methodological background of an economic approach to paternalism in contract law. The paper is a preliminary discussion of some theoretical issues related to my PhD thesis. The topic of the dissertation can be succinctly formulated as the legal and economic analysis of paternalism in contract law. The thesis starts with some discussion of conceptual and normative issues of paternalism in political and legal philosophy, and then focuses on legal policy questions in contract law. Methodologically, my purpose is to analyse whether and how the traditional economic arguments against paternalism and for freedom of contract should be reassessed in light of recent empirical and theoretical studies. More specifically, the question is whether the anti-paternalist view based on consumer sovereignty remains valid if, following behavioural decision theory we assume that not only (at least one of) the contracting individuals but also the legislator/regulator is imperfectly rational or not fully informed. That is, whether we have to modify the traditional anti-paternalism of law and economics for anti-anti-paternalism: a limited and critical version of paternalism.

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1. Introduction

1.1. Motivation

In the introductory chapter of the leading American law and economics textbook we read: “*economists frequently extol the virtues of voluntary exchange, but economics does not have a detailed account of what it means for an exchange to be voluntary. As we shall see, contract law has a complex well-articulated theory of volition. If economists will listen to what the law has to teach them, they will find their models being drawn closer to reality.*”¹

Even if this gesture of two economists towards lawyers is to be appreciated, it cannot be taken fully seriously as it stands. Jurisprudence and legal doctrines may doubtlessly often reflect practical rationality and offer at the level of folk psychology an intuitively appealing shortcut to endless philosophical debates. More precisely there is some close-to-ordinary-language (English) or dogmatic-technical (Continental) legal meaning of voluntariness (and other concepts like causation, intent, etc.) which usually half-knowingly reflects the philosophical or scientific standpoint of earlier ages or is just expressing some naïve, folk notions.² For law as a practical enterprise this is in most cases fully satisfactory.

But what law says about voluntariness can be called a “theory” only in this “practical” sense. If we want to understand and/or criticize the rationale behind legal rules then what law regulates in this or that way has to be critically examined and evaluated from an outside perspective, i.e. from a not strictly legal point of view. For instance, it is impossible to answer from a purely legal perspective how it is to reasonably regulate the legally required degree of voluntariness of contract formation or the criteria for the judicial control of standard form contracts.³

Of course, there are several possible outside perspectives. Referring back to the quotation, the problem motivating my research is how economic analysis can face this and similar challenges posed by the law. What has an economic analysis of freedom of contract and paternalism to offer for our understanding of the logic of contract law? If Cooter and Ulen are right to say that traditional economics (and thus standard *law and economics*) does not offer a fully developed answer to such questions, we should possibly look for them elsewhere.

This paper takes the methodology of rational choice theory, as applied and modified in the *law and economics* literature as a starting point and then discuss the

¹ Cooter - Ulen 2004, 11.

² See, e. g. Hart – Honoré 1985, Watson 1974.

³ This is especially true for the contract doctrines expressed in most of the civil codes in Europe, dating from the 19th century when legal scholars deliberately worked out their doctrinal constructions, both in civil law and common law countries as markedly ‘legal’ doctrines, i.e. independently of philosophical theories. More specifically, as James Gordley has convincingly reconstructed (see Gordley 1991), the Aristotelian and Thomistic philosophical theories which were used by the late Scholastics to give a coherent theoretical structure to contract law (and other areas of private law as well) from the 16th century on, have gone to disrepute and oblivion in later centuries. But there has not been any overarching alternative philosophical theory at hand to replace them, thus the fragmentary and heterogeneous ‘legal’ doctrines of the last two centuries, most prominently the will theory of contracts.

possible limits and corrections to this approach. In this sense it proposes an “economic” analysis of paternalism in contract law.⁴

1.2. Methods

As I see it, the tools recently developed within two branches of economics can contribute to a theoretically more coherent and simultaneously more nuanced perspective on the question of freedom of contract and paternalism than we currently have in *law and economics*. Needless to say, both freedom of contract and paternalism have been discussed in economics for some time, though the systematic analysis of the problematic is relatively recent. The standard *law and economics* literature usually views paternalism as a wrong reason for limiting freedom of contract or starts at least with an anti-paternalist presumption. This, however, is not a strongly and coherently argued view. It generally uses a strange mixture of liberal and utilitarian (welfarist) arguments and relies on some questionable implicit empirical claims as well. By reconsidering the standard economic arguments and confronting them with philosophical and jurisprudential considerations, I suggest modifying the traditional *law and economics* arguments about paternalism in two ways:

- (1) The empirical findings of behavioural decision theory offer a more realistic view of the situations susceptible for paternalistic intervention,
- (2) The analytical tools of the freedom of choice literature help to clarify the non-welfarist dimension of the problem.

Then, in light of these theoretical findings, it is possible to analyse and criticise in detail some contract law rules and doctrines that at first glance look paternalist. The last part of my thesis shall be dedicated to a policy oriented analysis of these specific contract law rules. This paper, however, concerns conceptual, empirical and normative issues as the theoretical underpinnings of the policy-oriented arguments. More precisely I shall deal with some aspects of the following three *types* of questions in turn:

1. (conceptual and normative) What does paternalism mean? Is it justified to limit one’s freedom in order to promote his good? In which cases, to what extent and by whom? Why and to what extent do we need freedom of contract? What are the legitimate reasons to interfere with contracts?
2. (empirical) Do people generally and in given contexts choose rationally? Do they evaluate risks correctly? How do they process the information available for them? Are there legal or political institutions that are more suitable to evaluate certain types of risk? How do individuals (consumers) and legal entities (firms) react to different regulations, what are the side-effects and possible non-intended consequences?
3. (policy oriented) Should law interfere with not fully-informed or not fully-rational contractual agreements for this reason, i.e. in order to protect one party against a sub-optimal contract? What are the best possible instruments for that? Which contract law doctrines serve legitimate paternalistic purposes?

The thesis is built on previous research in various fields: the philosophical literature on paternalism, the economic analysis of contract law, the existing mainstream economic literature on paternalism, the recent behavioural *law and economics* literature on

⁴ For the methodological background see Cserne 2004. A more precise argument (in Hungarian) is in Cserne 2005.

paternalism (for all these see the still incomplete list of references) and offers a selective and critical synthesis of these. It also draws on the social choice and political philosophy literature on freedom of choice by adapting the results to the problem of paternalism. This kind of application has to my knowledge not yet been analysed. The most extensive last part of the thesis is novel both in its perspective when asking for the justifiability of paternalistic contract law rules of different legal systems in light of the *modified* law and economics arguments, and in its subject matter when analysing the contract law book of the draft of the new Hungarian Civil Code.

2. Paternalism and freedom of contract – conceptual and justificatory issues

Besides paternalistic individual actions (e.g. towards children), cases of *legal* paternalism also abound: from medical law (the regulation of the doctor–patient relationship), drug prohibition, occupational safety and health regulation to the mandatory waiting time before marriage and the general irrelevance of consent to mutilation and homicide on part of the victim in criminal law. Sometimes paternalism can be an issue in a very subtle way, e.g. when it is about transfer of information and true or false believes. E.g. can a physician waive responsibility for the harm to his patient if she refuses or chooses certain treatment just because she does not want to hear and accept or believe the information, given to her by the doctor? How much is the doctor obliged and allowed to convince, persuade, press and coerce the patient to have or not to have a certain therapy? Similar questions about the interference of family, friends, strangers, and officials in our life we encounter almost every day. Nevertheless, paternalism is a relatively specific phenomenon. So we should beware of the indiscriminate use of the term for any interference with freedom of choice.

As a preliminary, I should also note that for most Western people nowadays the term ‘paternalism’ itself has some negative connotation. Consequently, almost every substantial contribution in the theoretical literature on paternalism starts with discussing the possibility of a non-pejorative and gender-neutral use of the word (or the eventual need for switching to a neologism like ‘parentalism’). In the following I use the word ‘paternalism’ because of its familiarity, and use it in a descriptive (classificatory) sense, dealing with the question of evaluation (justification) separately and leaving out possible gender issues altogether. Nevertheless, the definition of paternalism is not unproblematic.

2.1. Problems of definition

2.1.1. No starting point in law

It is primarily not for the intrinsic interest of philosophical issues⁵ that I do not jump over the conceptual problem of defining paternalism and directly focus on a more doctrinal or empirical analysis. It is rather the case that it would be almost impossible to do that. Both freedom and paternalism are ‘essentially contested concepts’.⁶ Especially

⁵ For the philosophical literature on paternalism, see e.g. Sartorius 1983, Kleinig 1984, Feinberg 1986, Suber 1999, Dworkin 2002.

⁶ Gallie 1956, cf. Smith 2002.

with respect to freedom (liberty), it is impossible to find the clear boundaries or conceptual features around which there would be a reasonable degree of consensus in the literature. Even if we put in brackets the intricacies of highly abstract philosophical distinctions, it is not easy to determine what we should mean by paternalism *in law*. Although intuitively we can determine a large number of regulations which seem paternalistic, the term itself hardly ever figures in legal texts or commentaries.⁷ Thus we cannot avoid recurring to some extra-legal definition of the term, and then using it in order to circumscribe the field we have to deal with.

2.1.2. A rough definition

There are three conditions that are usually included in the definition of paternalism. Thus the paternalist

- (1) intentionally limits the subject's liberty,
- (2) acts primarily out of benevolence toward the subject, and
- (3) disregards (is not motivated by) the subject's contemporaneous preferences.

What these elements of the definition more precisely mean should become clear later on. Also, we have to make clear which related phenomena should be distinguished from paternalism. Still, substantive problems cannot be solved by definition. As indicated above, paternalism has some justifiable and some unjustifiable cases which differ not on the level of definition but with regard to their justifiability (legitimacy, reasonableness, etc.). More precisely, they can be distinguished conceptually only if we introduce some further specifications for different kinds of paternalism.

2.2. *Internal distinctions: kinds of paternalism*

In the philosophical literature, the following distinctions are usually made:

- (1) pure vs. impure paternalism: in the former case, the motive/reason behind an action, a rule etc. is only paternalistic, with impure paternalism it is mixed with other reasons. To be sure, this distinction works at the level of actions, rules, etc. while I will refer to paternalism as a reason. Thus when we speak about legal rules, their paternalistic rationale, if any, is almost always impure. This is the consequence of what I shall call below the theoretical over-determination of rules.
- (2) direct vs. indirect paternalism: this distinction is especially relevant for contract law. By regulating contracts, not only the freedom of choice of the self-harming individual (the subject of direct paternalism) but that of the other party is limited. The latter case, when A's freedom is restricted in order to paternalistically promote B's good is called indirect paternalism. Indirect paternalism, of course, can be done with or without direct paternalism happening at the same time.

2.2.1. Hard and soft paternalism

A conceptual problem about paternalism is that what free will (voluntary consent) in a specific context means is not easy to tell, as there is no self-evident reference point or

⁷ Eidenmüller 1995, 360.

threshold. Or more precisely, there are a number of criteria that should be fulfilled for an action to count as fully autonomous. In practice this is an unattainable ideal thus the autonomy is always limited. This of course does not in itself justify paternalistic intervention but leads to a useful distinction, first introduced in the literature by Feinberg. He suggests to distinguish between hard (strong) and soft (weak) paternalism in the following way. Both forms are restricting individual liberty but while soft paternalism applies to actions which are not fully voluntary or informed and thus the intervention is not especially controversial (more easily justified), in case of hard paternalism this justification is more problematic as here autonomous (self-harming) action is restricted.

The standard distinguishing feature of hard paternalism is that the subject's conduct is substantially voluntary. Thus the lack of substantial voluntariness negates the value of autonomy with regard to that conduct. There are three sub-conditions to substantial voluntariness:

1. Capability of making choices (even if the decisions are foolish, unwise, reckless, these are still decisions of an autarchic subject)
2. Substantial freedom from controlling influences such as coercion, duress, or manipulation
3. Substantial freedom from epistemic defects, such as ignorance of the nature of her conduct or its foreseeable consequences.⁸

So, if the subject's conduct is substantially voluntary, then liberty limitation with respect to such conduct is hard paternalism and conversely, if the subject's conduct is not substantially voluntary for any of the three reasons above, then liberty limitation with respect to such conduct is soft paternalism.⁹

The importance of the distinction becomes clear if we agree with Joel Feinberg that soft (weak) paternalism is not paternalism in any interesting sense, because it is not based on a liberty-limiting principle independent of the harm principle. In this case, the intervention is defended (and according to Feinberg: justified) as the protection from a harm caused to the individual by conditions beyond his control.¹⁰

At first glance, the three sub-conditions may remind one different contract law doctrines. The rules of incapacity are supposed to regulate that only people being capable of making choices (in the above said sense) can conclude a valid contract. The contract law rules of fraud, duress serve to guarantee the lack of certain substantial external controlling influences (but not the absence of others, e.g. economic necessity). Substantial freedom from epistemic defects is taken care of, e.g. via rules on mistake, disclosure or cooling-off periods and other formalities making consent more deliberate. It is in the last part of the thesis that we can analyse systematically whether this fit really

⁸ See Pope 2004, 711-713, and references there.

⁹ In the philosophical literature, T. M. Pope criticises this distinction of hard and soft paternalism as it is not defined by the reason of the agent for limiting the subject's liberty (Pope 2004). According to him, if the agent disregards (does not care) whether the subject's conduct is substantially voluntary or not and limits his liberty notwithstanding, he exercises hard paternalism. As we shall see, this is often the case when paternalism is institutionalised via general rules and applies both to voluntary and non-voluntary actions. It is, however, not clear, why we should care about this difference between the 'objective' voluntariness of the subject's conduct and the paternalist's 'subjective' perception of it at the level of definition and not at the level of justification instead.

¹⁰ This is the way Feinberg defines his version of paternalism, by saying "soft paternalism would permit us to protect him from 'nonvoluntary choices,' which, being the genuine choices of no one at all, are no less foreign to him." (Feinberg 1986, 12) For a critique, see Arneson 2005.

holds for the contract law rules under scrutiny. Thus if the answer is affirmative, and the justifiability of soft paternalism is plausible then we can possibly distinguish these doctrines from instances of hard paternalism which are more difficult to justify.

2.2.2. Further distinctions

As the concept of soft paternalism already indicates, there are some necessary connections between analytical and normative problems here. Not only the distinction between hard and soft paternalism, but some further ones are also highly relevant for the justifiability of paternalism. Thus, it is not indifferent whether the intervention is

- (1) benefit-conferring or self-harm preventing,
- (2) exercised by an individual or by the state, and in the latter case
- (3) by means of private law, taxation or criminal law.

In the following chapters the focus will be on legal paternalism via contract law rules. Here, the intervention is by the state (either through legislation or by judicial control) but with relatively non-coercive means and mostly in order to prevent harm (compared to a status quo) to be inflicted on a contracting party. As we shall see, these specificities have a great impact on the legitimacy of paternalism. Still, the general questions about the justifiability of paternalism have logical priority.

2.3. Problems of justification

2.3.1. Theoretical over-determination of rules

As mentioned above, paternalism is understood as a reason for action or in case of legal paternalism, a possible justification for a rule (being itself in need of justification). It seems to be a general human characteristic that in a given instance (action, rule) several principles are or could be in play (as explanations, motives, rationalisations etc. for the action or rule). The possible overarching theoretical systems behind more specific reasons for intervention and also the possible justifications of a concrete rule are multiple. That is, one can construct several more or less coherent explanations or justifications for a rule. They are, of course, not equally plausible or convincing. Instead of discussing this far reaching problematic in its abstract meta-theoretical form, let's see a concrete example how this problem is relevant for the justification of paternalism.

Helmets and tobacco. It is often argued that to justify the compulsory use of safety helmets or the ban on tobacco advertisements it is fully sufficient to refer to the social burdens caused by accidents and tobacco-related medical costs and thereby the 'dubious' arguments about autonomy, coercion etc. can be avoided. In contemporary European countries with universal (i.e. nationwide and compulsory) social security systems, we can allegedly avoid referring to paternalism in order to justify the prohibition of certain self-harming behaviours and can "simply" refer to the external effects, i.e. the financial burdens that a given action would cause – provided self-inflicted harms are not excluded from the coverage of social security.

But it is possible that in pure social expense terms these paternalistic rules are counter-effective. While certain accidents without safety helmets often cause death, helmets usually save "only" the life of a severely disabled (i.e. in social expense terms

burdensome) person. Without smoking people live longer on average, thus it might easily be that they use up more social funds (mainly in form of pension) than smokers who die relatively early, near to the end of their working career. Not denying that if these effects are empirically provable, they are remarkable from a purely economic perspective, still they are not workable as ‘public reasons’ in the Rawlsian sense.¹¹ If we don’t want the arguments about paternalism to run fully against our intuitions, we should take paternalism seriously, and possibly also acknowledge the relevance of some non-welfarist arguments, as I will argue below.

The example serves to illustrate that if a rule is impurely paternalistic, i.e. there are several reasons behind it, we have to analyse each reason for its plausibility. Then we can see whether these reasons, taken together are enough to justify the rule.

In law we can see this uneasy relationship of general principles and specific rules very clearly. Namely, if we want to analyse a given legal doctrine non-dogmatically, i.e. not by asking for its technicalities, wording, or its place in a larger body of the legal system etc. but critically, looking for reasons justifying it, we often find that a given rule can be backed by several, often contradictory principles. Due to this over-determination we might not see clearly if a given rule is the expression of paternalism, self-interest of an influential group, symbolic expression of a generally held value (moralism) or the instrumentally rational response to an externality problem. To be sure, what matters are not the (unobservable and contradictory) subjective *intentions* of the lawmakers but the possible justifications for a legal rule. Of course, the legitimacy and authority of law largely depends on whether its rules are enacted and enforced for the right reasons.

2.3.2. Paternalism as linked to modern individuality

Historically, the problem of justifying paternalism is linked to the raise of liberalism and the value of individuality. Speaking about the same phenomenon in earlier ages and different cultures, we are inclined to use another term, patriarchalism.¹² Patriarchalism is a social order in which the patriarch’s concern to secure his own and his subjects’ individual good is subsumed under a conception of the general good that gives it definition and to which it contributes. E.g. in the medieval European social and cultural setting, characterised by general views on the *relational nature* of the self who is embedded in his roles, patriarchalism was backed by generally accepted values. By contrast, in case of paternalism (as a typically modern concept) we conceive the good of the paternalised individual as sufficiently independent of the good of others or some social whole to constitute *on its own* a focus of attention.

¹¹ See Rawls 1993, Gaus 2003, Larmore 2003. We shall come back to the problem of public reason and overlapping consensus in sec. 2.3.4.

¹² At least, according to the standard narrative in the history of political thought which attaches much importance to John Locke as a liberal political thinker and his critique of Sir Robert Filmer’s work, *Patriarcha* in the *Two Treatises of Government* (see Filmer 1991).

2.3.3. Freedom and benevolence

In defining and evaluating paternalism, we shouldn't confound words. There might be other values competing with freedom (autonomy) and not everything valuable is a sort of freedom. So if we want to limit freedom of choice in certain situations, then it is better to say that in a given case there are good reasons for preferring something else, e.g. well-being or security to freedom, instead of arguing that it is 'real' or 'positive' etc. freedom that is promoted by paternalism.¹³ At least if we define paternalism in the way that it implies doing something against the (free) will of the agent.

As mentioned before, paternalism is a certain kind of *reason* that we may use to justify or condemn restrictions of liberty. Liberty-limiting principles include mainly (1) the harm principle, (2) the offence principle, (3) moralism, and (4) paternalism.¹⁴ Since J. S. Mill's ideas about the limits of state power and the harm principle as the only justification for the use of coercion against competent individuals has become widespread in the Western world, paternalism has been a central problem of legal and political theory.¹⁵ Paternalism is problematic from the liberal point of view as it implies promoting the good of a person against his (free) will thus violating individual autonomy for the sake of the individual's welfare. The freedom-diminishing character of paternalism raises a moral question about it. As for justification, paternalism is not such an essentially condemnable thing as murder: in a formal sense it is rather like killing which has justified and unjustified cases.¹⁶ The moral interest of paternalism comes from the juxtaposition of two values: freedom and benevolence.¹⁷ In law, and especially in contract law there are also some specific arguments for or against paternalism, as we shall see below.

2.3.4. Overlapping consensus: avoiding metaphysics

Despite the general acceptance of the importance of liberty as a social and political value, in the Western world, there is much disagreement about why to value it and how to compromise it with other values. Accordingly, in the contemporary philosophical literature there is no consensus on the justifiability of paternalism. Looking at the end-result we can roughly distinguish three standpoints: (1) hard anti-paternalists consider paternalism generally, thus even in its soft form unjustifiable; (2) soft anti-paternalists distinguish hard and soft paternalism and condemn only the former; (3) finally there are those who argue that even hard paternalism can be justified in certain contexts. In contrast to law and legal reasoning, however, in philosophy the way of the argumentation is often more important or interesting than the end-result. Paternalism can be supported or attacked with very different arguments. Looking at the extensive philosophical literature on the topic, it seems difficult to decide between the three

¹³ Still this seems to be the view expressed in Burrows 1993, one of the few L&E articles in favour of paternalism.

¹⁴ For a more elaborate categorisation see Feinberg 1986, xvi-xviii.

¹⁵ There is now an enormous body of secondary literature on Mill's *On Liberty*. As one of the most thoroughgoing contemporary critique see Stephen 1992. As a starting point for the contemporary interpretations see Dworkin 1997.

¹⁶ Kleinig 1984.

¹⁷ Kleinig 1984, ch. 1.

standpoints without discussing such far-reaching questions as the nature of the good and the meaning of free will.

Still, my aspirations in this thesis are much more modest. As far as normative philosophy is concerned, I try to avoid taking side in far-reaching metaphysical debates in this work. Basically I will follow John Rawls' ideas about 'public reason' and 'overlapping consensus' and thus use arguments that can be, on a middle level of abstraction, acceptable or at least reasonable from several comprehensive philosophical/ethical perspectives.¹⁸ Although I don't think that this is the only reasonable way to do political/legal philosophy, by speaking about legal issues of more practical concern, the idea of searching for an overlapping consensus seems quite attractive and plausible. Even such a prominent figure of the *law and economics* movement as Richard Posner once argued for this idea as one possible basis for a general acceptance of the minimisation of social costs as the objective of tort (accident) law.¹⁹

Here we have to see whether a similar consensus is possible in another relatively specific area, the limitation of freedom of contract for preventing harm to a contracting party. To be more concrete and come closer to our topic, Michael Trebilcock brilliantly shows in his book on the limits of freedom of contract²⁰ how a given legal rule erecting such a limit can be backed by arguments coming from different legal and political philosophies. When analysing legal rules of contract, often we can show that the freedom of contract or an intervention limiting it can have several justifications which are not necessarily coherent with each other. On the other hand, I will try to find and use arguments which are capable of creating this overlapping consensus in a limited area of law: the law of contracts.

Just to indicate what a possible overlapping consensus about the scope of justified paternalism in contract law might be, I refer to a stylised version of the deontological (autonomy-based), the consequentialist (welfarist), and the perfectionist (Aristotelian) perspective. From this we can see that the practical conclusions of different philosophical arguments might be quite similar.

1. If one says that people should have the right to choose self-harming actions because there is an intrinsic value of freedom of choice, he still softens this anti-paternalist standpoint by allowing for intervention in certain cases.
2. If one's starting point is the good (well-being) of the person, as he himself conceives it, and additionally we have an empirically based presumption that freedom of choice promotes well-being, still this presumption can be refuted in any instance. More weight can be given to the value of freedom itself by acknowledging that the freedom to make one's own choices is a component of this well-being.
3. And what if the philosophical starting point is neither libertarian (deontological) anti-paternalism (like in 1.) nor a welfarist (consequentialist) view (like in 2.) but a perfectionist (communitarian) one? In this view one should strive for a good which is supra-individual (the overall utility, happiness, etc. of a community) or compare the individual's actual actions and decisions with a morally or otherwise superior preference or value system. It is nevertheless possible to argue that in several cases the individual is the best judge of how to

¹⁸ See Rawls 1993.

¹⁹ R. Posner 1995, 505.

²⁰ Trebilcock 1993.

attain this state of affairs or/and that in certain cases a third party, especially the state is not able to promote this good better than the individual.

To be sure, in Rawls' view overlapping consensus is not simply a compromise reached by softening or mixing irreconcilable views. I should not follow this idea here, only indicate that there are good arguments that there are conceptions of perfectionism and liberalism that do not exclude each other²¹ and to some extent they can also be harmonised with economic theory.²²

2.3.5. What paternalism is not: an eliminative strategy

In view of both the theoretical over-determination of rules and the historical and philosophical conditions, a possible strategy for justifying a given legal rule with potential reference to paternalism is the following. Paternalism is considered as a residual category, meaning that if we can find a (possibly implicit) reason for intervention in terms of a market failure or some third party effect, we should give priority to them and not attribute the regulation to paternalistic purposes. This strategy, of course, is mainly pragmatic and I only intend to apply it to the analysis of contract law not mentioning such areas as criminal or medical law (e.g. euthanasia) where both market failure and externality count for rather weak arguments, if at all. Still, even in the contractual area, as we shall see in part 4, there are possibly other reasons not falling into the category of externalities or market failure which are nevertheless not paternalistic. As examples moralism or other reasons relating to commonly shared values might come into mind where it is not the subjective good of the individual (or other specific persons) but some objective value is served by the regulation.

This eliminative strategy is helpful both in making clear the fundamental differences of paternalism and other reasons and in the pragmatic structuring of the arguments, especially in part 3 where the different ways of economic modelling of paternalism will be discussed. But it cannot spare us the direct confrontation with paternalism.

2.3.6. Justification through redefinition?

As noted above, the moral problem about paternalism can be seen as a conflict between freedom and benevolence. Still there are alternative views that redefine paternalism in such a way that it looks also normatively more acceptable. Some of these redefinitions are especially characteristic for the economic approach to paternalism, so we will discuss them in detail in part 3.

Maximising freedom. Horst Eidenmüller (along with less economically minded

²¹ Marneffe 1998.

²² Deneulin 2002, Buckley 2005a, b. In its most abstract form, perfectionism is a moral theory which views the human good (flourishing, excellence) as resting on human nature. Perfectionism has an ideal for each human: that he develops his nature. It accepts self-regarding moral duties, thus it tells us something about what we should choose for ourselves. In contrast to other moralities which hold that the good is subjective and thus exclude any claims about what humans ought to desire, perfectionism has an objective theory of the good. Nevertheless, for our purposes perfectionism is not so much relevant as a personal morality, rather as a political one, i.e. a normative idea about the aims of a political community, eventually formulated in legal rules. Specifically, but formally, perfectionism holds that "the best government most promotes the perfection of all its citizens." (Hurka 1993, 5.)

other German legal scholars, e.g. Michael Eberlin²³) considers paternalism justified only (or usually at least) if it *promotes* autonomy.²⁴ Freedom maximisation, the term used in Eberlin's monograph for the same idea of autonomy-promoting paternalism, refers to the normative idea that the freedom of choice of an individual not only may but should be restricted in the present if this promotes, on balance, his freedom in the future more. Of course, to make this idea any more than intuitive, we should be able to compare present and future freedom, *a fortiori*, to measure freedom. This problem will be dealt with in section 3.3. as well.

Collective self-protection. Eidenmüller also states that in the justification of paternalism first we have to recur to general constitutional principles and "objective values" expressed in the constitution. Then in the second turn, in a non-legalistic sense, i.e. beyond the reference to the constitution the justification can be based mainly on some sort of hypothetical consent. More concretely, reference is made to weakness-of-will and the institutions that are collectively imposed to protect against it. In this way, in a democratic state legal paternalism is nothing else but collective self-paternalism (of the majority). It is similar to what has been discussed in rational choice theory on the individual level with reference to the paradigmatic case of Ulysses and the sirens, i.e. the autonomous, rational side of the self defending itself against the irrational other.²⁵ This line of reasoning seems promising for justifying certain limitations of freedom of choice and is not necessarily (logically) linked to hypothetical consent at all.

In my view, it is more problematic to justify paternalism (especially hard paternalism) by *hypothetical consent*.²⁶ This approach is debatable on a level more general than the problem of paternalism would suggest. The essence of the problem is that the hypothetical consent behind the rule runs, in case of hard paternalism, against the *actual* will of the subject. As it has been discussed widely in the literature on "social contract", hypothetical consent as such does not live up to justify a rule or a regime, it is at best a metaphor referring to the public nature of arguments that rational individuals have reason to accept as justifying the rule. More specifically, if we take the fact of reasonable pluralism (Rawls) into account, it is rather improbable that there are a large number of hard paternalistic rules that can be backed by such hypothetical consent even in this reinterpreted sense: the very nature of the problem, namely that paternalism is about finding out (and enforcing against his will) what serves the good of a person, indicates that the core of the problem is "defined away" but remains unsolved if we assess paternalism in terms of a hypothetical consent.²⁷

2.4. Two specificities of legal paternalism

2.4.1. Over-inclusiveness and redistribution

Legal paternalism has to deal with a specific problem worth mentioning. Additional to the justification of the limitation of freedom in individual cases, the *legal* nature of paternalism, i.e. that it is formulated in general rules is problematic as well. Thus even if

²³ See, e.g. Enderlein 1996.

²⁴ Eidenmüller 1995.

²⁵ Cf. Elster 1984, 2000.

²⁶ This issue was discussed at the conference by my commentator, Prof. Dieter Schmidtchen. At this point I only present the sketch of the argument why I do not think this line of justification workable.

²⁷ This argument should be more elaborated on.

it might be justified to interfere in individual cases, the general rule would diminish the freedom of those who do not need to be assisted. This problem of the *over-inclusiveness* of rules vis-à-vis their background justification is the consequence of the generality of rules when the cases (subjects) are heterogeneous.²⁸ It is not unknown in the *law and economics* literature either. In a sense, it is a special case of how to find the optimal mix of rules and standards (or the division of labour between legislation and the judiciary) in regulation. In another sense, it points to the *redistributive consequences* of paternalism.²⁹ Namely, the costs of paternalistic rules are born by the rational individuals who do not need the assistance of the law but are actually impeded by it to carry out their actions as they want.

2.4.2. Uniformed regulator

There is a further instrumentalist argument against all sorts of paternalism which is independent of the Mill-Feinberg line of autonomy-based reasoning but, to be sure, used by libertarian authors as well. Thus, following the Hayekian line of arguments about the dispersed nature of knowledge in society, serious doubts can be raised about the superior knowledge of the *pater*. To put it very simply, the argument is that even if the paternalist legislator is benevolent, he is possibly ignorant about what promotes the good (well-being, happiness etc.) of the paternalised individuals. This argument is quite strong and it has bite against a much wider class of reasons than paternalism. In its extreme form, it works against all non-spontaneous, deliberate, planned law and rule governing the behaviour of others; though in this unqualified form and being not specific, its relevance is rather limited at this point. Still in part 3 and 4 we shall come across similar arguments.

2.5. Freedom of contract

Freedom of contract is an ideologically charged notion which may attract strongly-held political beliefs but which eludes the interest of the lawyer in his everyday work for the most part. Nevertheless, the question of freedom of choice and its limits have crucial importance in law, especially contract law. For instance, the validity of a contract, liability and remedies are often conditional on the (in)voluntariness of one party's action. There are also several typical cases when modern legal regimes set limits on the general principle of freedom of contract, for good or wrong reasons (labour law, consumer protection etc.). Paternalism is arguably one of these reasons.

Let's see briefly how freedom of contract is treated in moral and legal philosophy. Behind the law of contracts, a central subject area of private law lays a broad set of economic, social and political values that define the role of markets in modern developed countries. But markets are not the sole mode of social organisation. As Heilbroner argues, societies organise production and distribution basically through three institutions: tradition (social conventions and status), command (centralised information gathering and processing and coercion) and market (decentralised decisions). Most of the societies usually combine all these three organisational modes. At the same time a modern developed society, mainly based on market-type production

²⁸ The classic literature on the topic is Schauer 1991. See also Schauer 2003.

²⁹ See Mitchell 2005.

and distribution has to cope with certain backdrops of the market economy relative to the two other modes of social organisation (such as the potential for dramatic shifts in consumption and production, the destabilisation of personal, social and communal relationships, and a significant degree of inequality). Despite a relatively wide consensus in favour of economic liberalism and the market economy, there remain many troubling and potentially divisive normative issues about the extent of markets and freedom of contract.

Michael Trebilcock calls this consensus, together with its theoretical underpinnings the *private ordering paradigm*. In neo-classical economics this "predilection for private ordering over collective decision-making is based on a simple (perhaps simple-minded) premise: if two parties are to be observed entering into a voluntary private exchange, the presumption must be that both feel the exchange is likely to make them better off, otherwise they would not have entered into it."³⁰ To rebut this presumption, the economist has to refer either to contracting failures or market failures. These constitute (from an economic perspective) the reasons for the limits of freedom of contract. Or, as Milton Friedman has put it: "The possibility of coordination through voluntary cooperation rests on the elementary – yet frequently denied – proposition that both parties to an economic transaction benefit from it, provided the transaction is bilaterally voluntary and informed."³¹

Besides the consequentialist arguments used in economics there are, as we have already referred to it, non-economic justifications for the primacy of private ordering (and the rejection of paternalism) which are based on individual autonomy (negative liberty) as a paramount social value. These liberal theories see the law of contracts as a guarantee of individual autonomy. On the other hand, there are some other stances of political philosophy which are more ambivalent toward freedom of contract, such as theories based on the positive (affirmative) concept of liberty which are concerned with the fairness of distribution of welfare (equality) in society; and communitarianism that emphasises the essentially social nature of man (fraternity).

These four theories about freedom of contract partly cohere and converge but partly contradict each other. To be able to construct a normative theory of the law of contracts and deduce arguments from it for or against certain limits of freedom of contract, the complex relationship "between autonomy values and welfare (end-state) values (efficiency, utility, equality, community)" shall be cleared.³² If we explore the congruencies and conflicts between current moral and political philosophies and their normative implications regarding the fine details of the law of contracts and then contrast them with our moral intuition and legal rules in force, we will probably come to the conclusion that neither autonomy-based theories nor different sorts of utilitarianism nor communitarianism can offer alone a coherent theory about freedom of contract. This, of course, does not come as a surprise – the question is rather whether there is a reasonably large range of overlapping consensus between these theories. For our present purposes, it is important to see that the "convergence claim" (i.e. that a market ordering and freedom of contract simultaneously promote individual autonomy and social welfare) may be true in certain contexts but it is not robust enough to be true in general.

³⁰ Trebilcock 1993, 7.

³¹ Friedman 1962, 13.

³² Treilcock 1993, 21. As an ambitious recent meta-theoretical attempt to integrate welfare-based and autonomy-based theories of contract, see Kraus 2002. For an argument that law and economics offers the only acceptable theory of contract see Buckley 2005a.

An additional lesson, which has to be elaborated more in the thesis, is that there are problems (market failures) which cannot be appropriately addressed judicially, i.e. in a contract law setting where private law constrains the freedom of contract. This can be thus an argument for a mix of policy instruments.³³ In general, the plurality of the theories represents confronting purposes which, in turn can be achieved only by a plurality of institutions.

3. Analysis of paternalism with economic tools: mainstream and others

Freedom of contract and paternalism are perhaps too general issues to be very commonly treated in *law and economics* in this way, but they are especially interesting as they point to the limits of economic methods in the social scientific research of legal problems. In this sense, the subject raises a number of methodological problems for economics. More precisely, in the analysis of legal paternalism my starting point is the economic literature on (contract) law based on rational choice methodology. But as the findings of this branch of literature are rather unsatisfying when applied to the problem of paternalism, the research methods themselves come into focus – at least in this part of my work.

3.1. Paternalism in the mainstream

3.1.1. “Consumer sovereignty”

Utilitarianism or welfarism, arguably (in one form or another) the principal background philosophy of contemporary economics is used to be criticised on the basis that it accepts existing preferences as given, it does not offer “ethical criteria for disqualifying morally offensive, self-destructive, or irrational preferences as unworthy of recognition.” If, on the contrary, economic theory acknowledges some exceptions, as it usually does (e.g. in case of minors or mental incompetents) then “some theory of paternalism is required, the contours of which are not readily suggested by the private ordering paradigm itself.”³⁴

Of course, when we come about with suggestions for intervention etc. we rely not only on a standard of voluntariness but also on a standard of rationality, according to which weakness of will, sour grape mechanism etc. are irrational behavioural patterns. This strategy implies, however that we are measuring real world individuals on a kind of artificial scale. We are rather speaking about abstract subjects of a certain quality: rationality as put equal to autonomy (one’s preferences are to be respected in any case if they reflect his desires). Now, this autonomous self can be in conflict with the other features of the very same person, or in other terms, with different selves. Beside other problems with multiple self models applied in law, here is one important from a methodological viewpoint. It is not evident which features belong to this abstract person and what counts for an anomaly that needs or justifies a cure. This is an everyday methodological problem in economics. E.g. it is not clear if extreme risk

³³ Treilcock 1993, 248–261.

³⁴ Treilcock 1993, 21.

aversion is to be corrected for or an individual's risk attitude is just a *datum* which cannot be the object of regulation, manipulation etc. as belonging to the preference structure of the person making the decision. In sum, if the only basis for evaluating actions, rules, policies etc. are revealed preferences, it leads both to normative and conceptual problems. More importantly, it makes hard to understand the problem of paternalism.

3.1.2. Justifying paternalism “by eliminative redefinition”: *ad hoc* amendments

The rather meagre body of systematic economically-minded literature on paternalism³⁵ tries to justify paternalism roughly in the following way. For some cases paternalism is redefined or “explained away” by showing that a given policy can be justified by (1) externalities or (2) market failures. For instance in case of informational asymmetries we have to deal with some boundary cases of paternalism and correction of a market failure. In still other cases, consumer sovereignty is questioned by introducing the concept of (3) merit wants and merit goods,³⁶ i.e. formally modelling the individuals' utility function that the policy maker has to maximise differently from the way the individual perceives it. Still other models introduce specific (*ad hoc*) assumptions about the preference structure of the individuals, such as (4) path-dependent preferences, (5) dynamic inconsistency, or (6) multiple self models. There are finally such heterodox approaches that want to remedy the simplistic reduction of every normative instance to preferences over outcomes by (7) stressing the difference between what one desires vs. what one has reason to value, or by (8) highlighting the need for including freedom and/or fairness in the economic models.³⁷

As the concept of paternalism is neither legal nor economic, it should not come as a surprise, that (as noted above in sec. 2.1.1.) both lawyers translate it to their traditional doctrinal concepts and economists explain it away or model it in a more or less *ad hoc* way. This redefinition makes possible to use the standard tools of the discipline to handle a problem originally formulated in another language. Thus the eliminative redefinition of paternalism in economics is arguably the natural way to treat the substantive problem indicated by the concept. Indeed, at first glance it is relatively easy to incorporate paternalism in mainstream economic analysis: we just have to define specific preferences and/or specific informational imperfections and asymmetries.

3.1.2. Need for methodological change?

Still on a more general methodological level this is not unproblematic. It is deviant (the basic premise of consumer sovereignty or the ultimate decisiveness of (revealed) individual preferences is given up) and unknown (what should replace it). Although ultimately it can only be decided case by case which way of modelling is to be taken, I think that the tools recently developed within two branches of economics can contribute

³⁵ E.g. Burrows 1993, 1995, Zamir 1998. On paternalism in contract law, see also Kennedy 1982, Kronman 1982, Spengel 1988.

³⁶ See e.g. the still very illuminating summary article by Head 1966.

³⁷ In the thesis, these economic conceptualisations of paternalism shall be analysed in detail.

to a new perspective on the question of freedom of contract and paternalism. This perspective is potentially more coherent and fruitful than we currently have in economics.

As for the substantive questions at issue, by confronting economic arguments with philosophical and jurisprudential considerations, I suggest modifying the traditional law and economics arguments about paternalism in two ways: (1) the empirical findings of behavioural economics offer a more realistic view of the situations susceptible for paternalistic intervention, (2) the analytical tools of the freedom-of-choice literature help to clarify the non-welfarist dimension of the problem. These two schools are different concerning their theoretical background but their implications for contract law might complement each other.

On a more concrete level, as Russell Korobkin argued in a recent paper,³⁸ if our purpose is to come up with legal policy recommendations, we have to decide pragmatically, in each concrete case, whether the rational-choice or the behavioural theory offers a more plausible explanation of the phenomena analysed. Thus one way to deal with paternalism is by using specific assumptions in a traditional framework. Alternatively, we can rely on the emerging literature of behavioural (law and) economics. In any case, it is primarily the service of psychologists and behavioural scientists to have systematically analysed the possible target situations of paternalism.

3.2. Behavioural law and economics

3.2.1. Rationality

In light of this, in analysing paternalism in contract law I draw on findings of behavioural *law and economics* about how people behave in front of legal rules in experimental or real world settings. Here, the assumptions concerning the rationality of individual choice have an important but limited role. Without going into details now, I only mention that to use the assumptions of instrumental rationality and utility maximisation in modelling in an *explanatory* science only makes sense as long as the hypothesis that people in real world settings do indeed behave according to these rules, has some plausibility. In other terms, rational choice theory is a *normative* theory about how a rational individual *should* decide and choose. The use of these models in an *explanatory* context is thus “parasitic”³⁹, i.e. secondary to its role as a normative standard and conditional on it. If we want to understand and explain how real-world people behave in front of law we have to draw, at least *in some contexts* on non-standard economic models of individual decision-making, including bounded and biased instrumental rationality or expressive rationality.⁴⁰

Rationality as such has a strong place in social science. But rationality is defined in behavioural law and economics at most negatively, as the absence of Savage-type rationality. Behavioural law and economics does not rest on a single theory or definition

³⁸ Korobkin 2004.

³⁹ See Sen 2002, 43.

⁴⁰ One short remark on bounded rationality is in place. Here not the more specific ideas of Herbert Simon about satisfying behaviour etc. are meant (there are good arguments that this is one very specific model and there is no empirical support that it would be correct context-independently, in a wide range of real world issues) but the more general (and thus less precise) idea that human behaviour systematically deviates from the standard models of rational choice.

of bounded rationality that would allow the decisions of the contracting parties to be axiomatised. In this matter the theory remains inductive: there are specific behavioural regularities which are highly relevant for us, even if we cannot fully explain them.

3.2.2. Relevance for contract law

Why and how can thus behavioural decision theory be interesting for the economic analysis of contract law? The empirical findings of behavioural economics on the cognitive characteristics of contracting parties are abundant and relatively widely known. Intuitively, these well-documented and systematic cognitive deficiencies of individuals may justify some (soft) paternalism in certain contractual contexts. Thus a careful choice of potentially sticky default rules,⁴¹ the imposition of mandatory warnings or cooling-off periods are some forms that seem justified in light of these results. In general, behavioural law and economics argues for a change from anti-paternalism to anti-anti-paternalism, i.e. a critical, qualified and limited paternalism which takes into consideration that not only (at least one of) the contracting individuals but also the legislator/regulator is imperfectly rational or not fully informed e.g. about certain risks.⁴²

3.2.3. Problems with the behavioural approach

Several proponents of behavioural law and economics refer to the well-documented deficiencies of human rationality⁴³ which *per se*, in their view, justify paternalism or at least anti-anti-paternalism. But this literature is often not explicit about the normative issues involved in the problem of paternalism or tries to reduce them to a welfarist calculus of costs and benefits. In the literature informed by rational choice theory, there is a conceptualisation of paternalism (different from the usual philosophical approach mentioned above) which treats the question of paternalism as a multiple self problem or even an ‘intra-personal externality problem’. In certain cases of soft paternalism (i.e. when the paternalised subject is *not* a fully competent and fully informed individual), it is possible to argue that by imposing on him we defend his true self against weakness of will or mistake etc. E.g. those who argue for ‘asymmetric’ paternalism on a behavioural economic basis,⁴⁴ tend to compare the real world agents with the fully rational individual (assumed in orthodox economic models) and to say that bounded rationality is something which can be justifiably regulated in a similar way as externalities. Here, of course, we have, first, to suppose the existence of a true ‘inner self’ characterised by such desires and beliefs which are undisputed, accepted as rational (or at least not irrational in a way requiring intervention) and, second, to explain the behaviour of real world individuals as cases when this inner self falls prey to certain anomalies.

As already mentioned, it is not always easy to tell what is given and part of the autonomous self and what is potential subject to paternalistic correction. Attitudes toward risk, for instance, are usually taken as datum. But in the experimental results we

⁴¹ For a useful overview of the theories explaining this stickiness see Ben-Shahar – Pottow 2005.

⁴² Jolls et al., 2000. A useful German summary of the literature is Englerth 2004.

⁴³ I refer here to the literature on hindsight bias, availability heuristics, framing effect, prospect theory etc.

⁴⁴ Camerer et al. 2003. See also Rachlinsky 2003, Sunstein – Thaler 2003a, b, Mitchell 2005.

see that these attitudes are context-dependent, differ for gains and losses, and depend also on the amount of value at stake – the cognitive background of risk perception is thus too complex to allow for an easy conclusion.

There is a further problem with this sort of definition of paternalism. If consumers had the choice between possible default rules, mandatory warnings, cooling-off periods (these are some typical forms of rules suggested by the adherents of ‘asymmetric paternalism’) in an individual manner, maybe they would want some protective rules for themselves. Then the regulation cannot, without qualification, be called paternalistic. It is rather the expression of a hypothetical consent or the collective self-protection of the boundedly rational individuals against their own weakness of will, etc. This reformulation of the paternalistic rules as the result of *collective self-protection* could illustrate the more general point that not every legal regulation intending to promote or defend consumers’ interest can be called paternalistic just because of this purpose.

The behavioural literature often reflects a strong and devoted antipathy towards philosophical discussion of the problems of paternalism. They claim to be the representatives of ‘pure science’, offering hard empirical facts and being able to cut through dusty disputes about “faith” by pointing at empirical facts.⁴⁵ I think this attitude is rather unfortunate. Empirical research is crucial in answering questions about the best possible way to design legal rules of paternalism and even in the discussion of the reasons for paternalism.⁴⁶ But this literature also uses a normative benchmark, namely that of welfare, measured in an acknowledgedly simplistic way by cost and benefits.⁴⁷

3.2.4. Asymmetric paternalism

More precisely, it is argued that ‘asymmetric paternalism’ is justified (in a firm/consumers setting) if

$$(p * B) - [(1-p) * C] - I + \Delta \Pi > 0,$$

where B denotes the net benefits to boundedly rational agents, C is the net costs to rational agents, I stands for the implementation costs, $\Delta \Pi$ denotes the change in firms’ profits, and p is the fraction of consumers who are boundedly rational (all other consumers are supposed to be fully rational). Thus “a policy is asymmetrically paternalistic if it creates large benefits for those people who are boundedly rational while imposing little or no harm on those who are fully rational.”

This formula, of course, only illustrates the structure of the problem of legal paternalism. It is not the purpose to measure and quantify these variables but to highlight who are the beneficiaries and who bear the costs of a paternalistic intervention. Still, these trade-offs are not one-dimensional.

3.3. Freedom of choice: the non-welfarist dimension of paternalism

Even if we put aside the question whether this kind of literature *can be* successful in

⁴⁵ Camerer et alii 2003, 1222.

⁴⁶ On the empirical research in contract law scholarship see Korobkin 2002.

⁴⁷ Camerer et alii 2003, 1219.

reducing the problem to an issue of facts, i.e. whether and how the method of only using arguments about costs and benefits can be justified, it is important to see that the costs (and arguably some of the benefits) of paternalism are to be measured in terms of freedom of choice and opportunities, where not only the desirability of the outcomes but also the value of the very act of making a free choice matters. Originating from A. Sen's article on the impossibility of a Paretian liberal,⁴⁸ there is now an emerging branch of social choice theory literature dealing with this dimension of freedom of choice.

As noted above, the traditional economic approach to freedom of contract is an unreflected mixture of liberalism and utilitarianism and as such it cannot handle the problem where these two principles are in conflict. Thus also on a more abstract level the potential conflict of wealth-maximisation and autonomy draws attention to the non-welfarist dimension of the problem of paternalism.

The philosophical literature on autonomy, liberty, and paternalism often lacks the conceptual rigour or the degree of formalisation which would make the arguments directly accessible for the economic analysis. And conversely, economists cannot include relevant and important philosophical ideas in their analysis as long as they cannot translate them to their own language. Hence the relevance of the economic analysis of freedom of choice and the use of social choice theory to formalise, measure and evaluate freedom of choice.⁴⁹ Authors of the freedom of choice literature, besides searching for a formal method to measure freedom of choice, usually argue for the importance of non-welfarist measures of well-being, including freedom. This literature treats paternalism, if at all, as a restriction of autonomy and freedom and evaluates it in a clearly negative way. As I have indicated above, even if this involves a pragmatic compromise between freedom and other values, the unqualified anti-paternalism has to be abandoned. Still, the insights of the economics of freedom of choice are crucial in making possible to analyse the issues about freedom in a conceptually clear and rigorous way.

3.4. The lesson of part three

In sum, the lesson of part 3 is this: if we want to analyse the problem of paternalism in contract law economically while not neglecting the questions of autonomy involved, we should adapt the methodology of standard law and economics scholarship to the object under study. Still, how to do this more precisely cannot be decided *in abstracto*. It is to be found out during the very process of the analysis of specific contractual rules which is still ahead.

4. The proper role of paternalism in contract regulation

4.1. The legal policy perspective

By legal policy I mean a more or less coherent system of proposals for reforming (or interpreting) legal rules. The basic idea behind such proposals is that law should fulfil certain hypothetically or tacitly accepted normative criteria. In the *law and economics* literature (Pareto or Kaldor-Hicks) efficiency is the most important among them. This

⁴⁸ Sen 1970.

⁴⁹ Cf. Van Hees, 2004, Sugden 1998.

part of the thesis, following a policy perspective is concerned with some concrete rules in contract law from a practical evaluative point of view. More specifically, I will deal with questions about the optimal amount of paternalistic regulation in contract law and then make proposals how to improve them. This level of analysis is, to be noted, based on the justification of paternalism (“what are the reasons for leaving people freedom of choice or to intervene paternalistically?”) and some empirical facts or hypotheses (“what are the effects of freedom of choice in contract law, what is to be expected as the result of legislative intervention?”) and combines them in order to contribute to the legal policy discourse about the best legal means to achieve some (at this level) given goals.

4.2. The economics of contracts vs. the economics of contract law

The economic analysis of contracts and the economic analysis of contract law are two different research areas. The second is much more specific, relates mainly to the institutional (legal) framework in which transactions, governed by contracts, take place. But the two areas are not in a simple whole and part relation because, normatively, one objective of legal scholarship is to design contract law in such a way as to influence the contracting parties in a certain direction or at least to offer a framework within which they operate.

What is then the role of contract law from an economic perspective?⁵⁰ In general, it facilitates the voluntary (and well-informed) exchange of well-defined and exclusive private property rights. First, it is a “check on opportunism in non-simultaneous exchanges by ensuring that the first mover, in terms of performance, does not run the risk of defection, rather than co-operation, by the second mover.”⁵¹ Second, it reduces transaction costs. Third, it provides a set of default or background rules where the terms of a contract are incomplete. Fourth, it distinguishes welfare-enhancing and welfare-reducing exchanges.

4.3. The specificity of contract law with respect to paternalism

There is some specificity of contract law with respect to paternalism. It is an area where, as a general rule, a private ordering, namely the provisions of their contract apply to the individuals. Following the principle of freedom of contract, the state only enforces the promises the parties make to each other. Thus the general libertarian claim that law *as such* is interfering with individual autonomy and therefore is essentially paternalistic possibly does not apply to contract law.

4.3.1. Two forms of contract regulation

Another specificity in contract law is that here paternalism can be observed in two different forms. First, it may be found in regulation by legislative or administrative rules, formulated in general terms and applicable to every individual case uniformly.

⁵⁰ The economic literature on contract law is extensive. For an excellent recent summary of the standard law and economics view see Shavell 2003. This kind of analysis also fits under the heading contract regulation. On this see Hadfield 2005, Rubin 2005, Schwartz 2000, Schwartz – Scott 2003. On contract economics, see e.g. Werin – Wijkander 1992.

⁵¹ Treilcock 1993, 16.

These rules lie, structurally or doctrinally, often outside of traditional body of contract law (e.g. in labour law, administrative law. etc.) even if they restrict the power of individuals to bind enforceable contracts. (On the relevance of this doctrinal separation, see the next sec.)

On the other hand, there are several contract law doctrines which can be interpreted as motivated by paternalism. These are usually formulated as vague standards, leaving a relatively wide scope of discretion to the judiciary. For instance, it is for the judge to determine in individual cases whether a certain provision of a contract is “unconscionable”, “immoral” or “grossly unfair”.

To be sure, we face the usual trade-off implied by standards here. If the question of the legality (enforceability) of a contract term is left to *ex post* case-by-case determination, then the over- and under-inclusiveness of a general rule is avoided at the price of more *ex post* regulation by judges.

4.3.2. The limited importance of doctrinal boundaries

From a theoretical (either philosophical or economic) perspective, the actual doctrinal boundaries of contract law look accidental, if not irrelevant. For a contract theory, it is the purpose (or function or point) of a certain institution (e.g. making binding and enforceable promises possible) and the regulation thereof which matters. Thus irrespective of the reason why a given theory favours or would limit contractual freedom (autonomy, happiness, efficiency, etc.), the rules that are relevant for such a theory often lie outside contract law in a doctrinal sense. It is e.g. administrative or criminal law that regulates or forbids the marketing and/or purchase of certain goods. To be sure, the contract law part of civil codes usually refers to these limitations by declaring illegal contractual terms invalid (“contracts forbidden by statute”).⁵² Also labour law, which is often considered as a separate field of law, includes a lot of arguably paternalistic rules. But on the top of that, labour contracts are regulated heavily for occupational safety reasons via rules of administrative law.

During the 20th century there has been a tendency in civil law countries to keep their codes and the principle of freedom of contract relatively unchanged, and introduce “material” limitations to it behind this “formalistic” liberal façade. To be sure, the traditional rules on mistake, fraud, duress, incapacity etc. were present as they seemed to fit with a contract theory based on will, or at least not to raise big problems. Later on, the socially motivated legislation aiming at protecting the employee, the consumer etc. has led to the enactment of a large body of rules which could not fit easily within the classical doctrines.

In the last decades, the European legislation on consumer protection has led to a large body of rules, the doctrinal position of which is not uniform in the member states. Some have integrated these rules fully in their civil codes, others keep them separate. All this does not matter significantly for a non-doctrinal analysis. But it points to a related question about the uniform or segmented regulation of contracts.

4.3.3. Doctrinal Segmentation? Four categories of contract

It is an interesting question also for paternalism whether there are systematic differences

⁵² Cf. Beale 2004, ch 3.1., 295-332.

between contracting parties that make segmentation and thus a differentiated regulation of contracts reasonable. In a recent article Robert Scott and Alan Schwartz argue (by reformulating a widely used intuitive categorization) that four different types of contract (transaction) should be distinguished:⁵³

- (1) a firm sells to another firm
- (2) an individual sells to another individual
- (3) a firm sells to an individual
- (4) an individual sells to a firm.

Category 1 is the area of commercial or business law (with some qualifications about the definition of the firm they stress), category 2 contracts are primarily regulated by family law and property law, category 3 contracts “are primarily regulated by consumer protection law, real property law (mostly leases), and the securities law, while category 4 is mainly the domain of labour law. Their claim is that contract law should be different, thus involve different extent of paternalism for these categories of transactions.

In this light it is interesting that for instance the contract law part of the new Hungarian Civil Code is designed acknowledgedly primarily for business to business transactions (category 1). Thus the rules are supposed to be adapted to commercial settings and repeat players. One-shot contracts among inexperienced private parties (category 2) are handled as exceptions. Apart from these two groups of contract rules a relatively large body of special regulations is dealing with consumer contracts, by way of implementation of the respective EU directives (category 3). This rather formal typology suggests that there are at least three different contexts where the role of paternalism should differ. But it also raises the question whether this it’s the optimal degree of precision for the tailoring of contract law rules when the contracting parties are heterogeneous with regard to business expertise, cognitive abilities etc.

4.4. Non-paternalist reasons for limiting freedom of contract

As mentioned before, there are a few concurrent justifications beside paternalism for limiting freedom of contract which are not always easily distinguishable from each other or eventually from paternalism. In other terms, even by following the eliminative strategy there are boundary cases. Beside that, sometimes the justification for intervention is only *potentially* paternalistic. Being bound to formulate general rules despite the uncertainty about the distribution of competence, well-informedness etc. among individuals in a given community, the lawmaker decides not to enforce, or enforce on different terms contracts falling in certain predetermined categories: coercion, fraud, restraint of trade, etc. Thus these doctrines are potentially paternalistic.

4.4.1. Negative externality (harm and offence)

In the contractual context, externalities roughly mean imposition of costs or benefits from a particular exchange transaction on non-consenting third parties. Positive externalities pose incentive problems, leading to suboptimal quantity of the good (transaction) in question. Negative externalities are arguably more important with

⁵³ Schwartz – Scott 2003, 544.

respect to freedom of contract. Autonomy-based theories formulate the same negative effect under the name ‘harm’ (or, within another category of Joel Feinberg’s scheme: ‘offence’). The crucial conceptual problem here is that third-party effects (negative externalities in economics, harm in liberal theories) are pervasive. If all these effects should count in prohibiting the exchange process or in justifying constraints upon it, freedom of contract would be largely at an end. Once one moves beyond rather tangible harms to third parties, many activities might be viewed as generating some externality (by imposing costs on dependants, the social welfare system or the public health care system as we have seen above in sec. 2.3.1.), including inadequate dietary or exercise regimens, excessively stressful work habits or risky leisure activities. As we have seen, economists are still willing to refer to externalities (burdens for the social security system) in order to justify laws which on their face are paternalistic (e.g. safety measures).

4.4.2. Coercion

The seemingly simple question of what constitutes voluntary consent to a transaction is actually a serious conceptual problem. Suppose there is full information, no cognitive deficiencies and the contract is complete. The question is then, whether the *constrained choice* of a party renders his consent involuntary nevertheless. In one sense, all contracts are “coerced” because of the scarcity of resources and opportunities. But on the other side, except for extreme cases (actual physical force, torture or hypnotic trance) almost every exchange can be viewed as voluntary (*coactus tamen volui*).⁵⁴

Rights theorists define coercion by drawing a basic distinction between threats and offers. Threats reduce the possibilities open to the recipient of the proposal, whereas offers expand them.⁵⁵ The difficulties arise, however, in specifying the offeree’s baseline, against which the offer is to be measured. This measure is not self-evident. It may be statistical (what he might reasonably expect), phenomenological (what he in fact expects), or moral (what he is entitled to expect). Thus “the distinction between threats and offers depends on whether it is possible to fix a conception of what is right and what is wrong, and to determine what rights people have in contractual relations independent of whether their contracts should be enforced.”⁵⁶

There are other approaches to contractual coercion, elaborated e.g. from a Hegelian or an Aristotelian perspective which are based on different theories of substantive fairness, or still others that are based on hypothetical, rather than actual consent and thus invert the conventional arguments of economists for voluntary exchanges, mentioned above in sec. 2.5. (While there voluntariness implies welfare-improvement, here the other way around). The implications of these theories for different cases of constrained choice diverge.⁵⁷ Still, as long as they justify the non-

⁵⁴ This problem has already been discussed by Aristotle, see *Nicomachean Ethics*, 1110a-b.

⁵⁵ See Nozick 1997.

⁵⁶ Trebilcock 1993, 80.

⁵⁷ Trebilcock construes seven cases and demonstrate the implications of the different theories. (1) The highwayman case (creation and exploitation of life-threatening risks: a highwayman or mugger holds up a passer-by confronting him with the proposition: ‘Your money or your life’ and the passer-by commits himself to hand over the money). (2) The tug and foundering ship case (exploitation but not creation of life-threatening risks: a third party encounters the highwayman and the passer-by before the transaction is consummated and offers to rescue the passer-by for all his money, less one dollar. Or imagine the same situation between a foundering ship on the stormy sea and a rescuing tug). (3) The dry wells case

enforcement of a coerced contract, they do that for reasons which are essentially different from paternalism, as they are not constraining but respecting the free will of the person, with freedom defined here as lack of coercion.

4.5. Prima facie paternalistic contract doctrines

4.5.1. Imperfect information

Contract law deals with several typical situations where at least one contractual party has imperfect information. Both asymmetric and symmetric information imperfections are possible cases for paternalistic intervention.

In general, the problem of asymmetric information is not easily distinguished from paternalism. The question here is: how much information is required for the exercise of an autonomous choice. Or stated differently, if one party to a contract is substantially less well informed about some aspect of the subject matter than the other, should contracts be unenforced or enforced on different terms, on that account. The problem is, of course, that information is almost always imperfect.

In terms of the doctrines of common law these information failure cases include fraud, negligent misrepresentation, innocent misrepresentation and material non-disclosure. In behavioural terms, information processing disabilities or cognitive deficiencies ("transactional incapacity" and "unfair persuasion") also belong here, potentially along with the entire issue of standard form contracts. Here, however, the economic analysis has made clear the issues involved without recurring to paternalism.

Symmetric information imperfections correspond to the domain of contract doctrines frustration, contract modification and mutual mistake. These legal doctrines define the scope of permissible private or judicial adjustments to contractual relationships in the light of new information. The *law and economics* literature generally argues that in long-term relationships there is a range of contractual and other strategies for adjusting the allocation of unknown and remote risks: explicit insurance, hedging in futures markets, indexing clauses, 'gross inequities' clauses, arbitration clause, etc. The absence of these from a long term contract thus reasonably implies that the promisor agreed to assume the risk in question. Still, there might be cases when this sort of informational deficiency justifies mandatory legal rules.

4.5.2. Disclosure, cooling-off, unconscionability

There are several further contractual doctrines that are intuitively classified as

(exploitation but not creation of life-threatening risks with one supplier and many bidders: in a remote rural area all wells except from A's dry up in a drought and A auctions off drinking water to desperate inhabitants for large percentages of their wealth. Or, the same sea situation with several ships and one rescuer). (4) The Penny Black case (exploitation but not creation of non-life-threatening situations: A comes across a rare stamp in his aunt's attic and sells it either to B exploiting his idiosyncratic intense preferences or through a Sotheby's auction to the highest bidder). (5) The lecherous millionaire case (A agrees to pay for a costly medical treatment of B's child [or offers her an academic position or a promotion in the firm] in return for B's sexual favours). (6) The cartelised auto industry case (contrived monopolies: major automobile manufacturers form a cartel to curtail drastically consumers' rights of action with respect to personal injuries). (7) The single mother on welfare case (non-monopolised necessity: a person in necessity contracts with another who lacks monopoly but the terms are especially burdensome to the first, reflected in high risks and low return).

paternalistic. Still, in an economic sense they operate rather differently. Let's indicate briefly the differences between three of them: mandatory disclosure, cooling-off periods, and unconscionability. (What now follows is only a sketch of the argument.) Suppose two parties conclude a contract about the transfer of an asset with uncertain value (low or high, with some probabilities). Consumer sovereignty ("consumers should get what they want"), as cited above from Trebilcock and Friedman, whether it is ultimately justified with welfare arguments or autonomy arguments or otherwise, sets a presumption against judicial intervention in this transaction.

Disclosure rules are in this case about communicating information that there is a risk. The information may be written in fine print and thus there are arguments for requiring bigger letters. This can be justified in pure economic terms: it is less costly for the seller to produce the information. But the whole issue is clearly dealt with in the time before the realisation of the risk.

The rule providing a mandatory cooling-off period is arguably to cure the problems of weakness of will and other defects of rationality, e.g. in door selling situations, by aggressive sales techniques etc. This rule is not obviously paternalistic. In theory, the sellers are interested to tie themselves and offer a cooling-off period voluntarily to the buyers. The cooling-off period is usually short, ending (for good economic reasons) before the realisation of the risk, often even before the delivery of the good. Still, in the EU the regulation is different; the good is already delivered during the 14 days period of *Rücktrittsrecht*.

The third doctrine, unconscionability works differently again. Technically, it works as an excuse when the seller wants to recollect money and the buyer, after finding out that he had bad luck (the low-value case realised), asks the court for assistance to rescind from the contract.⁵⁸ If unconscionability is applied to cases of the transfer of a good of uncertain value, this is in some sense opportunistic: only those with bad luck go to the court or have to go there because of non-payment. But, of course, the doctrine is not only or primarily applied to the case of risky exchanges. There may be a fully riskless, but simply involuntary exchange at issue, where judicial remedy should be available, even if in that case we face coercion or fraud and not (hard) paternalism in the meaningful sense of the word. Still, as the state of mind of the contracting parties is in most cases practically improvable, unconscionability is used as a *proxy for involuntariness*. Apart from this, there is still some space for paternalistic intervention, in the case of systematic cognitive failures.

4.6. An outlook: paternalism in the new Hungarian Civil Code

In dealing with questions about the optimal amount of paternalistic regulation in contract law and then making proposals how to improve them necessitates more specific scrutiny of specific contract law rules. In the last sections of the thesis I will concentrate on a small number of contractual problems, and compare how they are solved in different legal regimes. A special emphasis will be given to the contract rules of the new Civil Code of Hungary in order to contrast them with the previous rules and current European contract law regulations.

⁵⁸ An early law and economics analysis of unconscionability is Epstein 1975. For a comparison of mainstream and behavioural economic arguments on unconscionability, see Korobkin 2003a, b.

The draft of the new Hungarian Civil Code is a work of legal scholars slightly influenced by *law and economics* and strongly relying on European codifications and model rules. This impact however does not go much beyond such basic objectives as the reduction of transaction costs. The reasoning of the drafters is mainly systemic and comparative, rather than consequentialist. This historical background, of course only helps to explain the origins of the rules in the draft Code. In order to analyse, explain and criticise them, we shall use the tools developed in parts 2 and 3.

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