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Economics and the Law of Unconscionability

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The notion that economics can inform the law is commonplace. Public policymakers routinely seek the council of economists before enacting a legal change. By contrast, most economists never consider looking to the law for guidance in understanding economics. The law is an arena in which economics is applied–not a source of economic insight. Yet, this need not be the case. In *Legal Foundations of Capitalism* [1924], John R. Commons traced the concept of private property in Supreme Court decisions in an effort to uncover the competing conceptions of value that shaped various approaches to economics. This article is offered in that spirit. It looks at the law of "unconscionability," not to criticize or to applaud the law, but to illuminate the rhetorical nature of economic inquiry. The analysis begins with a brief overview of the doctrine of unconscionability. It then turns to five economic critiques [Epstein 1975; Trebilcock 1980; Kennedy 1976; Commons 1924; Klein 1980]. Each of these studies employs a distinct approach to economics–classical, neoclassical, Marxian, institutional, and transaction cost–and offers a distinct "economic" critique of unconscionability. The doctrine emerges as a paradigm that illuminates the legal preconceptions and fundamental values that shape these five schools of economic thought.

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An Overview of the Law of Unconscionability

The unconscionability doctrine directs courts to police private contracts–unconscionable terms are not enforced. Section 2-302 of the Uniform Commercial Code provides:

> if a court as a matter of law finds the contract or any clause of the contract to be unconscionable at the time it was made the court may refuse to enforce the contract, or it may enforce the remainder of the contract without the unconscionable clause. . . .

Traditional analysis identifies two unconscionability issues–substantive and procedural. The substantive inquiry calls for the replacing of clear and unambiguous contract language with terms supplied by the court. A court may impose a warranty where the contract expressly disclaims any liability or require a trial on the merits where the contract calls for a summary judgment. Although any contract clause can be substantively unconscionable, the precedents typically involve contracts or clauses that conflict with customary business practices [Ostas 1992]. The procedural inquiry supplements the defense doctrines of fraud, duress, and undue influence. For example, the courts emphasize procedural issues in refusing to enforce the fine print on standard-form contracts when there is reason to believe that the language was not fully comprehended by the nondrafting party. The typical unconscionability case involves both substantive and procedural issues.

Perhaps more has been written on Section 2-302 than on any other provision in the Code. Much of this interest can be explained by the amorphous nature of the doctrine. In the abstract, unconscionability can mean virtually anything. Some scholars denounce this lack of precision [e.g., Posner 1986, 104]; others see this flexibility as a virtue [e.g., Kennedy 1976]. Where one comes out on this debate depends on how one views the court's role. Do we need an active judiciary? And what values should the courts promote or protect? These questions reside at the core of any economic analysis of law. Divergent answers generate divergent economic critiques. It is to these views that we now turn.

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A Classical or Libertarian Vision of Unconscionability

As used here, the term "classical" refers to the libertarian, or "rights-based," values that inform the political economy of John Locke, Adam Smith, and more recently the public choice analysis of James Buchanan. This approach to economics posits liberty, autonomy, and property as fundamental first principles from which all public policy is derived. Libertarians largely distrust discretionary power in the hands of governmental officials, including the judiciary [Buchanan 1974].

Richard Epstein provides a classical critique of unconscionability [1975]. He begins by pointing out that judicial deference to contractual language can be defended on either utilitarian or libertarian grounds [1975, 293]. Utilitarian justifications rely on *consequences*; libertarians emphasize *rights*. For all true libertarians, a regime of free contracting is a moral imperative dependent not on the consequences it generates, but on the values of private property and autonomy from which it is derived. With this in mind, a central question guides Epstein's analysis of substantive unconscionability–does the given contract reflect an autonomous "meeting-of-the-minds" between the parties? If it does, then the courts should dismiss the unconscionability claim no matter how unfair the agreement may seem to an outside observer. Substantive inquiries are simply inconsistent with the values of liberty and autonomy. He calls for the courts to abandon the substantive component of unconscionability review [1975, 295]. He is slightly more tolerant of procedural inquiries. If the contract does not reflect an autonomous agreement, then there is no moral imperative on the courts to enforce the express language. Nonetheless, Epstein fears the abuse of judicial discretion, prefers legislation, and calls for a curtailment of procedural unconscionability [1975, 304-305].

A study of unconscionability brings the fundamental values and legal preconceptions of classical economics into focus. For me, libertarian values resonate deeply. Appeals to autonomy, self-reliance, and liberty are firmly rooted in American culture. Should not the parties be free to determine with whom they will trade and upon what terms? An affirmative answer would require the court to enforce even the most obnoxious contract terms whenever the parties fully understood those terms *ex ante*. Perhaps this is not as strange as it sounds. A party does not agree to an exchange unless he or she believes that it is in his or her interest. And as

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Buchanan reminds us, this potential for "mutual gains from trade" is "the principle lesson" of economic theory [Buchanan 1987, 26-29]. Yet, classical political economy ignores an important unconscionability factor–the relative wealth of the parties. A party's ability to negotiate terms is a function of her ability to withhold her assent. In the extreme, one envisions a world of Charles Dickens with a classical court blindly enforcing a contract between a coal company and an impoverished, but autonomous, 14-year old. Unbridled property rights can lead to unsavory results.

A Neoclassical or Utilitarian Vision of Unconscionability

The neoclassical approach to law is associated with the works of Richard Posner [1986]. Embracing utilitarianism, Posner assesses legal rules with reference to consequences, leaving little or no room for natural rights concerns. The sole purpose of contract law is to promote an efficient allocation of resources. In pursuit of this goal, courts are to provide an incentive structure that reduces transaction costs. Compared to libertarians, neoclassicals tolerate a much more active judiciary [Buchanan 1974].

Neoclassical economists have successfully explained most of the common law in terms of judicial fidelity to economic efficiency. Yet, unconscionability is somehow seen as an exception [Posner 1986, 104]. Michael Trebilcock provides a neoclassical analysis [1980]. He begins with the assertion that unconscionability review reflects the judiciary's concern with abuses of "bargaining power." Equating bargaining power with monopoly power–the true threat to allocative efficiency–he concludes that when markets are competitive, there is no need for the judicial concern with unconscionable contracts. The forces of competitive equilibrium assure that any "unfair" or unjustifiable contract practice will soon be extricated from the marketplace. Observing affirmative findings of unconscionability in competitive settings, he suspects an abuse of judicial discretion and denounces the doctrine.

The question remains regarding why can the courts be trusted to pursue efficiency in virtually every area of the common law and yet simultaneously prove to be so untrustworthy with the unconscionability doctrine. One answer lies with the neoclassical fear of wealth redistribution. Neoclassical economists uniformly support judicial activism that enhances allocative efficiency, while simultaneously denouncing activism aimed at redistributing wealth or

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power. Unconscionability cases seem to raise the specter of judicial attempts to redistribute wealth. The typical case pits a corporation or other relatively wealthy and powerful party against a consumer or other unsophisticate. Systematic judgments in favor of the weaker party suggest a wayward court. An efficiency-minded court should be immune to issues of class, wealth, and power. Findings in favor of the less powerful appear to be misplaced, though perhaps well-intentioned, paternalism.

A Marxian or Radical Vision of Unconscionability

To a Marxist–and to many other heterodox thinkers–the neoclassical approach to law is fundamentally flawed. Neoclassicals assert that contract law's sole role is to promote market transactions; yet, which transactions are made depends on the initial distribution of power and wealth in society. If the initial distribution is unjust, then any "efficient" allocation of resources generated by this distribution will be similarly unjust. This suggests that efficiency is severely limited as a moral precept, and if efficiency does not equate to justice, then there is no reason to seek efficiency. Justice, say the radicals, demands that the courts actively direct their attention to issues of unequal power and unequal wealth.

Duncan Kennedy, a founding father of Critical Legal Studies, provides an essentially Marxian critique of unconscionability [1976]. Referring to an early precedent, he writes: "I believe that there is value as well as an element of real nobility in the judicial decision to throw out, every time the opportunity arises, consumer contracts designed to perpetuate the exploitation of the poorest class of buyers" [1976, 1777]. In short, Kennedy likes the unconscionability doctrine. In the hands of a right-minded judge, unconscionability provides authority to redistribute wealth and power on a case-by-case basis. Judicial activism in the name of regulating abuses of power is welcome.

A common theme unites Marxian economics and Critical Legal Studies. Scholars in both traditions argue that the courts tend to favor the ruling class. Although the unconscionability doctrine could conceivably be used to redistribute wealth and power, in the eyes of critical scholars, it is unlikely that the courts will use it to this end. This failure to act is the natural consequence of a liberal education. Conventional wisdom teaches that redistribution is

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best achieved through a generalized scheme of progressive taxation and welfare transfer–not through the common law. The danger, of course, is that tax and transfer legislation will not establish distributive justice and the common law obsession with allocative issues will become illegitimate. If economists and policymakers always place issues of unequal power and wealth to one side, these issues will never be addressed. Radical scholarship serves as a constant reminder of this danger.

An Institutional or Pragmatic Vision of Unconscionability

Institutional economists begin with the proposition that the judge must play an active role in all economic activity; he or she is an implicit actor in every transaction [Commons 1924, 67]. A good judge is pragmatic, always seeking better ways to reduce conflict. Judges must consider rules in light of evolving economic conditions and be alert to antiquated customs and practices. Courts provide economic value by finding ways to reduce the inevitable tensions generated by human interdependence.

John R. Commons provided the first economic critique of unconscionability [1924, 56-59]. Like Trebilcock, Commons began his analysis with the notion of bargaining power. Commons, however, did not equate "bargaining power" with "monopoly power." Instead, he identified three distinct sources of power: political, economic, and personal. Political power is the right to compel by force; economic power (monopoly power) is the ability to withhold property from others; and personal power is the natural consequence of placing confidence, or trust, in one's trading partner. Turning to the unconscionability precedents, Commons observed that the courts had used the doctrine to regulate power of the *personal* kind. He wrote that "with regard to the unconscionable contract . . . it is perfectly lawful . . . to exercise superior economic power or superior mental and managerial faculties, over others, provided advantage is not taken of recognized special relations of confidence, trust, dependence, or the like" [1924, 58-59]. Hence, affirmative findings of unconscionability have relatively little to do with the presence of monopoly power. Unconscionability reflects a judicial concern with abuses of *trust* in economic transactions.

Commons wrote that "confidence in others is the largest of all [economic] utilities" [1924, 204]. Although a court cannot force people to trust one another, it can reinforce the trust that already

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exists. It does this, in part, by reviewing the substance of private contracts against the backdrop of customary expectations, or "working rules," associated with any given transaction and by being alert to abuses of trust in contract negotiations. In short, institutional analysis reveals that the unconscionability doctrine can play an important and justifiable role in promoting economic value.

A Transaction Cost Vision of Unconscionability

Transaction cost, or new institutional economics, is associated with the works of Oliver Williamson. Beyond its name, new institutionalism has little in common with the ongoing tradition associated with Commons, Veblen, and Ayres. In fact, the approach is distinct from each of the four traditions thus far discussed. For present purposes, the key distinction lies in the transaction cost view of the courts. Transaction cost economists argue that parties structure contracts in order to avoid the use of the courts. Contracts serve as private "governance structures" designed to economize on "bounded rationality," to safeguard "transaction-specific investments," and to limit the costs of "opportunism" [Williamson 1985]. In this scheme, the courts play a very passive role. Efficiency is the primary economic value, but it is achieved through deference to private contracting with little explicit role for the courts. The analysis assumes that the parties will structure their contracts in a fair and efficient manner.

Benjamin Klein provides a transaction cost critique of unconscionability [1980]. Given this school's faith in private ingenuity and its preference for judicial passivity, one would expect Klein to be highly critical of the doctrine. This is indeed the case. He analyzes a set of unconscionability precedents that question the fairness of "unilateral-termination" clauses in franchise agreements. These clauses permit the franchisor to terminate the relationship without cause and with little or no notice. Klein argues that such clauses merely reflect innocent, and sometimes ingenious, attempts by the parties to reduce transaction costs. Franchisors have collateral investments to protect; a wayward franchisee threatens the reputation of the entire franchise network. A trial on the merits upon dissolution is too slow. Termination without a prior showing of cause enables a summary judgment and provides an efficient "safeguard." After all, a

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franchisor has no incentive to unjustly terminate good franchisees.

Klein's view of the economic process is as interesting for what it omits as for what it includes. For example, the argument fails to consider the transaction-specific investments made by the franchisee. A successful franchisee will build goodwill with a resulting rise in the value of the particular franchise. Were the franchisor to terminate without cause and then resell, it could capture this increase. Alternatively, the termination clause could be used as a threat to renegotiate terms with the original franchisee. An economic theory that assumes a passive role for the court and that posits that contracts always reflect efficient terms misses such arguments.

Table 1. Competing Values and Policy Prescriptions

Economic School	Core Values	Role of Court	Uncon?
Classical	Liberty, property	Inactive	Abolish
Neoclassical	Efficiency	Active	Abolish
Marxian	Redistribute power	Active	Expand
Institutional	Trust, confidence	Active	Expand
Transaction cost	Efficiency	Inactive	Abolish

Conclusion

Each of the studies considered herein offers a distinct "economic" critique of unconscionability. These divergent policy prescriptions are driven more by the individual economist's core values and preconceived notions of the role of courts than by any inexorable "economic logic." Yet, for many judges, economic jargon carries a strong rhetorical appeal. Who can argue with efficiency? The wise judge is alert to the rhetorical quality of economic reasoning.

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