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Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law

Erin Ann O'Hara

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This Article uses public choice theory to analyze the function of choice-of-law clauses in contracts. Choice-of-law clauses are now quite common and are increasingly enforced, especially with the proliferation of international and Internet transactions. Because these clauses can be used by parties to avoid regulation, academics are now vigorously debating the extent to which this contractual opt out should be permitted. The Article presents a positive political theory of the interplay of legislative action and the enforcement of choice of law. It demonstrates that the important normative debate over choice of law is somewhat misguided because both sides fail to fully understand the effect that these clauses can have on interest group bargaining in the legislature. Once the issue is fully understood, seemingly counterintuitive posturing can result: Regulatory proponents may actually favor choice-of-law clauses, and Libertarians can find themselves opposing their enforcement.

Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law

*Erin Ann O'Hara**

| | | |
|------|---|------|
| | INTRODUCTION | 1552 |
| I. | CONTRACTUAL CHOICE OF LAW IN A NUTSHELL..... | 1558 |
| | A. <i>State Law Examples</i> | 1563 |
| | B. <i>Federal Law Examples</i> | 1567 |
| | C. <i>Academic Debate</i> | 1569 |
| II. | CONTRACTS, INTEREST GROUPS, AND OPT OUTS..... | 1572 |
| | A. <i>The Coase Theorem and Choice of Law</i> | 1573 |
| | B. <i>The Interest Group Wrinkle</i> | 1577 |
| | C. <i>The Influence of Choice of Law on Interest Group Bargains</i> | 1579 |
| | 1. Continuing wealth transfers..... | 1584 |
| | 2. Single-period transfers | 1586 |
| III. | ONE-SHOT WEALTH TRANSFERS AND FRANCHISE REGULATIONS | 1588 |
| | A. <i>The Franchise Form</i> | 1588 |
| | B. <i>Franchise Protection Laws</i> | 1591 |

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| | | |
|----|---|------|
| C. | <i>Choice of Law with Single-Period Transfers</i> | 1594 |
| D. | <i>Contractual Choice and Statutory Repeal</i> <i>Compared</i> | 1601 |
| | CONCLUSION..... | 1603 |

INTRODUCTION

Virtually every regulator—whether legislator, judge, bureaucrat, parent, or other institutional administrator—must, at some point, consider the possibility that her subjects will elude her grasp. Examples abound throughout history, indicating that people are willful and notoriously difficult to control. Plaintiff's lawyers know that the mere possibility of a damages award leads many defendants to attempt to transfer, hide, or dissipate their assets.¹ The Internal Revenue Service is plagued by the reality that differential tax treatment creates incentives for taxpayers to structure their transactions strategically.² Efforts to regulate or otherwise limit gun ownership³ or alcohol,⁴ drug,⁵ or cigarette⁶ consumption inevi-

1. See, e.g., *Hoxworth v. Blinder, Robinson & Co.*, 903 F.2d 186, 194-97 (3d Cir. 1990) (empowering the district court to issue a preliminary injunction against a securities firm and its president to protect future damages claims); Kern Alexander, *The Mareva Injunction and Anton Piller Order: The Nuclear Weapons of English Commercial Litigation*, 11 FLA. J. INT'L L. 487, 490 (1997) (discussing legal measures available to plaintiffs to preserve assets to satisfy judgments); Linda J. Candler, *Tracing and Recovering Proceeds of Crime in Fraud Cases: A Comparison of U.S. and U.K. Legislation*, 31 INT'L LAW 3, 25-27 (1997) (same).

2. See Roger D. Lorence, *The Demonization of Structured Finance Transactions*, 10 J. INT'L TAX'N 16 (1999) (discussing government's "war on tax-advantaged transactions").

3. See Brendan J. Healey, *Plugging the Bullet Holes in U.S. Gun Law: An Ammunition-Based Proposal for Tightening Gun Control*, 32 J. MARSHALL L. REV. 1, 23 (1998) ("Background checks, as well as point-of-sale recordkeeping, could lead to a rise in black-market trading in ammunition.").

4. See James Ostrowski, *The Moral and Practical Case for Drug Legalization*, 18 HOFSTRA L. REV. 607, 650 (1990) (noting the curtailment of black market violence associated with the production, distribution, and sale of alcohol when the Prohibition Era ended).

5. See Laura L. Hirschfeld, *Legal Drugs? Not Without Legal Reform: The Impact of Drug Legalization on Employers Under Current Theories of Enterprise Liability*, 7 CORNELL J.L. & PUB. POL'Y 757, 769 (1998) (discussing the elimination of the black market as the most compelling argument favoring legalization or decriminalization of drugs).

6. See Regulation Restricting the Sale and Distribution of Cigarettes and Smokeless Tobacco to Protect Children and Adolescents, 61 Fed. Reg. 44,396, 44,398 (1996) (noting the possibility that the black market is a partial justification for not completely banning tobacco products); Daniel K. Benjamin & William R. Dougan, *Efficient Excise Taxation: The Evidence From Cigarettes*, 40 J.L. & ECON. 113, 117 (1997) (discussing discrepancies in state cigarette taxes that create incentives for interstate smuggling); Jon D. Hanson & Kyle D. Logue, *The Costs of Cigarettes: The Economic Case for Ex Post Incentive-Based Regulation*, 107 YALE L.J. 1163, 1298-1301 (1998) (discussing the possibility of a black market in cigarettes). Black markets can arise in any regulatory context. For a recent example, see Saleem S. Saab, *Move*

tably encourage black market activity. Even worse, attempts to control behavior can also create perverse incentives that produce even more of the harm sought to be avoided. Under the Federal Endangered Species Act, for example, efforts to force landowners to take measures to preserve endangered species have prompted them to preemptively destroy habitats.⁷

Potential evasion is ubiquitous, and the more easily a rule is circumvented, the more difficult it becomes for the regulator to influence behavior. Indeed, sometimes the widespread disregard of legal measures leads to their repeal, reformulation, or initial rejection. The Twenty-First Amendment eliminating prohibition,⁸ the relaxation of the fifty-five mile per hour speed limit,⁹ and the Tax Reform Act of 1986¹⁰ are all examples. The converse is trivially true too: the lower the cost of eliminating or containing evasion, the more successful will be the regulator's efforts. For example, employee withholding taxes, when coupled with employer reporting requirements, can significantly enhance the viability of an income tax.¹¹

Over Drugs, There's Something Cooler on the Black Market—Freon: Can the New Licensing System Stop CFC Trafficking?, 16 DICK. J. INT'L L. 633, 634 (1998). U.S. prohibition on the production of chlorofluorocarbons coupled with low production costs in developing countries has generated a growing black market in the trafficking of CFCs. *See id.*

7. *See* Barton H. Thompson, Jr., *People or Prairie Chickens: The Uncertain Search for Optimal Biodiversity*, 51 STAN. L. REV. 1127, 1153-54 (1999) ("Because the government has limited monitoring capabilities, many property owners also will try to eliminate endangered species or destroy potential habitat while the government is not looking."); Dean Lueck & Jeffrey Michael, *Preemptive Habitat Destruction Under the Endangered Species Act*, 23-24 (May 1999) (draft manuscript, presented at American Law and Economics Association meetings).

8. *See* Symposium, *A Fork in the Road: Build More Prisons or Develop New Strategies to Deal with Offenders*, 23 S. ILL. U. L.J. 385, 402 (1999) (quoting Odie Washington, Director of the Illinois Department of Corrections, as remarking, "I'm always reminded that we worked for about fourteen years during prohibition to stop our nation from drinking. We ultimately found out how unsuccessful that was. The legislators, writers, ministers and many, many others in the community finally got together and . . . finally came to the conclusion that you cannot legislate alcohol.").

9. *See* William H. Simon, *Should Lawyers Obey the Law?*, 38 WM. & MARY L. REV. 217, 234 (1996) (noting widespread driver disregard of the fifty-five mile per hour limit and the fact that several jurisdictions adjusted their limits to approximate more closely actual driver practice).

10. *See* STAFF OF JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 917-18 (Comm. Print 1987) (noting that under preceding law, foreigners manipulated the transfer of their property to avoid U.S. taxes).

11. *See* Edward A. Zelinsky, *For Realization: Income Taxation, Sectoral Accretionism, and the Virtue of Attainable Virtues*, 19 CARDOZO L. REV. 861, 900 (1997) ("By a substantial margin, the IRS collects the taxes owed on employees' wages more successfully than it gathers the taxes attributable to any other type of income. This success is universally attributed to employers' withholding from employees' compensation and employers' subsequent remittance to the IRS of these withheld funds.") (citations omitted).

To curtail circumvention, lawmakers often must attempt to control several margins simultaneously. Take, for example, efforts to eliminate racial discrimination in the workplace. As civil rights advocates have always known, a racist employer confronted with a law prohibiting discrimination in hiring has many other avenues along which to satisfy his discriminatory tastes. He can pay his minority employees less, treat them disparately regarding their job responsibilities and privileges, pass them over for promotions, fire them with less cause, or otherwise create or encourage a hostile work environment.¹² Although anti-discrimination efforts have produced some success, many people are left discouraged and cynical about the enormity of the task.¹³ Generally, the more easily compliance leakage can be clamped off, the more likely it becomes that the regulatory machine can deliver changes in behavior.

These basic truisms raise an interesting question: why do regulators sometimes forgo efforts to prevent evasion? Some types of evasion are both acknowledged and permitted by those charged with making or enforcing rules. Leakage in these contexts can represent acknowledgement of the limits, either *de jure* or *de facto*, of regulatory authority.¹⁴ Or, they can indicate regulator insincerity about legal enforcement.¹⁵ But the problem can be recast from the perspective of those who demand the rules: why do interest groups seeking proposed legislation sometimes not advocate simple meas-

12. Cf. DERRICK BELL, *FACES AT THE BOTTOM OF THE WELL: THE PERMANENCE OF RACISM* 5 (1992) ("Racial discrimination in the workplace is as vicious—if less obvious—than it was when employers posted signs: no negroes need apply."); Ronald Turner, *Thirty Years of Title VII's Regulatory Regime: Rights, Theories and Realities*, 46 ALA. L. REV. 375, 393-94 (1995) (noting that "[s]outhern school systems engaged in resistance of various forms which amounted to an evasion of *Brown*").

13. See, e.g., DERRICK BELL, *AND WE ARE NOT SAVED: THE ELUSIVE QUEST FOR RACIAL JUSTICE* (1987); Richard Delgado, *Derrick Bell and the Ideology of Racial Reform: Will We Ever Be Saved?*, 97 YALE L.J. 923, 923 (1988) (referring to race as "America's oldest and most intractable problem"); see also Randall Kennedy, *Race Relations Law and the Tradition of Celebration: The Case of Professor Schmidt*, 86 COLUM. L. REV. 1622, 1623 (1986) (criticizing courts for their ineffective treatment of race cases).

14. See, e.g., BARRY C. FIELD, *ENVIRONMENTAL ECONOMICS* 219-20 (1994) (noting that the inevitability of limited budgets may foreclose the possibility of ever reaching acceptable levels of compliance with environmental regulation); Michael D. Montgomery, *Raising the Level of Compliance with the Clean Water Act by Utilizing Citizens and the Broad Dissemination of Information to Enhance Civil Enforcement of the Act*, 77 WASH. U. L.Q. 533, 541-42 (1999) (discussing the EPA's lack of staff necessary to pursue more than a fraction of Clean Water Act violators).

15. See, e.g., Colin S. Diver, *Presidential Powers*, 36 AM. U. L. REV. 519, 528 (1987) ("Many critics of Reagan's executive orders maintain that an antiregulatory administration has used the regulatory review process to postpone or discourage altogether the promulgation of rules needed to protect the public health and safety.").

ures that would have the effect of eliminating some evasion of the proposed law?

This Article explores the evasion of one type of regulation—rules that limit or interfere with parties' ability to contract. Laws forbid the making of some contracts, and examples include prohibitions on contracts for murder, gambling, and prostitution.¹⁶ Outright criminal prohibitions on contracting typically produce underground markets that involve organized crime.¹⁷ More typically, regulations either forbid or mandate the incorporation of certain contract terms. Minimum wage laws, worker's compensation rules, securities regulations, franchise termination laws, usury laws, and insurance regulations provide just a few examples.¹⁸

The means by which the regulated can avoid governing restrictions vary, but at least two options do not involve illegality. First, individuals can physically exit the jurisdiction by locating or conducting their business elsewhere.¹⁹ One is free to gamble in Nevada,²⁰ pay less to workers in Mexico,²¹ charge unlimited interest in South Dakota,²² and so on. Given that each jurisdiction provides a

16. See Mark Pettit, Jr., *Freedom, Freedom of Contract, and the "Rise and Fall,"* 79 B.U. L. REV. 263, 290 (1999) (explaining that some contracts, like contracts for murder, are bilaterally criminal, while others, such as usurious contracts, are unilaterally criminal). Courts will not enforce contractual obligations to perform illegal acts. See *Kaiser Steel Corp. v. Mullins*, 455 U.S. 72, 78 (1982); *McMullen v. Hoffman*, 174 U.S. 639, 654 (1899); *Armstrong v. Toler*, 24 U.S. 258, 271-70 (1826); *In re American Fuel & Power Co.*, 122 F.2d 223, 228 (6th Cir. 1941); *Ewing v. National Airport Corp.*, 115 F.2d 859, 860 (4th Cir. 1940); see also Howard W. Brill, *The Maxims of Equity*, 1993 ARK. L. NOTES 29, 37 (noting that gambling contracts are unenforceable as illegal); Margaret Jane Radin, *Market Inalienability*, 100 HARV. L. REV. 1849, 1937 n.261 (1987) (noting that contracts to render sexual services are void as illegal). See generally ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 1476 (1963) (explaining that contracts in furtherance of immorality are void).

17. See *supra* notes 3-6 (discussing black markets that arise with regulatory restrictions).

18. See LAWRENCE FRIEDMAN, CONTRACT LAW IN AMERICA 23-24 (1965) (noting that public policy developments replaced contracts, including "labor law, antitrust law, insurance law, business regulation, and social welfare legislation").

19. For two classic discussions of this "exit" option, see ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 21-29 (1970); Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956) (arguing that the ability of citizens to move to a jurisdiction with more favorable provision of public goods, including laws, serves to discipline local political bodies by creating interjurisdictional competition for citizens).

20. See NEV. REV. STAT. ANN. § 202.450 (1997); NEV. REV. STAT. ANN. § 244.335 (1995); NEV. REV. STAT. ANN. § 463.0129 (1994).

21. See Benjamin Rozwood & Andrew R. Walker, *Symposium on the North American Free Trade Agreement: Side Agreements, Sidesteps and Sideshows: Protecting Labor from Free Trade in North America*, 34 HARV. INT'L L.J. 333, 335 (1993).

22. See *Greenwood Trust Co. v. Commonwealth*, 776 F. Supp. 21, 26 (D. Mass. 1991) (noting that both Delaware and South Dakota have eliminated their usury laws after federal laws were interpreted to enable banks to charge any interest rate permissible in their home state).

menu of benefits to its domiciliaries, however, even temporary exit can be undesirable. Second, parties may be able to remain in the state but contract for the law of an unregulating jurisdiction. For example, a credit card agreement might provide that it is governed by and subject to the law of South Dakota and that any future disputes between the parties will be resolved according to South Dakota law. In fact, this cheapest form of evasion, contractual choice of law, is on the rise in the United States and has been used successfully to avoid civil liability even for activities otherwise deemed criminal.²³

Presumably interest group proponents have a stake in preventing this regulatory slippage. More often than not, however, legislation includes no provision preventing contracting parties from avoiding statutory compliance with a choice-of-law clause. Contractual choice of law is increasingly enforced,²⁴ and, when no precedent controls, applicable judicial standards leave resolution of the issue considerably uncertain.²⁵ As a consequence, statutory silence regarding choice of law often creates a significant possibility for successful contractual evasion. Why don't interest groups routinely seek legislative insurance to control this leakage?

The answer likely includes several partial explanations. The lobbyist might be ignorant about choice of law, or he could be lazy, or hoping to generate future fees from his interest group members by raising the issue later. Alternatively, the law could be primarily symbolic; some laws express and encourage important moral or ethical sentiments even though they are virtually impossible to enforce. Still, in many cases, dedicated and sophisticated interest group representatives do propose enforceable laws without attempting to prevent evasion through contractual choice of law.

This Article offers a competing explanation for why choice of law goes unhindered in some statutes: contractual evasion makes it more likely that the interest group will obtain the benefit it seeks from the legislature. Although contractual opt outs appear to evis-

23. See, e.g., *Richards v. Lloyd's of London*, 135 F.3d 1289, 1296-97 (9th Cir. 1998) (enforcing the choice-of-law provision to enable defendant to avoid federal securities fraud and RICO laws); *Woods-Tucker Leasing Corp. of Ga. v. Hutcheson-Ingram Dev. Co.*, 642 F.2d 744, 753-54 (5th Cir. 1981) (holding that the parties' choice of Mississippi law was effective to avoid Texas usury law); *Christiansen v. Beneficial Nat'l Bank*, 972 F. Supp. 681, 685 (S.D. Ga. 1997) (holding that Delaware's choice-of-law clause was enforceable even though terms of agreement violated Georgia's criminal usury statute). Although a choice-of-law provision might possibly affect a prosecutor's decision to press charges, presumably the parties cannot waive any criminal liabilities to which they may be subject.

24. See *infra* Part I.

25. See *infra* Part I.B.

cerate interest group transfers, sometimes an opt out actually guarantees a transfer by making it politically palatable. More interestingly, when parties can be expected to bargain around the regulatory transfer by other means, contractual choice of law serves a purpose different from that assumed in the conflicts literature.²⁶ In these cases, a choice-of-law clause helps the parties eliminate future dead weight losses that society would incur in the absence of contractual choice. Thus, it is possible for contractual choice of law to reduce the costs, but not the benefits, associated with the regulation, thereby enhancing the likelihood of its enactment.

This analysis generates some interesting implications for the current academic debate on contractual choice of law. Those opposed to unconstrained contractual choice of law typically seek to empower the regulating state to alleviate social problems.²⁷ In contrast, those who favor broad contractual choice tend to scorn the underlying regulations.²⁸ From a systemic perspective, some have recently argued that contractual choice of law promotes competition among jurisdictions to create improved legal systems.²⁹ Although debaters disagree about whether choice of law generates a race to the top or a race to the bottom for state lawmaking, both sides seem to assume that enforcing choice-of-law provisions inevitably leads to fewer regulations.

This Article demonstrates that the debaters' assumption can be both false and misleading. By focusing on the *ex ante* incentives that choice of law creates for interest groups, I hope to demonstrate that in some cases, choice-of-law clauses enhance interest group incentives to seek regulatory wealth transfers while simultaneously dampening opposition to the proposed laws. If a particular law is primarily motivated to transfer wealth rather than generate social benefits, then permitting the regulated party to opt out in future periods can actually enhance its political viability.

Part I of this Article briefly describes current law regarding choice-of-law clauses. When regulations do not specifically prohibit contractual choice, these clauses are increasingly used and enforced by the courts. Drafters also are more frequently incorporating these clauses into contracts in order to avoid states' mandatory rules (those around which the parties could not otherwise contract). After describing the law surrounding choice-of-law clauses, this Ar-

26. See *infra* Part II.C.2.

27. See *infra* Part II.C.

28. See *infra* Part II.C.

29. See *infra* Part I.C.

ticle analyzes the function of the clauses from an economic and public choice perspective. Part II.A discusses the relationship between choice of law and the Coase Theorem, and Part II.B introduces a few simple but important insights from public choice theory. Both the Coase Theorem and public choice theory turn out to be relevant to the debate over contractual choice of law. Part II.C presents a decision tree to illustrate the influence that choice-of-law provisions have on interest group efforts to generate laws. Part II.C also discusses the effect of the clauses on both laws that are perceived to be beneficial and those that are adjudged harmful.³⁰ For laws that (1) are primarily geared to transfer wealth from one group to another; and (2) represent, *de facto*, a one-time, rather than a periodic or ongoing, wealth transfer, contractual choice of law has the counterintuitive effect of actually enhancing the effectiveness of the law.

Part III explores this special category of regulation, using franchise termination laws as a possible example. For reasons explained in Part III, groups attempting to transfer wealth often propose a regulatory vehicle to achieve that transfer. If the bulk of the transfer occurs in a single period rather than continuing into the future, then contractual choice of law can provide future benefits to both the winners and the losers of the wealth transfer.

I. CONTRACTUAL CHOICE OF LAW IN A NUTSHELL

Until about forty years ago, all of the U.S. states followed a rule-based approach to determine which state's substantive law would apply to resolve a multi-state dispute.³¹ Because these suits involved people, property and events that touched more than one jurisdiction, the rules, as at least roughly embodied in the First Restatement of Conflict of Laws,³² attempted to delineate which of the involved states should have the power to determine the parties' rights and obligations.³³ These territorial rules came under attack

30. Admittedly it is difficult, indeed impossible, to establish objectively whether any law is "good" or "efficient." See Thomas F. Cotter, *Legal Pragmatism and the Law and Economics Movement*, 84 GEO. L.J. 2071, 2119-20 & n.213 (1996) (noting that analysts quite often disagree about the efficiency of laws, including anti-discrimination laws and the unconscionability doctrine). I nevertheless use the categories to locate the present debaters, who think they know whether laws are good or bad, and to distinguish their positions, which depend upon their assumptions, from the category of cases for which my analytical point holds.

31. See LEA BRILMAYER, *CONFLICT OF LAWS: CASES AND MATERIALS* 1 (4th ed. 1995) (acknowledging that the territorial approach "once represented the universal American approach to choice of law").

32. RESTATEMENT OF CONFLICT OF LAWS (1934).

33. See JOSEPH H. BEALE, *THE CONFLICT OF LAWS* §§ 2.1, 5.2 (1935).

by the legal realists³⁴ who found them arbitrary³⁵ and, in any event, rife with both ambiguities and escape devices³⁶ that together worked to eviscerate the very certainty and predictability that they purported to deliver.³⁷

As a result of this mounting criticism, a majority of the states' courts began to move from the rule-based to one of a number of standard-based approaches to choice of law.³⁸ Some assert that this choice-of-law revolution was, in essence, driven by a strong desire to achieve progressive tort reforms,³⁹ but whatever its motivation, the shift to standards did not enhance the certainty of the law governing contracts.⁴⁰ When choice-of-law decisions are made ac-

34. For well-known works that focus on the weaknesses of the traditional rule-based approach, see generally WALTER WHEELER COOK, *THE LOGICAL AND LEGAL BASES OF THE CONFLICT OF LAWS* (1942); BRAINERD CURRIE, *SELECTED ESSAYS ON THE CONFLICT OF LAWS* (1963); *Fowler v. Harper, Policy Bases of the Conflict of Laws: Reflections on Rereading Professor Lorenzen's Essays*, 56 *YALE L.J.* 1155 (1947); Roger J. Traynor, *Law and Social Change in a Democratic Society*, 1956 *U. ILL. L.F.* 230.

35. See William H. Allen & Erin A. O'Hara, *Second Generation Law and Economics of Conflict of Laws: Baxter's Comparative Impairment and Beyond*, 51 *STAN. L. REV.* 1011, 1017 (1999) ("To conflicts scholars, the rules seemed largely arbitrary, indeed counterintuitive.") (citing several examples of criticisms); Perry Dane, *Vested Rights, "Vestedness," and Choice of Law*, 96 *YALE L.J.* 1191, 1197 (1987) (describing Walter Wheeler Cook's critique of traditional choice-of-law rules).

36. See Allen & O'Hara, *supra* note 34, at 1017-18 (discussing criticisms regarding characterization issues and public policy exception); William F. Baxter, *Choice of Law and the Federal System*, 16 *STAN. L. REV.* 1, 3 (1963) ("As means to the end of predictability, [the rules] are vulnerable to attack, not because they are too rigid, but because they are not rigid enough.").

37. Cf. F. GOODRICH, *HANDBOOK OF THE CONFLICT OF LAWS* § 92, at 261-62 (3d ed. 1949) (noting that application of a law other than that dictated by the First Restatement "would impose a criterion which would not have been foreseen by at least one of the two parties to the suit").

38. See 1 *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* 395 (1998); *INTERNATIONAL ENCYCLOPEDIA OF LAW AND ECONOMICS* (forthcoming 2000). State counts for the competing approaches vary by commentator. According to Patrick Borchers, for torts, fifteen states have retained the First Restatement approach, twenty-four states have adopted a Second Restatement approach, four states use interest analysis, and five states use a better law approach, leaving three states unclassified. See Patrick J. Borchers, *The Choice of Law Revolution: An Empirical Study*, 49 *WASH. & LEE L. REV.* 357, 373-74 (1992); see also Symeon C. Symeonides, *Choice of Law in the American Courts in 1998: Twelfth Annual Survey*, 47 *AM. J. COMP. L.* 327, 331-45 (1999) (classifying states for torts and contracts cases).

39. See *Paul v. National Life*, 352 *S.E.2d* 550, 553 (W. Va. 1986) ("[N]early half of the state supreme courts in this country have wrought a radical transformation of their procedural law of conflicts in order to sidestep perceived substantive evils, only to discover later that those evils had been exorcised from American law by other means."); BRILMAYER, *supra* note 31, at 231-33; Russell J. Weintraub, *An Approach to Choice of Law That Focuses on Consequences*, 56 *ALA. L. REV.* 701, 701-03 (1993); Geri J. Yonover, *Kinder, Gentler Erie: Reining in the Use of Certification*, 47 *ARK. L. REV.* 305, 326-27 (1994) ("'[T]ort reform' wars often are being fought on the conflict of laws battlefield.").

40. Actually, the First Restatement did a particularly poor job of providing choice-of-law certainty in the area of contracts. Validity issues and issues regarding substantial perform-

ording to multi-factored standards that are applied only after a dispute arises, parties have severe difficulty knowing what law will govern their future disputes. In some cases, they cannot even ascertain whether their arrangement is legally enforceable.⁴¹

To restore some measure of certainty and predictability to contracts,⁴² courts increasingly began to recognize and enforce both choice-of-law and choice-of-forum clauses.⁴³ The drafters of the Second Restatement included a provision strongly favoring choice-of-law clauses.⁴⁴ Section 187 provides:

ance of the contract are governed by the "place of execution" of the contract, but determining that place requires the uncertain application of the law of offer and acceptance. See Baxter, *supra* note 35, at 4 ("When, and therefore where, binding agreement occurred is often debatable."). Moreover, while issues regarding substantial performance were to be governed by the law of the place of execution, the details of performance were governed by the law of the place of performance. Even the First Restatement drafters felt compelled to admit that "no logical line" separates these two types of contract issues. RESTATEMENT OF CONFLICT OF LAWS § 358 cmt. b (1934). My point in the text is simply that multi-factored standards are at least equally poor choices for contracting parties who value the certainty and predictability of their contractual bargain and the duties that are owed pursuant to their relationship.

41. The Second Restatement's general contract provision illustrates the difficulty of attempting to apply a standard. It provides that the law of the state with the most significant relationship to the transaction and the parties will determine the rights and duties of the parties. See RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 188(1) (1971). The court can consider "(a) the place of contracting, (b) the place of negotiation of the contract, (c) the place of performance, (d) the location of the subject matter of the contract, [and] (e) the domicile residence, nationality, place of incorporation and place of business of the parties." *Id.* § 188(2). In determining the place with the most significant relationship, the court should take into account "(a) the needs of the interstate and international systems, (b) the relevant policies of the forum, (c) the relevant policies of the other interested states and the relative interests of those states in the determination of the particular issue, (d) the protection of justified expectations, (e) the basic policies underlying the particular field of law, (f) certainty, predictability, and uniformity of result, [and] (g) ease in the determination and application of the law to be applied." *Id.* § 6(2). "As Javolenus once said to Julian, *res ipsa loquitur*." Paul, 352 S.E.2d at 554.

42. Choice provisions are typically justified by the need to provide predictability to the parties and to protect the parties' expectations. See EUGENE F. SCOLES & PETER HAY, CONFLICT OF LAWS 657 & nn. 1-3 (2d ed. 1992).

43. See *id.* at 660 n.2 (citing numerous cases). I do not mean to suggest that contractual choice of law was an innovation of the 1970s; the clauses were enforced in some American courts as early as the 19th century. See *id.* at 659 n.1. Nevertheless, both the use and enforcement of choice-of-law clauses have increased dramatically in the last few decades. See, e.g., Kuehn v. Childrens Hosp., Los Angeles, 119 F.3d 1296, 1301-02 (7th Cir. 1997) (Posner, J.) ("Choice of law clauses are common and when reasonable are enforced.") (citing several recent cases); Frietsch v. Refco Inc., 56 F.3d 825, 830 (7th Cir. 1995) (Posner, J.) (noting that American courts have become hospitable to choice-of-law clauses). Judge Posner took the converse position when he reasoned that because the parties omitted a choice-of-law provision in their contract, no reasonable expectations would be frustrated by the court's choice-of-law determination. *Kuehn*, 119 F.3d at 1302.

44. The First Restatement had been silent on the issue of choice of law. Its reporter, Joseph Beale, condemned contractual choice of law as an attempt by the parties to legislate privately. See Joseph Beale, *What Law Governs the Validity of a Contract: III. Theoretical and Practical Criticisms of the Authorities*, 23 HARV. L. REV. 260, 261 (1910).

(1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.

(2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either

(a) the chosen state has no substantial relation to the parties or the transaction and there is no other reasonable basis for the parties' choice, or

(b) application of the law of the chosen state would be contrary to the fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.⁴⁵

Subsection one of this provision governs default rules and is relatively uncontroversial. The parties may write these specific provisions into their contract, so subsection one merely enables them to achieve the same result with a shorthand expression of their preferred terms.⁴⁶ Subsection two treats contractual efforts to avoid mandatory rules, those that the parties cannot circumvent in a purely domestic relationship. This latter subsection calls into question the extent to which parties in a multi-state context should be entitled to opt out of otherwise mandatory regulations.

Section 187 is used to interpret statutes that are silent about contractual choice of law; explicit legislative statements trump application of the section. Recently, state statutes have addressed the validity of choice-of-law provisions in a number of contexts. Most well known is the Uniform Commercial Code ("UCC"), which endorses the widespread use of choice-of-law clauses. Unless otherwise provided, "when a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties."⁴⁷ Unlike the Second Restatement, the UCC presently does not explicitly enable a court to deny enforcement of a choice-of-law clause on the ground that it would violate a fundamental policy of a state closely connected to the transaction. Elsewhere in the UCC, however, the drafters do indi-

45. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971).

46. *See id.* at cmt. c.

47. U.C.C. § 1-105 (1) (1999).

cate some situations in which the use of contractual choice of law should be more limited.⁴⁸

In the last few years, the National Conference of Commissioners on Uniform State Laws has incorporated a number of contractual choice-of-law provisions into other proposed uniform laws. The resulting statutes acknowledge a need for uniform and predictable laws in common multi-jurisdictional transactions. For example, the UCC enables the parties to a funds transfer to choose their governing law.⁴⁹ The same is true for letters of credit,⁵⁰ and broad choices are available for investment securities intermediaries.⁵¹ The Uniform Consumer Credit Code recognizes limited use of choice-of-law provisions in commercial leases.⁵² In addition, the Uniform Premarital Agreement Act provides that choice-of-law provisions are valid for some purposes.⁵³ Some of these uniform law provisions even eliminate the requirement that the law chosen bear a reasonable relationship to the transaction or the parties, leaving contractual choice completely unfettered.⁵⁴

In a similar vein, the American Law Institute is currently considering a potentially broad expansion of contractual choice in non-consumer contracts.⁵⁵ While the proposal limits contractual choice of law in consumer contracts to those jurisdictions where the consumer resides or will use the contracted goods or services,⁵⁶ the "reasonable relationship" test would be eliminated for non-consumer contracts.⁵⁷ Contractual choice in this latter category of

48. Under Article 2A, for example, the parties to a consumer lease may choose only the law of the state in which the lessee resides at the time the lease agreement becomes enforceable or within 30 days thereafter, or the state where the goods will be used. U.C.C. § 2A-106(1) (1999).

49. U.C.C. § 4A-507(b) (1999).

50. See U.C.C. § 5-116 (1999).

51. See U.C.C. § 8-110 (1999).

52. UNIF. CONSUMER CREDIT CODE § 1.201(8) (1974), 7A U.L.A. 30 (1999).

53. UNIF. PREMARITAL AGREEMENT ACT § 3(a)(7), 9B U.L.A. 373 (1987).

54. See U.C.C. § 4A-507 cmt. 3 (1999) (funds transfers); U.C.C. §§ 5-116(a) & (e) (1999) (letters of credit).

55. See U.C.C. Article 1 § 1-301, Discussion Draft (April 14, 2000).

56. See *id.* § 1-301(b) ("If one of the parties . . . is a consumer, the agreement is not effective unless the State or country designated is either: (1) the State or country in which the consumer resides at the time the transaction becomes enforceable or within 30 days thereafter; or (2) the State or country in which, under the contract between the parties, the goods, services, or other consideration flowing to the consumer are to be received or are used by the consumer or a person designated by the consumer.").

57. *Id.* § 1-301(a) and note.

contracts is left virtually unfettered,⁵⁸ subject to a public policy exception⁵⁹ that the drafters contemplate would be invoked rarely.⁶⁰

In the absence of a legislative provision, the courts typically apply section 187 of the Second Restatement to choice-of-law clauses, and, in recent years, routinely enforce them.⁶¹ Even in the case of mandatory rules, courts are increasingly permitting the parties to choose the set of state rules (or non-rules) that will govern their relationship. Enforcement is by no means guaranteed, however, because the courts have taken varying positions on the enforcement of the clauses in individual contracting contexts.

A. State Law Examples

Usury provides a particularly interesting example of a mandatory law that can be quite easily circumvented with a choice-of-law provision. Usurious contracts are typically unenforceable, and indeed, sometimes criminal.⁶² Moreover, under the First Restatement of Conflicts, a state's usury laws were treated as reflecting its strong public policy and were therefore entitled to respect by the other states.⁶³ As a consequence, restricting states were not required to enforce usurious contracts, even though they were valid in the place of contracting.⁶⁴ Since the drafting of the Second Restatement, however, the courts' view of usurious contracts has changed

58. Contractual choice would be restricted slightly in some non-consumer contracts. If the contract bears no reasonable relationship to any foreign country, then the parties would be required to choose the law of a U.S. jurisdiction. *See id.* § 1-301(d). Moreover, as with the current UCC, party choice is sometimes limited in other parts of the Code. *See id.* § 1-301(e); *see also* note ("Subsection (e), which is essentially identical to current UCC Section 1-105(2), indicates that choice of law rules provided in other Articles govern when applicable.").

59. *See id.* § 1-301(c) ("An agreement . . . is not effective to the extent that the law of the State or country designated is contrary to a fundamental policy of the State or country whose law would otherwise govern.").

60. *See id.* at note.

61. *See Symeonides, supra* note 37 at 273 ("As in previous years, contract conflicts in which the contract contains a choice-of-law clause are too numerous to mention, much less discuss. The vast majority of these cases routinely uphold such clauses, often without much discussion.").

62. *See Pettit, supra* note 15, at 290. *See generally* Susan Pannell McAllister, *Judicially Imposed Usury Penalties in the Absence of Statutory Penalties: Can Freedom of Contract Co-Exist with Public Policy after Merritt v. Knox?*, 68 N.C. L. REV. 1021 (1990) (discussing and critiquing North Carolina's treatment of usurious contracts); Paul B. Rasor, *Biblical Roots of Modern Consumer Credit Law*, 10 J.L. & RELIGION 157, 175 (1993-94) (quoting cases in which the Court used biblical references to condemn usury contracts).

63. *See* RESTATEMENT OF CONFLICT OF LAWS § 612 (1934) (stating the public policy exception).

64. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971), note at 574 (1971) (noting the courts' refusal to enforce usurious contracts under the First Restatement).

dramatically. In the last fifteen years, courts have almost uniformly enforced choice-of-law provisions that enable the parties to evade state usury laws.⁶⁵ Although many of these cases are litigated in federal courts using their diversity jurisdiction pursuant to *Erie R.R. v. Tompkins*⁶⁶ and its progeny,⁶⁷ a federal district court must follow the choice-of-law precedents of the state where the district is located.

Antenuptial agreements are also incorporating choice-of-law provisions with mounting, albeit tentative, judicial support. When two people decide to marry, they may have reasons to circumvent their state's usual distribution of assets in the event of divorce or death. In an antenuptial agreement, the betrothed couple attempts to contract around a state's determination of fair distribution.⁶⁸ According to the drafters of the uniform law on prenuptial agreements, the parties should be entitled to choose the law they prefer to govern the interpretation of their contract.⁶⁹ Several courts have gone further, however, and enabled the spouses to use choice-of-law clauses to ensure the validity of their agreement.⁷⁰

States have varying requirements regarding the enforceability of antenuptial agreements. Some states recognize antenuptial agreements in contemplation of death, but are hostile to those formed in contemplation of divorce.⁷¹ Others recognize the validity

65. See, e.g., *Jett Racing & Sales, Inc. v. Transamerica Commercial Fin. Corp.*, 892 F. Supp. 161, 162-64 (S.D. Tex. 1995); *Kinley Corp. v. Integrated Resources Equity Corp. (In re Integrated Resources, Inc.)*, 851 F. Supp. 556, 564-65 (S.D.N.Y. 1994); *Karl Rove & Co. v. Thornburgh*, 824 F. Supp. 662, 676 (W.D. Tex. 1993); *American Honda Fin. Corp. v. GLOMC, Inc.*, 820 F. Supp. 1157, 1159-60 (E.D. Ark. 1993); *Capital Center Equities v. Estate of Gordon (In re Capital Center Equities)*, 137 B.R. 600, 613 (Bankr. E.D. Pa. 1992); *Sumner Realty v. Willcott*, 499 N.E.2d 554, 556 (Ill. App. Ct. 1986). Exceptions typically involve the chosen law of a state that has no substantial connection to the contract. See, e.g., *Culbert v. Rols Capital Co.*, 184 A.2d 612 (N.Y. App. Div. 1992) (holding that if a company is only nominally operating in New Jersey to evade New York usury laws, the connection is insufficiently substantial to justify the choice-of-law provision); *Cook v. Frazier*, 765 S.W.2d 546 (Tex. App. 1989) (holding that the parties' attempt to create Utah connection was mere subterfuge to avoid Texas usury laws).

66. *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938).

67. See *Klaxon Co. v. Stentor Elec. Mfg.*, 313 U.S. 487 (1941) (holding that federal courts sitting in diversity must follow the choice-of-law rules of the state); see also *Day & Zimmerman, Inc. v. Challoner*, 423 U.S. 3, 4 (1975) (reaffirming the commitment to the *Klaxon* rule).

68. The state may develop distribution rules that are thought to accord best with the intent of the parties. Likely, however, the courts will conclude that the married couple wanted a "fair distribution," so the two inquiries are likely substantively equivalent.

69. UNIF. PREMARITAL AGREEMENT ACT § 3(a)(7), 9B U.L.A. 373 (1987).

70. See, e.g., *Elgar v. Elgar*, 679 A.2d 937, 942-44 (Conn. 1996); *In re Estate of Massello*, No. 14613, 1997 WL 89091, at *3 (Del. Ch. Feb. 24, 1997); *Carr v. Kupfer*, 296 S.E.2d 560, 562 (Ga. 1982).

71. See *id.* at 561.

of all antenuptial agreements, but place requirements on their formation.⁷² State laws cover the need for notarization, witnesses, representation by attorney or explicit waiver of that right, disclosure of the assets of the parties in the agreement, and fundamental fairness of the terms of the agreement at the time of the signing.⁷³ These varying laws create potential choice-of-law difficulties, given that one or both spouses may move to a new state by the time their marriage is dissolved.⁷⁴ Contractual choice of law might therefore enable the spouses to rely on the validity requirements of a single jurisdiction. Most courts that have decided the issue have expressed a general willingness to enforce choice provisions, or at least those clauses that will not result in manifest injustice.⁷⁵

In contrast to their positions regarding usurious and antenuptial agreements, a few states have refused to enforce choice-of-law provisions in non-competition agreements between employers and employees.⁷⁶ Typically, an employee who signs a non-competition clause agrees that when he leaves his firm, he will not compete with the employer or work for the employer's competitors for a fixed period of time. Usually, the employer is concerned with protecting trade secrets or other confidential information, and the

72. See Brian Bix, *Bargaining in the Shadow of Love: The Enforcement of Premarital Agreements and How We Think About Marriage*, 40 WM. & MARY L. REV. 145, 153-58 (1998) (discussing varying substantive and procedural prerequisites to enforcement).

73. See, e.g., *Elgar*, 679 A.2d at 945-45 (holding under New York law, antenuptial agreements are enforceable absent fraud, duress, or undue influence and separate representation is unnecessary where both parties were experienced business people and full financial disclosure was made); *Gustafson v. Jensen*, 515 So.2d 1298, 1300-01 (Fla. Dist. Ct. App. 1987) (holding under Florida law, tearing up of an antenuptial agreement with intent that the terms be no longer legally binding constitutes abandonment of the agreement); *Penballow v. Penballow*, 649 A.2d 1016, 1020-21 (R.I. 1994) (holding under Rhode Island law, an unconscionable premarital agreement was still enforceable absent proof of both involuntary execution and nondisclosure and/or waivers so long as it is in writing and signed by both parties).

74. Even under a single state's choice-of-law precedents, it may not be clear what law applies to their agreement. Compare *In re Estate of Nicole Santos*, 648 So.2d 277 (Fla. Dist. Ct. App. 1995) (holding that place of contracting applied to antenuptial agreement), with *Gustafson*, 515 So.2d at 1300 (rejecting the place of contracting rule for antenuptial agreements).

75. See, e.g., *Elgar*, 679 A.2d at 942-44 (applying the Second Restatement and determining that choice of New York law was valid); *Carr*, 296 S.E.2d at 562 ("Absent a contrary public policy, this court will normally enforce a contractual choice of law clause."); *Massello*, 1997 WL 89091, at *3 ("Normally, a bargained-for choice-of-law contract provision will govern.").

76. See SCOLES & HAY, *supra* note 41, at 668 ("Courts almost always strike down or modify such covenants if they violate the law of the employee's home state, despite stipulations in the employment contract for a different law, on the ground that employees need protection against the superior bargaining position of employers.").

clause helps protect the employer's investment in training employees and developing customer relations.⁷⁷

State policies vary regarding enforcement of these non-competition clauses. Most states will enforce a clause to the extent that it is reasonable in geographic scope and duration.⁷⁸ However, a few states further limit or deny their enforcement because they are thought to harm competition for the provision of goods and services within the state and to inhibit the employee's *ex post* earning potential.⁷⁹ When the employing firm is headquartered in a state that enforces non-competition clauses, but its employee is located in a state that provides less or no protection for the employer, the firm can attempt to protect itself with a choice-of-law clause.

Unfortunately, however, enforcement of these clauses often turns on an *ex post* race to judgment. If the employer files a breach of contract claim in the state whose law is contractually designated, the court typically enforces the provision.⁸⁰ After all, enforcement of the non-competition clause benefits the in-state employer, and courts typically prefer to apply forum law because it is more familiar⁸¹ and it generates precedent for use in future cases.⁸² If the claim is not filed in the employer's home state, however, enforcement of the choice-of-law provision is unlikely in any case in which enforcement of the non-competition clause turns on the governing

77. See *Reed, Roberts Assocs. v. Strauman*, 353 N.E.2d 590, 593 (N.Y. 1976) (holding that an employer has a legitimate interest in safeguarding trade secrets and confidential customer information).

78. See, e.g., *Affiliated Paper Cos. v. Hughes*, 667 F. Supp. 1436, 1445-50 (N.D. Ala. 1987); *Hughes Assocs. v. Printed Circuit Corp.*, 631 F. Supp. 851, 855-58 (N.D. Ala. 1986); *Reed, Roberts*, 353 N.E.2d at 593.

79. See, e.g., *Enron Capital & Trade Resources Corp. v. Pokalsky*, 490 S.E.2d 136, 139 (Ga. Ct. App. 1997) ("Covenants against disclosure, like covenants against competition, affect the interests of this state, namely the flow of information needed for competition among businesses, and hence their validity is determined by the public policy of this state."); *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670 (Tex. 1990) (holding that Florida's choice-of-law provision was properly ignored, given Texas' direct interest in (1) the employee in its state; (2) the employer doing business within its state; (3) the employee's new business within the state; and (4) the consumers of services furnished within Texas); Renald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575, 607-08 (1999) (discussing California's refusal to enforce non-competition clauses against employees).

80. See, e.g., *Medtronic, Inc. v. Gibbons*, 684 F.2d 565, 567-68 (8th Cir. 1982); *Shipley Co. v. Kozlowski*, 926 F. Supp. 28, 29-30 (D. Mass. 1996); *JAK Prods. v. Wiza*, No. IP 92-110-C, 1992 WL 472277, at *3 (S.D. Ind. March 11, 1992); *Shipley Co. v. Clark*, 728 F. Supp. 818, 825-27 (D. Mass. 1990).

81. See Friedrich K. Juenger, *The Need for a Comparative Approach to Choice-of-Law Problems*, 73 TUL. L. REV. 1309, 1315 (1999).

82. See Francesco Parisi and Erin A. O'Hara, *Conflict of Laws*, in 1 NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 387, 390 (1998).

law. If, for example, the employee, perhaps with his new employer, files a declaratory judgment action in the employee's state,⁸³ the court usually applies the public policy language of the Second Restatement to strike down the choice-of-law provision.⁸⁴

Of course, the case law is not entirely bereft of examples where courts in the employee's state enforce choice-of-law provisions. In virtually every one of these cases, however, the court notes that the same result follows under application of either state's laws.⁸⁵ Because the state incurs no cost in applying the law that is designated by the parties, respecting party autonomy impedes no state policy. From the employer's perspective, however, the choice-of-law provision does not assist in the enforcement of a non-competition clause.

B. Federal Law Examples

The federal courts have increasingly enforced choice-of-law and choice-of-forum⁸⁶ provisions in international transactions, even when the provisions are used to evade federal law that might otherwise regulate one of the parties. Indeed, the courts seem to recognize that expansive and unyielding application of American law can cost us significant international trade opportunities. As the Supreme Court has stated in the context of enforcing choice-of-forum clauses, "[w]e cannot have trade and commerce in world markets

83. The same problem can arise if the court in the employer's home state lacks personal jurisdiction over the employee. However, a choice-of-forum provision can solve this problem, because the provision is very often treated as consent to jurisdiction.

84. See, e.g., *Barnes Group, Inc. v. C & C Prods., Inc.*, 716 F.2d 1023, 1030-31 (4th Cir. 1983); *Marketing & Research Counselors, Inc. v. Booth*, 601 F. Supp. 615, 617 (N.D. Ga. 1985); *Enron Capital*, 490 S.E.2d at 139; *DeSantis*, 793 S.W.2d at 677.

85. See *Baxter Int'l, Inc. v. Morris*, 976 F.2d 1189, 1196 (8th Cir. 1992); *Ferrofluidics Corp. v. Advanced Vacuum Components, Inc.*, 968 F.2d 1463, 1468-69 (1st Cir. 1992); *Webcraft Techs., Inc. v. McCaw*, 674 F. Supp. 1039, 1043-44 (S.D.N.Y. 1987) (agreement upheld under both); *American Air Filter Co. v. McNichol*, 361 F. Supp. 908, 911 (E.D. Pa. 1973) (both laws the same); see also *LCI Communications, Inc. v. Wilson*, 700 F. Supp. 1390, 1396 (W.D. Pa. 1988) (involving no objections by either party to the application of Ohio law, as designated in the contract).

86. Forum selection provisions are important because they can most often get parties into a court that will enforce the choice-of-law provision. In fact, the Supreme Court endorses recognition of choice-of-forum clauses while fully acknowledging that enforcement often means that the parties have *de facto* chosen their own governing law. See *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 516, 517 n.11 (1974) (arbitration clause); *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 13 n.15 (1972).

and international waters exclusively on our terms, governed by our laws, and resolved in our courts.”⁸⁷

Using this reasoning, the seven circuits that have so far considered the issue all have determined that parties to international transactions can use choice-of-law clauses to opt out of federal securities regulations, at least where the chosen country’s law provides some, albeit considerably less, right to relief.⁸⁸ The securities regulations provide an interesting example of contractual opt outs because the statutory language of both the Securities Act of 1933 and the Securities Exchange Act of 1934 expressly disables the parties from attempting to avoid their liabilities with direct contractual waivers. For example, the 1933 Act states, “[a]ny condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.”⁸⁹ In the process, the Second, Ninth, and Eleventh Circuits have also determined that the parties may use choice-of-law clauses to opt out of their civil RICO liabilities,⁹⁰ a somewhat surprising result, given that, by definition, civil RICO only attaches when one has violated a federal racketeering and organized crime statute that imposes very harsh criminal penalties.⁹¹

Of course, the federal courts, like the states, have not uniformly enabled parties to international transactions to opt out of federal regulations. The Supreme Court has stated, at least in dicta, that private parties will not be permitted to opt out of the

87. *The Bremen*, 407 U.S. at 9; see also *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 587-88, 593-94 (1991) (quoting *The Bremen* and enforcing a forum selection clause typewritten on back of a ticket); *Scherk*, 417 U.S. at 516 (“A contractual provision specifying in advance the forum in which disputes shall be litigated and the law to be applied is . . . an almost indispensable precondition to achievement of the orderliness and predictability essential to any international business transaction.”).

88. See *Lipcon v. Underwriters at Lloyd’s, London*, 148 F.3d 1285, 1292-99 (11th Cir. 1998); *Richards v. Lloyd’s of London*, 135 F.3d 1289, 1292-96 (9th Cir. 1998); *Haynsworth v. Corp.*, 121 F.3d 956, 962-70 (5th Cir. 1997); *Allen v. Lloyd’s of London*, 94 F.3d 923, 928-30 (4th Cir. 1996); *Bonny v. Society of Lloyd’s*, 3 F.3d 156, 159-62 (7th Cir. 1993); *Roby v. Corporation of Lloyd’s*, 996 F.2d 1353, 1360-66 (2d Cir. 1993); *Riley v. Kingsley Underwriting Agencies, Ltd.*, 969 F.2d 953, 956-58 (10th Cir. 1992); see also *Shell v. R.W. Sturge, Ltd.*, 55 F.3d 1227 (6th Cir. 1995) (holding forum-selection clauses enforceable despite the public policy behind Ohio’s securities statutes).

89. 15 U.S.C. § 77n (1994). The Securities Exchange Act of 1934 contains a substantially similar restriction. See 15 U.S.C. § 78cc(a) (1994).

90. See *Lipcon*, 148 F.3d at 1299 n.20; *Richards*, 135 F.3d at 1296; *Roby*, 996 F.2d at 1366.

91. See *Racketeering Influenced and Corrupt Organizations Act of 1970*, 18 U.S.C. §§ 1961-1968 (1994).

federal antitrust laws.⁹² Similarly, parties may not use choice-of-law clauses to opt out of the Carriage of Goods by Sea Act.⁹³ Moreover, many more contractual choice-of-law issues have yet to be worked out fully by the courts. The increasing enforcement of choice-of-law opt outs in general, coupled with the consequent uncertainty of the enforcement of these opt outs in particular circumstances, should intensify the legislative focus on contractual choice of law.

C. Academic Debate

The rise in the use and enforcement of choice-of-law clauses has sparked debate among scholars over the desirability of enabling parties to opt out of regulation. Early critics of the enforcement of choice-of-law provisions objected to the idea on the grounds that the clauses impermissibly restrict the regulating state's legislative jurisdiction.⁹⁴ Until recently, proponents of contractual choice of law focused on the practical benefits of letting the parties choose. After all, contractual disputes are private rather than public, and predictability and certainty are especially important to contracting parties.⁹⁵ Since, by definition, there is an inevitable conflict in the laws of the possibly applicable jurisdictions, a choice-of-law clause promotes certainty of party obligations and enables both the parties and the courts to economize on litigation costs.⁹⁶

92. See *Mitsubishi Motors Co. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 637 n.19 (1985) (“[I]n the event the choice-of-forum and choice-of-law clauses operated in tandem as a prospective waiver of a party’s right to pursue statutory remedies for antitrust violations, we would have little hesitation in condemning the agreement as against public policy.”).

93. See *Vimar Seguros y Reaseguros, S.A. v. M/V Sky Reefer*, 515 U.S. 528, 539 (1995).

94. See Richard J. Bauerfeld, *Effectiveness of Choice-of-Law Clauses in Contract Conflicts of Law: Party Autonomy or Objective Determination?*, 82 COLUM. L. REV. 1659, 1666-67 (1982); Beale, *supra* note 43, at 261 (“[S]ince the parties can adopt any foreign law at their pleasure to govern their act, [] at their will they can free themselves from the power of the law which would otherwise apply to their acts.”); Brainerd Currie, *Conflict, Crisis and Confusion in New York*, 1963 DUKE L.J. 1, 45; Brainerd Currie, *Married Women’s Contracts: A Study in Conflict-of-Laws Method*, 25 U. CHI. L. REV. 227, 248 (1958) (arguing that allowing the “incapacitated” party to contract around capacity can subvert the interests of her domicile state); see also Albert A. Ehrenzweig, *Adhesion Contracts in the Conflict of Laws*, 53 COLUM. L. REV. 1072, 1090 (1953) (disapproving the enforcement of choice-of-law clauses in adhesion contracts).

95. See Willis L. M. Reese, *Choice of Law in Torts and Contracts and Directions for the Future*, 16 COLUM. J. TRANSNAT’L L. 1, 24 (1977).

96. See MICHAEL J. WHINCOP & MARY KEYES, *POLICY AND PRAGMATISM IN THE CONFLICT OF LAWS* 18 (forthcoming 2000) (arguing that party choice of law reduces transaction costs); John Prebble, *Choice of Law to Determine the Validity and Effect of Contracts: A Comparison of English and American Approaches to the Conflict of Laws*, 58 CORNELL L. REV. 433, 495 (1973) (discussing the position that contractual choice simplifies the judicial task while contributing to certainty in commercial transactions); see also Donald T. Trautman, *Some Notes*

In the last couple of years, a few conflicts scholars have argued that contractual choice of law can provide systemic benefits for legal systems. In effect, party choice places competitive pressures on jurisdictions to provide laws that appeal to the joint preferences of the parties. Because the parties can choose their governing law prior to the time a dispute arises, the law they choose is likely to be the law that best suits their individual relationship. These latest proponents of choice-of-law clauses view them as likely to promote more efficient laws in each jurisdiction.⁹⁷ Although this literature is just now being published, critics are already rejecting this “race-to-the-top” argument by characterizing choice of law as ultimately creating a “race to the bottom.”⁹⁸

on the Theory of Choice of Law Clauses, 35 MERCER L. REV. 535, 541-42 (1984) (arguing that the differing jurisdictions are attempting to solve the same problem anyway, often with functionally equivalent means).

Recently, scholars have also pointed out that because parties and their transactions are heterogeneous, contractual choice of regulatory regimes enables them to each choose the law that is best suited to the particular transaction. See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 914-18 (1998).

97. See WHINCOP & KEYES, *supra* note 95, at 18 (arguing that party choice of law promotes competition among the states to provide better laws); Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Competition*, in FALL AND RISE OF FREEDOM OF CONTRACT 325 (F.H. Buckley ed., 1999) (arguing that party choice leads to efficient laws); Erin A. O'Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, U. CHI. L. REV. (forthcoming 2000); Michael J. Whincop & Mary E. Keyes, *Statutes' Domains in Private International Law: An Economic Theory of the Limits of Mandatory Rules*, 20 SYDNEY L. REV. 435, 436, 442-43 (1998) (arguing that attempts to avoid legal rules by contract “should not be viewed pejoratively”); see also Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2395, 2402, 2410 (1998) (arguing that state regulatory competition should replace federal securities regulation and that the “choice of law clause approach” will lead to more favorable securities laws); Paul B. Stephan III, *Regulatory Cooperation and Competition—The Search for Virtue* (visited Sept. 14, 2000) <http://papers.ssrn.com/pa-per.taf?abstract_id=169213> (arguing that under some circumstances, choice-of-law clauses can promote jurisdictional competition creating a race to the top).

98. See Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (arguing that issuer choice of securities regulation will result in suboptimal disclosure to investors); Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race-to-the-Bottom?*, 85 CORNELL L. REV. 1035, 1074 (2000) (noting that foreign asset protection laws can be used by local defendants to shield their assets from plaintiffs); Joel P. Trachtman, *Regulatory Competition and Regulatory Jurisdiction in International Securities Regulation* (draft manuscript on file with author) (arguing that jurisdictional competition in the securities context will create a race to the bottom); see also Stephan, *supra* note 96 (acknowledging that choice-of-law clauses can help facilitate a race to the bottom). For other critiques of contractual choice, see James D. Cox, *Choice of Law Rules For International Securities?*, 66 U. CIN. L. REV. 1179, 1191 (1998) (arguing that because U.S. securities laws are public rather than private law, they should not be subject to party choice); Darrell Hall, Note, *No Way Out: An Argument Against Permitting Parties to Opt Out of U.S. Securities Laws in International Transactions*, 97 COLUM. L. REV. 57, 59-60 (1997) (arguing that Congress intended securities laws to be mandatory).

The roots of the “race-to-the-bottom” argument are visible in the ideologically charged rhetoric of the Congressional supporters of the Defense of Marriage Act (“DOMA”).⁹⁹ DOMA was Congress’s response to Hawaii’s recognition of same-sex marriages. To the proponents of DOMA, who were quite openly hostile to same-sex marriage,¹⁰⁰ differing state marriage laws threatened to create *de facto* party choice regarding marital status. If couples could go to Hawaii to create a marriage, then states that wanted to compete for tourist dollars would end up eroding other states’ restrictions on same-sex marriage.¹⁰¹ DOMA purported to enable each state to deny marital benefits to single-sex couples married elsewhere,¹⁰² and it also denied federal benefits to them.¹⁰³ DOMA’s proponents were, in essence, arguing that party choice would create a race to the bottom.

The proponents of the “race-to-the-top” argument discussed in the text each came to the field of conflict of laws from the field of corporate law. The argument has its roots in the corporate debate over corporate chartering. A corporation can choose to incorporate in any state, regardless of whether it has any other connection to that state. See Larry E. Ribstein, *Choosing Law by Contract*, 18 J. CORP. L. 245, 267-69 (1993) (discussing the difference between the internal affairs rule and the conflicts rule applied to other business contracts). In essence, then, corporate charting is a form of contractual choice of law. See *id.* at 270. Many in the field of corporations viewed corporate charting as creating pressures for the states to compete to provide efficient corporate laws. See generally Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); see also Ronald J. Daniels, *Should Provinces Compete?: The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130 (1991) (discussing Canadian corporate law). Others, however, viewed the competitive pressures as creating a “race to the bottom” in which the states attract incorporation business by exploiting the principle-agent problems that result from the separation of the ownership from the control of the corporation. See generally William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW 1125 (1976); see also Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992) (discussing that some areas of corporate law produce the race-to-the-bottom).

99. Defense of Marriage Act, Pub. L. No. 104-199, 110 Stat. 2419 (1996) (codified at 28 U.S.C. § 1738C (Supp. II 1996) & 1 U.S.C. § 7 (Supp. II 1996)).

100. The House Report accompanying the bill stated that DOMA was a response to an “orchestrated legal assault being waged against traditional heterosexual marriage by gay rights groups and their lawyers.” H.R. Rep. No. 664, at 2-3 (1996). The Report also quotes Representative Henry Hyde approvingly: “Same-sex marriage, if sanctified by the law . . . trivializes the legitimate status of marriage and demeans it by putting a stamp of approval . . . on a union that many people . . . think is immoral.” *Id.* at 16. See generally Charles J. Butler, Note, *The Defense of Marriage Act: Congress’s Use of Narrative In the Debate Over Same-Sex Marriage*, 73 N.Y.U. L. REV. 841 (1998) (quoting several polemical statements indicating that DOMA was aimed to entrench view that same-sex marriage is immoral).

101. Cf. H.R. Rep. No. 664, at 17 (1996) (noting the states’ concern about their ability to defend their marriage laws against the threat posed by the “Hawaiian situation”).

102. See Defense of Marriage Act, Pub. L. No. 104-199, § 2 (codified at 28 U.S.C. § 1738C (Supp. II 1996)).

103. See Pub. L. No. 104-199, § 3 (codified at 1 U.S.C. § 7 (Supp. II 1996)).

As is unfortunately clear in the case of DOMA, the debate typically turns on the debater's normative views of the regulation at issue. If regulation is desirable, then choice of law creates a race to the bottom by eroding efforts to eliminate social harms. If regulation is undesirable, then choice of law creates a race to the top by promoting a state of minimalist restrictions on autonomy.¹⁰⁴

Although the two sides of this debate disagree about whether party choice of law represents a race to the top or to the bottom, both sides seem to assume that party choice of law makes it more difficult for states to regulate. The remainder of this article demonstrates that, at least in the short run, precisely the opposite can be true.

II. CONTRACTS, INTEREST GROUPS, AND OPT OUTS

More often than not, regulatory statutes are silent regarding the enforcement of choice-of-law provisions. This silence can be the result of rational calculation on the part of a statute's interest group proponents for at least two reasons. First, silence can represent a political compromise necessary to ensure the enactment of the regulation. Second, contractual opt outs can, under specified conditions, serve to dissipate the costs rather than the benefits of the law. In order to explain these phenomena, I first briefly describe the works of Ronald Coase, in section A, and Gary Becker, in

104. A similar debate is underway regarding the effects of jurisdictional competition for the desirability of federalism. Compare William W. Bratten & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 259 (1997) (arguing that jurisdictional competition works only under a very narrow set of circumstances), Sheryll D. Cashin, *Federalism, Welfare Reform, and the Minority Poor: Accounting for the Tyranny of State Majorities*, 99 COLUM. L. REV. 552, 555-57 (1999) (arguing that jurisdictional competition will erode efforts to redistribute wealth to the poor), and Thomas W. Merrill, *Chief Justice Rehnquist, Pluralist Theory, and the Interpretation of Statutes*, 25 RUTGERS L.J. 621, 640 (1994) (noting that interjurisdictional spillovers and consequent races to the bottom limit beneficial effects of regulatory competition), with Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 707-12 (1988) (arguing that state competition of banking regulations would be beneficial), Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 33-35 (1983), A.P. Hamlin, *The Political Economy of Constitutional Federalism*, 46 PUB. CHOICE 187, 189-91 (1985) (describing the public choice perspective of federalism and its potential for both reducing political exploitation and satisfying heterogeneous demands for public services), and Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1244-45 (1992) (arguing for a presumption favoring regulation at the state level). See generally Symposium, *Constructing a New Federalism: Jurisdictional Competence and Competition*, 14 YALE J. ON REG. 1 (1996) (exploring the movement toward federalism in a variety of contexts).

section B. Section C details the influence of choice of law on interest group bargains.

A. The Coase Theorem and Choice of Law

In a seminal article entitled *The Problem of Social Cost*, Ronald Coase set forth the reasoning widely recognized today as the Coase Theorem.¹⁰⁵ The article itself primarily addressed the problem of nuisance, or what Coase saw as the difficulties that arise when competing land uses create or impose externalities on the adjacent landowner(s).¹⁰⁶ Until Coase, economists typically thought that the problem was best solved either with liability rules or with Pigovian taxes.¹⁰⁷ By charging the creator of the externality an amount equivalent to the cost that she imposes on her neighbor(s), the harming landowner is forced to internalize the costs of her nuisance and will thereby be given the incentive to engage in socially efficient behavior. Coase identified two reasons why Pigovian taxes would likely prove unsatisfactory. First, to Coase, the problem was not one of a "bad guy" harming a "good guy," but rather one of choosing among the most efficient of alternative land uses.¹⁰⁸ Given the difficulties of assessing relative inefficiencies in any context, the government risks guessing incorrectly when it determines which landowner should be taxed. Second, assuming that the government chooses the correct person to tax, assessing the appropriate tax likely proves impossible.¹⁰⁹

Coase offered a much simpler and more efficient solution: assign the property right to one of the landowners. In his article, Coase uses the example of a railroad and a farmer who dispute over

105. R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

106. Elsewhere, Coase defines "externality" as:

the effect of one person's decision on someone who is not a party to that decision. Thus, if A buys something from B, A's decision to buy affects B, but this effect is not considered to be an "externality." However, if A's transaction with B affects C, D, and E, who are not parties to the transaction, because, for example, it results in noise or smoke which impinge on C, D, and E, the effects on C, D, and E are termed "externalities."

R. H. COASE, *THE FIRM, THE MARKET AND THE LAW* 24 (1990).

107. See Coase, *supra* note 104, at 1-2. The term "Pigovian taxes" refers to the ideas set forth in A. C. PIGOU, *THE ECONOMICS OF WELFARE* (1920) and A. C. PIGOU, *WEALTH AND WELFARE* (1912). An oral tradition by economists interprets Pigou's work as advocating that one who creates a negative externality be taxed by the amount of harm that she causes. See Coase, *supra* note 104, at 39-41.

108. *Id.* at 2.

109. See *id.* at 41-42.

the emission of sparks by the trains.¹¹⁰ The sparks destroy the farmer's crops along a strip of land adjacent to the tracks, and the Pigovian solution would be to tax the railroad the cost of the crop damage. Coase argued that the issue is better framed as how best to use the strip of land along the tracks.¹¹¹ Viewed in this manner, an efficient result might more reliably be achieved by either (1) giving the farmer the right to grow crops free from damage; or (2) giving the railroad the right to emit sparks without compensating for resulting damage.¹¹²

Enter the Coase Theorem: The assignment of rights is critical, but the particular designee becomes irrelevant in the absence of transaction costs. By replacing taxation with a property right, the parties, who are better informed than the government, will bargain to an efficient resolution of the problem. If it is worth more to the railroad to emit sparks than it is to the farmer to be protected from crop damage along the spark-vulnerable section of his field, then, assuming the farmer holds the property right, the railroad will pay the farmer for the right to emit sparks. If instead the farmer loses more in crop damage than it would cost the railroad to prevent the damage, then, assuming the railroad holds the property right, the farmer will pay the railroad for the right to farm free of spark damage. Of course, in both examples if the property right is apposite, then no bargain is required to ensure the efficient outcome. The assignment of the property right can affect the distribution of wealth (i.e. whether money is transferred from railroad to farmer), but not allocative efficiency (whether resources are put to their most productive uses).¹¹³

Of course, bargaining is never costless, so the Coase Theorem needs restatement to be useful: As long as transactions costs are less than the gain to the parties from bargaining around the initial assignment, the property rights solution induces an efficient resolution. From the perspective of an economist, the parties can undo an inefficient rights allocation by choosing an alternative one. For example, the railroad could pay the farmer in return for the farmer signing a release promising not to sue for crop damage. Or, the railroad could purchase the strip of land that is vulnerable to damage

110. *See id.* at 29-34. Actually, the example originated with Pigou. *See* A. C. PIGOU, *THE ECONOMICS OF WELFARE* 134 (4th ed. 1932).

111. *See* Coase, *supra* note 104, at 34.

112. *See id.* at 6-8.

113. *See id.* at 10.

from the trains. Presumably, Coase had in mind this direct type of bargaining.

The conflicts scholar sees an alternative bargaining technique: The farmer and the railroad might enter into an agreement which provides that all of their disputes will be resolved according to the law of another state. To avoid the liability rule, they must choose the law of a state that does not impose liability on railroads for spark damage. Under either the direct bargaining or choice-of-law clause solution, the farmer and the railroad are, in effect, opting out of the governing law. The choice-of-law clause option becomes attractive to the parties when the regulating state law treats the liability rule as a mandatory rather than a default rule. If, for example, the state where the farm is located refuses to enforce releases, then their bargaining may only be feasible in the shadow of an alternative state's law.

As always, to the rational decision maker, bargaining is only worthwhile if the expected benefits to bargaining around the liability rule exceed their costs. The expected benefits turn on the likelihood that the choice-of-law provision will be enforced. As indicated in Part I, under prevailing conflicts doctrine, the enforceability of choice-of-law provisions is often uncertain.

Even if bargaining around the law produces gains to the contracting parties, their agreement may not enhance social efficiency. Some contracting is restricted to protect third parties from potential harms they might suffer.¹¹⁴ Suppose, for example, that a man hires a hit man to murder his wife. The agreement might produce large gains for the contracting parties, but contracting is nevertheless restricted to protect the targeted spouse. Similarly, contracts that restrain trade are restricted to protect third party consumers. And, to some extent, contracts for gambling or the sale of drugs are prohibited to protect the moral sensibilities of the rest of society. Coasean bargaining presupposes that all parties who may suffer from the externalities of the proposed behavior are parties to the

114. Social efficiency might also be reduced because one of the individuals lacks the capacity to act as a rational decision maker. In these cases, the party thinks the bargain creates gains for him, but the state has determined that the person's judgment cannot be trusted. See Christine Jolls, Cass R. Sunstein & Richard Thaler, *A Behavioral Approach to Law And Economics*, 50 STAN. L. REV. 1471, 1541-43 (1998) (arguing that empirical evidence indicates that people tend to underestimate negative risks in ways that call into question the "anti-paternalism" position). See generally JON ELSTER, *SOUR GRAPES: STUDIES IN THE SUBVERSION OF RATIONALITY* (1983) (arguing that preferences are often shaped by the very conditions that a society wishes to eliminate).

contract. If third parties are injured, then bargaining will not necessarily produce an efficient result.¹¹⁵

Alternatively, "efficiency," at least in a narrow economic sense of wealth maximization, is not always the relevant objective. An economist at a recent conference on environmental regulation conveyed this point: "telling people recycling is inefficient is like arguing that people shouldn't take communion because it is non-nutritious."¹¹⁶ Laws may support or further some other important value, such as altruism, personal autonomy, or the enjoyment of natural beauty. To preserve these important non-efficiency objectives, states may prevent the parties from bargaining around the law.

Still other laws are aimed neither at efficiency nor at promoting other social virtues, but rather are enacted to transfer wealth. Coase dealt with the assignment of rights to force competing users to internalize the costs of their externalities. However, some laws are not aimed at externalities. One of the lessons that can be derived from the public choice literature is that sometimes laws are inefficient because they are primarily intended to transfer wealth from one group to another. People tend to gravitate toward those activities that will yield them the highest benefits—and for some, that means organizing to advocate laws that will benefit themselves at the expense of others. These wealth-transferring laws may be good or bad, fair or unfair. My point here is simply that some will have an incentive to obtain legislative transfers, and that those who stand to lose their wealth may have an incentive to fight redistributive efforts.

As with some public choice literature, I separate "equalizing" from "non-equalizing" wealth transfers.¹¹⁷ Equalizing wealth transfers are those intended to redistribute wealth from rich to poor that can produce offsetting advantages that might make them desirable

115. Cf. P.S. ATIYAH, *THE RISE AND FALL OF FREEDOM OF CONTRACT* 332 (1979) ("If A and B make a contract which benefits both parties it still cannot be deduced that the performance of the contract will be in the public interest unless it is clear that the contract will not impose any costs on third parties; or, more accurately, that it will not impose costs on third parties in excess of any benefits conferred on third parties.").

116. Daniel K. Benjamin, Remarks at the Free-Market Environmentalism Conference, sponsored by the Political Economy Research Corporation, Bozeman, Montana (June 1999).

117. See William R. Dougan & James M. Snyder, *Interest Group Politics Under Majority Rule*, 61 J. PUB. ECON. 49, 54-61 (1996) [hereinafter Dougan & Snyder, *Interest Group Politics*]; Erin A. O'Hara & William R. Dougan, *Redistribution Through Discriminatory Taxes: A Contractarian Explanation of the Role of the Courts*, 6 GEO. MASON L. REV. 869, 882-92 (1998).

even to the rich who bear the costs of the transfers.¹¹⁸ The remainder of this Article focuses instead on “non-equalizing” wealth transfers, or those intended to transfer wealth in a fashion that does not tend toward equality. An example of a non-equalizing redistribution would be a tax that transfers wealth from employees of the garment industry to people living in Texas, without regard to the wealth or the incomes of the employees burdened or the Texans who benefit. For non-equalizing wealth transfers, winners and losers can be expected to oppose one another in the legislative arena. In the public choice literature, attempts to achieve these non-equalizing wealth transfers are often referred to as “rent-seeking.”¹¹⁹ The next section elaborates on the theory of competition among interest groups. The remainder of this Article explores the connection between this interest group theory and choice of law.

B. The Interest Group Wrinkle

The legislature is itself a marketplace, and interest groups compete with one another in that marketplace for legislative benefits.¹²⁰ In this competitive process, as with all others, groups that are more successful at creating benefits for themselves at low cost are more likely to obtain the benefits that they seek.¹²¹ Laws therefore tend to benefit those groups that are able to (1) organize cheaply and effectively; (2) prevent others from entering the group to usurp a share of the benefits; and (3) minimize intra-group competition that threatens to dissipate the proceeds obtained.¹²²

118. See O'Hara & Dougan, *supra* note 116, at 877-78 (arguing that under a broad range of conditions, the rich will agree not to prohibit redistribution from wealthy to poor).

119. See, e.g., MAXWELL L. STEARNS, PUBLIC CHOICE AND PUBLIC LAW 120-26 (1997); Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224 (1967) (criticizing prior economic literature for its failure to account for the significant social costs incurred in private efforts to obtain these rents).

120. See generally Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983) [hereinafter Becker, *Theory of Competition*] (arguing that competition for political favors helps to constrain deadweight costs associated with legislation).

121. See *id.* at 395-96.

122. See generally William R. Dougan & James M. Snyder, *Are Rents Fully Dissipated?*, 77 PUB. CHOICE 793 (1993) [hereinafter Dougan & Snyder, *Rents*] (discussing conditions under which interest groups can obtain legislative benefits without fully dissipating the potential rents in the lobbying process); O'Hara & Dougan, *supra* note 116, at 889-92.

Interestingly, unlike equalizing redistribution, non-equalizing redistribution more often takes the indirect¹²³ form of regulation than it does the more efficient form of direct¹²⁴ cash transfers.¹²⁵ Economists have identified two reasons for the phenomenon. First, indirect transfers may more likely fool the public into believing that the law benefits the general public,¹²⁶ whereas simply doling out cash can smack too strongly of political favoritism. Second, indirect transfers make it easier for the beneficiaries of the transfers to protect their proceeds.¹²⁷ Some regulations, like occupational licensing requirements, are designed to keep out newcomers who might attempt to benefit from the increased salaries created by an artificially reduced supply of doctors, lawyers, architects, or other professionals. These licensing requirements may in fact benefit the public; no doubt the most successful legislative efforts have both a public interest component that appeals to voters and a private interest component that creates incentives for strong interest groups to push for the law. My point is simply that a licensing requirement may transfer more wealth to doctors than a direct cash transfer because it limits the ability of outsiders to enter the "doctor" group. Indirect transfers also can help the beneficiaries prevent dissipation of their gain in a fight over how to distribute the proceeds of a fixed transfer within the group. Cash will be fought over, but the indirect transfer has the allocation decision already built into it.¹²⁸ Under a physician-licensing requirement, for

123. Indirect transfers typically involve some form of regulation, such as licensing requirements, price controls, price supports, and laws mandating or restricting particular business practices.

124. Direct transfers involve cash payments to the members of the favored group. They can involve direct cash payments as well as tax credits and deductions.

125. See Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211, 213-14 (1976); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MANAGEMENT SCIENCE 3, 4 (1971) [hereinafter Stigler, *Regulation*] (explaining why the oil industry might prefer import quotas to cash subsidies).

126. See Gary Becker, *Comment*, 19 J.L. & ECON. 245, 246 (1976) [hereinafter Becker, *Comment*] (noting that indirect transfers are commonly explained by voter ignorance); see also Philip Nelson, *Political Information*, 19 J.L. & ECON. 315, 323 (1976) (discussing the "dominant view" that voter ignorance explains indirect transfers).

127. See also GEORGE J. STIGLER, *THE THEORY OF PRICE* 333 (4th ed. 1987) ("The fact that cash transfers, which seem simple and efficient, are used relatively little compared to control of entry of firms, provision of public education, and so on suggests that to identify beneficiaries and police cash grants is often expensive."); Becker, *Comment*, *supra* note 125, at 247-48 (arguing that if interest groups prefer regulation, it must be the relatively efficient means by which to transfer benefits to interest groups). See generally Dougan & Snyder, *Rents*, *supra* note 121 (discussing policy designs that are most likely to enable interest groups to reap positive benefits).

128. See Dougan & Snyder, *Interest Group Politics*, *supra* note 116, at 63-64; O'Hara & Dougan, *supra* note 116, at 891-92.

example, doctors can reap super-competitive profits, and each doctor can affect the amount of profits she receives by choosing the quantity and identity of her patients and the location of her practice. However, the means by which the doctors can earn these profits is already contained in the form of the transfer, so subsequent squabbling over the proceeds of the wealth transfer is eliminated.

Because laws are skewed in favor of those that have a comparative advantage in rent-seeking, not all laws will be socially efficient in the Kaldor-Hicks sense that the winners gain more than the losers suffer.¹²⁹ Certainly, we would expect some efficient laws to be enacted, especially those that entail few or no losers, because legislators who propose such laws gain political support from the voters.¹³⁰ For example, we would expect the legislature to enact a law that coordinates drivers by requiring that everyone drive on the right (left) side of the road because virtually everyone gains from this coordination, and losers suffer relatively little. In addition to efficient laws, however, we can also expect inefficient ones.

Gary Becker's important insight was that inefficient transfers tend to be efficiently inefficient—a sort of silver lining for the otherwise “dismal science” of economics. In general, the higher the costs a transfer imposes on taxpayers or others, the more they have an incentive to organize to fight that transfer.¹³¹ So, interest groups have an incentive to minimize the costs that the transfer imposes on others in order to minimize opposition to the proposed law. Economizing on the transfer costs increases the likelihood that the legislation will pass, both because the transferees can obtain the transfer cheaply with no or little opposition (so it is worth attempting), and because the legislator needs to worry less about loss of potential political support than she would otherwise.

C. The Influence of Choice of Law on Interest Group Bargains

What does interest group theory have to do with choice of law? As Part I established, contracting parties may opt out of an increasing number of otherwise mandatory laws by choosing the

129. For a definition and further discussion of the Kaldor-Hicks efficiency concept, see RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 13-16 (4th ed. 1992).

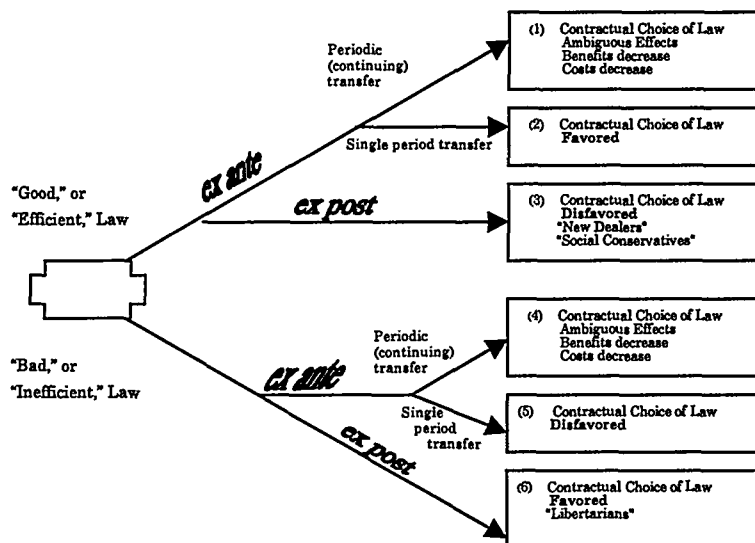
130. *Cf.* Becker, *Theory of Competition*, *supra* note 119, at 396 (“Policies that raise efficiency are likely to win out in the competition for influence because they produce gains rather than deadweight costs, so that groups benefited have the intrinsic advantage compared to groups harmed.”).

131. *See id.* at 395 (arguing that increased dead weight costs of regulation discourage interest group proponents while encouraging taxpayer opposition).

law of a non-regulating jurisdiction. As at least implicitly recognized by both sides of the contractual choice of law debate, evasion can make the law significantly less valuable to its proponents. Does this fact imply that contractual choice of law, as a mechanism to opt out of mandatory rules, will inevitably undermine the interests of regulatory supporters? Not necessarily. Of course, the debate indicates that one's view on choice-of-law clauses depends upon one's opinion about whether the mandatory rule at issue represents sound policy. This section establishes that, as a positive matter, the normative analysis is more complex than apparently presupposed by both sides of the debate. Under some circumstances, regulatory proponents would embrace contractual opt outs, while Libertarians might condemn them as counterproductive.

Until now the debaters have focused almost exclusively on the *ex post* effects of choice of law on regulation. That is, once the law has been enacted, what does a choice-of-law clause do to the effectiveness of the law? This Article calls attention to the *ex ante* influence of choice of law on the incentives it creates for interest groups to lobby for or against potential laws. The addition of this *ex ante* focus can complicate one's normative views about the desirability of opting out of the law in question. Contractual choice of law can have significant but sometimes ambiguous effects on the incentives of interest groups to obtain or defeat potential legislation. In some cases, the ability to opt out of a law makes it easier to pass, and the opt out can help minimize the dead weight cost of transfers that are incurred by both the winners and the losers, as well as by the taxpayers. Figure 1 helps to illustrate how contractual choice of law can increase the likelihood of regulation.

Figure 1



In Figure 1, a decision tree helps the reader to distinguish the current debate from the normative conclusions that result from an *ex ante* inquiry into the problem. The tree presents a stylized version of the thought process of a decision maker who ponders whether to favor or oppose contractual choice of law. I assume that the decision maker's normative conclusion turns critically on a subjective assessment of the merits of the underlying law. In other words, the question she must answer is, "do I think parties should be permitted to opt out of law X with a choice-of-law clause?" Moreover, for purposes of the analysis, I assume that her answer depends upon whether she likes the effects that law X has on society. The decision maker could apply any criterion that she prefers to answer this latter question, whether it is social wealth, social welfare, individual autonomy, fairness, self-interest, or some other objective. Her conclusion about the desirability of the law is represented in the first branching of the decision tree. One who believes that the law is good travels the upper branch, while one who condemns the law travels the lower branch.

Some scholars view the question more broadly, by considering whether, as a general policy matter, choice-of-law clauses should be enforced in the context of mandatory rules.¹³² At the risk of grossly oversimplifying political positions, I place "Social Conservatives"

132. See, e.g., WHINCOP & KEYES, *supra* note 95, at 18; Beale, *supra* note 43, at 261; Kobayashi & Ribsein, *supra* note 96, at 325 (arguing that party choice leads to efficient laws).

and "New Dealers" on the top branches and "Libertarians" along the lower branches. Thus, those who believe that regulations are typically beneficial find themselves traveling along the upper branches, while those who believe that regulations are typically detrimental find themselves traveling along the lower branches.

After assessing whether the underlying law(s) is beneficial, the decision maker must then determine whether the choice-of-law issue is properly viewed *ex ante*, meaning before the passage of the law in question, or *ex post*, once the law has come into effect. This assessment is represented by the second set of branching in both the upper and lower branches of the decision tree. If the decision maker evaluates a particular statute, then the appropriate focus turns on whether the law in question has yet been enacted. If, for example, the decision maker is an interest group, deciding whether to lobby the legislature for a prohibition on opting out of a proposed regulation would entail an *ex ante* inquiry. In contrast, deciding whether parties should be permitted to opt out of existing regulation entails an *ex post* inquiry. If, instead, the decision maker is viewing the issue from a more general perspective, then he may need to consider both the *ex ante* and *ex post* effects to determine whether, on net, he believes that contractual choice of law is desirable. Although the general inquiry ultimately may require a joint consideration of these two perspectives, they are separated in the decision tree to contrast the current debate with the *ex ante* focus added by this Article.

Those who have opposed choice-of-law clauses based on their favorable views of existing regulation(s), the "New Dealers" and "Social Conservatives," are located at node 3. In contrast, those on the other side of the present debate, the "Libertarians," are located at node 6. Recall that the "Libertarians" view choice of law as a mechanism to dampen the effects of particular laws and to foster jurisdictional competition that encourages deregulation.

Nodes 3 and 6, taken together, represent a dichotomy that also can be viewed in terms of social welfare by returning to the discussion of Coasean bargaining from Part II.A. Recall that Coase was concerned with the problem of nuisance, or interfering land uses. By assigning a property right, the state forces the neighboring landowners, through the process of bargaining, to internalize the costs that their preferred behavior imposes on other(s). If, as Coase assumed, those individuals with conflicting interests are all represented in subsequent bargaining, then they can, if transaction costs are low enough, adopt an efficient solution on their own. From this Coasean perspective, then, regulation becomes the state's best

guess about how the parties' relationship is most reasonably ordered. If the regulation does not suit the parties to a particular contract, then they should be permitted to bargain around the law to reach their own more efficient solution. If the assumptions hold, then those concerned with social welfare maximization are located at node 6. In this Coasean world, the existence of the legal rules may be desirable, but only to the extent that they function as default rules.

Consider now those regulations for which Coase's assumptions do not hold. As mentioned in Part II.A, some regulations that restrict contracting are justified by third party concerns. Suppose, then, that the contracting parties are not those that the regulation intends to protect, so that Coasean bargaining is not likely to yield optimal results. One would be hard pressed to argue, for example, that the hit man and the husband should be permitted to opt out of a prohibition on their contract, because their bargaining does not take into account the harm to the wife (or the rest of us) from performance. Here, the "property right," as represented by the prohibition, belongs to the wife and perhaps also the greater community, so that Coasean bargaining only works if the wife, along with anyone else who suffers from the killing, is party to the agreement. Because such inclusive contracting is highly unlikely, if indeed it is possible,¹³³ one might quite reasonably take a node 3 position regarding murder-for-hire contracts.

Of course, this example seems unrealistic because no jurisdiction is likely to enforce murder-for-hire contracts, and the very effort to enforce such an agreement subjects one or both of the parties to the risk of severe criminal sanctions in their home state. Choice-of-law provisions, therefore, will not likely create effective means by which to opt out of universal prohibitions. But, gambling, prostitution, and other contractual prohibitions are often defended by a desire or need to protect the preferences of third parties. For example, a gambling addiction could leave the gambler's family destitute, prostitution facilitates the spread of communicable diseases, and both activities offend the moral sensibilities of other members of the community. At the same time, states differ dramatically in their attitudes toward these activities. The more direct and severe the negative effects of these activities on third parties located in the regulating state, the more likely the contractual choice-of-law decision is located at node 3 rather than node 6.

133. Individuals who suffer from the awareness that this bargain facilitates suicide presumably would not agree to allow the parties to contract around the prohibition.

In contrast to the *ex post* considerations of nodes 3 and 6, consider now the issue from an *ex ante* perspective. Keeping in mind Becker's important insight that successful interest groups economize on the costs of their proposed laws, how does contractual choice of law affect the incentives of interest groups to advocate or resist the enactment of regulation? The *ex ante* inquiry is important because those opposed to regulation prefer to minimize interest group incentives to advocate the laws while simultaneously maximizing incentives to resist regulatory efforts. In fact, regulatory opponents much prefer that legal efforts be thwarted altogether than that they be dampened after enactment by choice of law. Of course, those in favor of regulation prefer the converse—to maximize incentives to advocate the proposed law and to minimize potential opposition.

1. Continuing wealth transfers

Returning to our inquiry, how does the possibility of contractual choice of law affect the likelihood that a proposed law will be enacted in the first place? First, suppose that the law can be expected to provide benefits and impose costs over a number of future periods, at least when people cannot opt out of the law. Consider, for example, a proposed state law prohibiting gambling. Some groups will favor the prohibition, perhaps including some churches, individuals who think wagering is immoral, some family members of gambling addicts, and the state agency that administers the lottery to help pay for education. Others will oppose the prohibition, perhaps including providers of gambling services and equipment, black market lenders, and those who enjoy wagering. Both the benefits and the costs that result from the prohibition would flow periodically, over the life of the prohibition. Each side can form interest groups to take its cause to the legislature, and, depending on the balance of political powers, the proposed law is either likely to pass or to fail.

Now suppose an additional fact: the citizens who wish to gamble can do so over the Internet by contracting with an outfit that is physically located outside of the jurisdiction. When the individual enters the gambling site, she clicks past a screen that states that by entering, the individual agrees that the law of some specified non-regulating jurisdiction applies to the gambling relation-

ship. Suppose that this “contractual choice” is enforceable.¹³⁴ How does this possibility of regulatory evasion affect the likelihood that a prohibition on gambling will be enacted?

Without more information, it is unclear whether opting out raises or lowers the likelihood of enactment. The ability to opt out clearly makes the law less valuable, which diminishes the incentive for interest groups to organize and lobby for its passage. On the other hand, the possibility of evasion also decreases the incentives for opponents to fight its enactment. The easier it is to opt out of the restriction, the stronger will be the effect on each interest group’s incentives, but regardless of the strength of these effects, they will run in the same direction for both proponents and opponents. No doubt, all outcomes depend upon relative elasticities, or responsiveness to changed circumstances, and here too, the enactment of the law may well turn on which side’s incentives are more severely dampened by the possibility of opting out.¹³⁵ But, without more detailed information about those elasticities, the decision maker is unable to determine whether contractual choice of law would be desirable from the *ex ante* perspective. Thus, if the decision maker desires the prohibition (a “Social Conservative”), he finds himself at node 1. If he opposes the prohibition (a “Libertarian”), he finds himself at node 4.

To the outside observer, contractual choice of law ambiguously affects the likelihood of regulation. But the interest groups themselves likely have superior information about both their own and their opponents’ incentives, and may therefore be much better able to assess whether the opt out increases or decreases the likelihood of enactment. Proponents who fear that their law will be defeated may acquiesce on opting out by not proposing that it be prohibited in the legislation. They may prefer to press the issue later, by arguing to the courts that the opt out offends public policy under

134. One state court has stated that internet gambling violates both New York State and federal law. *See People ex rel. Vacco v. World Interactive Gaming Corp.*, No. 404428/98, 1999 WL 591995, at *6-7 (N.Y. Sup. Ct. July 22, 1999) (discussing, *inter alia*, the Federal Interstate Wire Act, 18 U.S.C. § 1084(a)). However, a similar analysis applies to any possibility short of certainty that the opt out is effective. The stronger the likelihood of successful evasion, the stronger the effects on the opposing interest groups.

135. Of course, the relative effects only matter at the margin. It may be the case both that (1) the Nevada casinos have much less incentive to oppose a gambling prohibition if they can opt out of it, and (2) gambling opponents’ incentives to seek a prohibition in Nevada are diminished, but by less than the casinos. Nevertheless, the Nevada casinos and other gambling interests may have so much at stake in either event that the law is doomed even with the possibility of opting out.

section 187 of the Second Restatement.¹³⁶ Of course, the proponents run the risk that, after enactment, the courts will ultimately enforce choice-of-law provisions. But, the compromise might be necessary to ensure that the law is enacted. This political compromise becomes a partial answer to the question posed in the Introduction: why don't interest group proponents of regulation always attempt to include a prohibition on contractual choice of law?

This *ex ante* inquiry has so far implicitly assumed that the proposed law will impose costs on the losers over a number of periods and that the losers can evade the costs in future periods with an enforceable choice-of-law clause. Not all laws fit this pattern, however, and the remainder of this Article focuses on an alternative possibility: some laws effectively transfer wealth to their beneficiaries only during a single period. These one-shot transfers are represented at node 4 of the decision tree.

2. Single-period transfers

Recall from Part II.B that rent-seeking most often takes the form of regulation that promises to create super-competitive profits for interest group members. In some cases, this wealth transfer occurs in a single period, even though the statute remains on the books for many years. Wealth transfers can be limited to a single period if the losers can avoid future transfers with a choice-of-law clause. Of course, if the transfer shifts wealth between two contracting parties, then the burdened party might prevent future transfers in other ways, including by altering the terms of future contracts. Suppose, for example, that a new law requires landlords to refund security deposits to their tenants along with a ten percent annual rate of interest. Under existing lease agreements, assuming no constitutional constraints,¹³⁷ wealth is transferred from landlords to tenants. However, if landlords can pass their costs back to the tenants by raising the rent in future lease agreements, the wealth transfer is confined to a single period.¹³⁸

136. See *supra* note 44 and accompanying text.

137. See *infra* note 187 (discussing constitutional treatment of application of franchise termination laws to existing contracts). Notice that these constitutional constraints can significantly limit rent-seeking.

138. I am not the first lawyer to observe that legal efforts to transfer wealth between contracting parties can quickly become futile. See Duncan Kennedy, *Distributional and Paternalistic Motives in Contract and Tort Law, With Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563, 612, 617-18 (1982) (arguing that efforts to transfer wealth from sellers to buyers can work only in limited circumstances). Richard Craswell

Alternatively, regulation may be sufficiently onerous that those burdened can credibly threaten to exit the jurisdiction. Several credit card companies, for example, have relocated to South Dakota and Delaware, in order to avoid interest rate caps in other states.¹³⁹ Those caps worked to the detriment of the credit card companies, especially when coupled with caps on late payment fees, but the companies were able to shed future costs through exit.

When the contract terms are altered or the loser credibly threatens to exit the state, the choice-of-law provision is not affecting future wealth transfers to the beneficiaries because, by definition, there are none. In these circumstances, choice-of-law clauses serve a different function; they minimize the dead weight costs associated with the law. All transfers generate dead weight losses, which represent the lost surplus to both parties that results from legal alteration of their relationship.¹⁴⁰ A warranty of habitability, for example, might transfer wealth from landlords to tenants for at least a single period, and that transfer might represent "good" or "bad" policy, but it will also entail costs that neither party can recoup. Landlords lose the producer surplus (profits that could have been spent elsewhere) that came from lower maintenance costs. Tenants, who find that landlords have raised rents to cover these added expenses, lose the consumer surplus that came from spending this additional income on alternative items. Because contractual choice of law helps to minimize these dead weight costs, it has the effect of dampening opposition to the proposed law without a corresponding diminution of the incentives to seek single-period wealth transfers. In these circumstances, the possibility of opting out of the law makes its enactment more rather than less likely.

has argued that one indication of consumer benefit from a legal rule is the ability of sellers to pass on their costs, because the greater the consumer surplus created, the better able the seller is to charge for the costs it incurs from the legal change. See Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361, 398 (1991). The converse is also true: The more inefficient the transfer, the less the transferor is able to recoup the costs of the transfer. My point is narrower. To the extent possible, the transferor will take back the transferee's gains from the transfer.

139. See David A. Moss & Gibbs A. Johnson, *The Rise of Consumer Bankruptcy: Evolution, Revolution, or Both?*, 73 AM. BANKR. L.J. 311, 333 (1999) (discussing the Supreme Court's decision that "created an enormous incentive for credit card issuers to move their operations to states with high usury caps and for state legislatures [like Delaware and South Dakota] to ease or eliminate their consumer-credit usury laws"); Lawrence M. Ausubel, *Credit Card Defaults, Credit Card Profits, and Bankruptcy*, 71 AM. BANKR. L.J. 249, 260-61 (1997) (same); Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of the Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672, 685-86 (1987) (same).

140. See STIGLER, *supra* note 126, at 332.

Returning to the decision tree in Figure 1, if the decision maker favors this single-period wealth transfer, then from an *ex ante* perspective she would prefer to allow contracting parties to opt out of the law. If she instead opposes the law, then permitting the parties to opt out of the law only makes matters worse for her. The former decision maker finds herself at node 2, and the latter at node 5. Node 5 represents yet a second category of proposed laws whose proponents would not be expected to advocate a prohibition on choice-of-law clauses. As with the political compromise category, the proponents are omitting the choice-of-law prohibition to maximize the likelihood that the law is passed. But here the omission represents no compromise; instead, both proponents and opponents prefer *ex post* to be able to opt out of the law.

The next Part elaborates on this category of one-time transfers using state franchise termination laws as a possible example. Franchise termination laws are intended to benefit franchisees at the expense of franchisors, so they serve as a useful illustration of how some laws effect only single-period transfers. Moreover, franchise contracts provide a useful example of how contractual choice of law can sometimes be used to minimize the continuing dead weight losses associated with regulation. Although I will be assuming throughout most of Part III that these regulations were designed to transfer wealth rather than to promote fairness by eliminating disparities in bargaining power, I will return to the difficulty of distinguishing between the two at the end of Part III. In reality, state franchise regulations likely were motivated by both concerns. And, ultimately, the analysis is both consistent with and relevant to either explanation of these laws.

III. ONE-SHOT WEALTH TRANSFERS AND FRANCHISE REGULATIONS

A. *The Franchise Form*

Franchising, as a business form,¹⁴¹ has become a common means by which companies bring their products and services to the

141. According to the United States Department of Commerce, franchising takes two forms. The first, product and trademark franchising, entails "an independent sales relationship between supplier and dealer in which the dealer acquire[s] some of the identity of the supplier." U.S. DEP'T OF COMMERCE, FRANCHISING IN THE ECONOMY 1985-87 1 (1987). The second, business-format franchising, is "characterized by an ongoing business relationship between franchisor and franchisee that includes not only the product, service and trademark,

consumer. The franchise form is a hybrid that lies between two more traditional marketing strategies. First, a manufacturer can own the retail stores that deliver its goods to market. An employee who captures only a modest share of the store's profits manages a company-owned store, and the manager's incentives therefore are not aligned with the profit-maximizing goals of the company.¹⁴² Consequently, the manufacturer inevitably incurs agency costs associated with unit managers' shirking and perquisite-taking.¹⁴³

Alternatively, the manufacturer could sell its goods to independently owned and managed retailers. Each retailer is motivated to maximize its sales and profits, but retailers are also likely to free ride off the manufacturer's trademark and to shirk on trademark enhancement. The independent retailer incurs only a portion of the costs if he diminishes the trademark by providing low quality service, product delivery, repairs, or advertisements, while the manufacturer bears the full cost of reduced consumer goodwill.¹⁴⁴ These agency costs are larger for retailers who transact primarily with transient, rather than repeat, customers.¹⁴⁵ Often, neither of these two traditional business forms provides a satisfactory means for the manufacturer to maximize profits.

The franchise relationship steers a middle course between these two forms that can help many companies to better control agency costs than they could by relying primarily on either company-owned or independently-operated retailers.¹⁴⁶ Franchisees

but the entire business format itself—a marketing strategy and plan, operating manuals and standards, quality control, and continuing two-way communications." *Id.* at 3. Throughout this Part, I focus on the latter franchising category.

142. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 312-23 (1976) (comparing the behavior of a manager who owns all of the residual claims on a firm to one who earns less than all of this firm's profits); see also D. L. Noren, *The Economics of the Golden Arches: A Case Study of the McDonald's System*, 34 AM. ECONOMIST 60, 62 (1990) (noting that McDonald's decision to franchise was influenced by the poor entrepreneurial incentives of company run stores).

143. See James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form*, 18 J. FIN. ECON. 401, 404-05 (1987).

144. See Richard L. Smith II, *Franchise Regulation: An Economic Analysis of State Restrictions on Automobile Distribution*, 25 J.L. & ECON. 125, 126-27 (1982) (discussing incentive problems associated with independently-owned automobile dealerships).

145. See James A. Brickley et al., *The Economic Effects of Franchise Termination Laws*, 34 J.L. & ECON. 101, 130 (1991).

146. Paul Rubin apparently was the first to offer the agency cost explanation for franchising. See Paul H. Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223, 226-30 (1978). Prior to Rubin, franchising was typically explained as a mechanism enabling the franchisor to raise capital quickly. See *id.* at 325-26. Most economists find the agency cost explanation more satisfactory. See, e.g., Brickley & Dark, *supra* note 142, at 403 (discussing an empirical study supporting the agency cost theory of franchis-

own their businesses, most often own or lease all of the capital assets that they use, and are the residual claimants of store profits.¹⁴⁷ At the same time, the franchisee cedes some of its decision making control to the franchisor to enable the franchisor to maintain the value of its trademark.¹⁴⁸ Typically, the franchisor provides the marketing concept, product development, service procedures, operating manuals, employment manuals, and quality standards.¹⁴⁹ Franchisors may also provide or dictate the standards for or suppliers of equipment, product supplies, employee uniforms, maintenance, insurance, bookkeeping, real property, and other franchise needs.¹⁵⁰

Of course, no solution perfectly controls agency costs. Monitoring by the franchisor is costly, and perfect monitoring impossible, so that some free riding on the value of the trademark remains.¹⁵¹ Moreover, franchisees who have sunk the bulk of their assets into running the franchise will have undiversified portfolios creating risk averse investment decisions that can be suboptimal.¹⁵² In fact, the vast majority of companies that rely on franchising retain some stores as company-owned. Consistent with the agency theory of franchising, empirical research indicates that companies tend to franchise those units where monitoring of the unit managers is more difficult. A company is therefore more likely to franchise those stores that are located far from company headquarters and those that are in less densely populated areas (making the units farther apart from one another).¹⁵³

Although less than an ideal business form, franchising grew at staggering rates in the United States between 1972 and 1986. Total nominal sales through franchise outlets grew by 442 percent, while the number of outlets grew by 65 percent during the same period, from 189,640 to 312,810.¹⁵⁴ By 1987, franchise contracts ac-

ing); Smith, *supra* note 143, at 126 (arguing that the capital-raising explanation fails to explain why a franchise continues to exist after the capital shortage is resolved).

147. See Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 934 (1990).

148. See *id.* at 932; Smith, *supra* note 143, at 127. See generally G. Frank Mathewson & Ralph A. Winter, *The Economics of Franchise Contracts*, 28 J.L. & ECON. 503 (1985) (explaining the use of franchise contracts and making predictions from a model to account for variability in such contracts).

149. See Hadfield, *supra* note 146, at 933.

150. See *id.* at 933 n.29.

151. See Brickley & Dark, *supra* note 142, at 404.

152. See *id.* at 405.

153. See *id.* at 411-19.

154. See Patrick J. Kaufmann & Francine Lafontaine, *Costs of Control: The Source of Economic Rents for McDonald's Franchisees*, 37 J.L. & ECON. 417, 418 (1994).

counted for one-third of all retail sales in the United States.¹⁵⁵ Franchising businesses continue to evolve, and some of the more well-known franchises include fast food restaurants, clothing and shoe stores, convenience stores, car rentals, real estate brokers, tax and accounting service providers, and employment agencies.¹⁵⁶

B. Franchise Protection Laws

With this growth in franchises came a concern in several states that the large national franchisors were engaging in post-contractual opportunism against small, local franchisees.¹⁵⁷ Because franchisees typically are required to sink relatively large investments up front,¹⁵⁸ franchisees voiced concern that franchisors would exploit that investment by raising prices, forcing franchisees to make unnecessary renovations, or usurping successful franchises.¹⁵⁹ In short, to their proponents, franchise termination laws were necessary to correct a disparity in bargaining power between franchisors and franchisees that made it impossible for the franchisees to bargain individually for these protections.¹⁶⁰

In eighteen states, franchisees had sufficient local political clout to obtain legislation protecting them from harsh actions by franchisors.¹⁶¹ Sixteen states passed statutes preventing franchise termination without cause.¹⁶² Ten of those states also require cause for non-renewal of the franchise contract.¹⁶³ In addition, ten states mandate that any franchisee who is not in compliance with the state's contract requirements be given a reasonable period to cure any defects.¹⁶⁴

155. See U.S. DEP'T OF COMMERCE, *supra* note 140, at 14; Hadfield, *supra* note 146, at 928.

156. See Hadfield, *supra* note 146, at 934-36.

157. See *id.* at 951-53.

158. See *id.* at 934 (listing estimated initial capital requirements for various franchises).

159. See *id.* at 951-53. On the general problem of post-contractual opportunism, see Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 297-98 (1978), and Oliver E. Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 235-38 (1979).

160. I consider here only those franchise regulations that affect the contractual relationship between franchisor and franchisee. This Article does not consider other franchise laws that may regulate franchisee-consumer relations, franchisee-salesman relations or salesman-consumer relations. See Smith, *supra* note 143, at 139 (noting that these alternative types of regulations exist for automobile franchises).

161. See Kobayashi & Ribstein, *supra* note 96, at 446 n.104.

162. See *id.* at 446 n.106.

163. See *id.*

164. See *id.* at 340 & n.107. Other statutory provisions appear to mimic contractual terms rather than imposing new ones. These latter regulations appear to ensure monopoly territories for franchisees by preventing franchisor encroachment. See Smith, *supra* note 143, at

Economists have argued that these regulations are not necessary to protect the franchisees. The predation theory appeared inconsistent with the strong demand for new franchise opportunities. McDonald's, for example, only accepts between two and seven-and-one-half percent of the more than 2000 franchise applications submitted annually.¹⁶⁵ Empirical evidence supports the theorists' suppositions,¹⁶⁶ demonstrating that the opportunities for super-competitive profits drive the demand among prospective franchisees.¹⁶⁷ Further evidence weakens the predation theory. In 1986, an estimated 80 percent of the contracts extended the franchise for a period between five and twenty years.¹⁶⁸ Nearly 65 percent of the contracts included terms between ten and twenty years. These longer periods are presumably intended to be commitments by franchisors to refrain from acting opportunistically against franchisees with sunk investments.¹⁶⁹

Franchisors could still threaten to terminate an existing contract because many franchise contracts permit termination at-will.¹⁷⁰ At-will termination enables franchisors to maintain more effectively the value of the franchise trademark by monitoring franchisee free riding. Franchise contracts cannot feasibly specify all franchise duties, and franchisees can shirk in ways that are diffi-

133-35, 138-39 (discussing automobile dealer licensure requirements and restrictions on creating new dealerships or competing directly with franchisees). These provisions appear to be consistent with the public choice theory of regulation as industry cartelization, as pointed out by Stigler in *Regulation*, *supra* note 124. I do not consider these statutory provisions in this Article.

165. See Kaufmann & Lafontaine, *supra* note 153, at 418 (quoting Barbara Marsh, *Going for the Golden Arches*, WALL ST. J., May 1, 1989, at B1); see also Noren, *supra* note 141 (discussing the McDonald's franchise relationship and requirements).

166. See Mathewson & Winter, *supra* note 147, at 513-14 & n.15, 525 (noting long queues of potential franchisees and presenting a model predicting that franchisees will earn "rents" in equilibrium); Francine Lafontaine, *Agency Theory and Franchising: Some Empirical Results*, 23 RAND J. ECON. 263, 281 (1992) (noting empirical data on the relationship between royalty rates and franchise fees suggests the possibility that franchisors purposefully enable franchisees to earn rents).

167. See generally Kaufmann & Lafontaine, *supra* note 153 (providing an empirical study indicating that McDonald's franchisees earn "rents").

168. See Hadfield, *supra* note 146, at 937 (citing U.S. DEP'T. OF COMMERCE, *supra* note 140, at 13).

169. See Brickley & Dark, *supra* note 142, at 409 ("Long-term contracts can help to internalize the benefits of franchisee investment in firm-specific human and physical capital. With frequent contract negotiation the likelihood of appropriation by the franchiser of the quasi-rent from this type of investment increases.").

170. See J. Howard Beales, III & Timothy J. Muris, *The Foundations of Franchise Regulation: Issues and Evidence*, 2 J. CORP. FIN. 157, 160 (1995).

cult to prove in a simple breach of contract action.¹⁷¹ At-will termination protects the franchisor, but only by creating the potential for franchisor opportunism.¹⁷² The practical threat of opportunism may be slight, however, given that franchisors are repeat players with strong reputational constraints on their actions.¹⁷³ Any franchisor that expects to continue franchising has little incentive to terminate a contract without cause given that it negatively impacts the price that other franchisees are willing to pay.¹⁷⁴ Unless the franchisor expects to go bankrupt, in which case even the regulations will not bind the franchisor, the future value of its reputation should contain it from behaving egregiously. The lack of a strong market failure justification for these laws gives rise to the possibility that franchise termination laws are, at bottom, rent-seeking efforts on the part of franchisees.¹⁷⁵

Even if a franchise termination law results from genuine concerns for franchisees' weaker bargaining position,¹⁷⁶ the analysis remains relevant so long as the reader agrees that one important effect of the law is that it confers a benefit on franchisees at the expense of franchisors. A law may be "good" or "bad," but if it is, in essence, a one-time transfer of wealth, then a permissive stance on choice-of-law provisions increases the likelihood of its enactment.

171. See *id.* at 159-60; Benjamin Klein, *The Economics of Franchise Contracts*, 2 J. CORP. FIN. 9, 18 (1995).

172. See Beales & Muris, *supra* note 169, at 161; Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. 356, 356, 359-60 (May 1980).

173. See Beales & Muris, *supra* note 169, at 161.

[T]he effect of the relative reputational loss on franchisors and franchisees who engage in hold-ups is one reason why a contract results that appears (to some) one-sided. Franchisors generally are more likely to have reputation capital than are franchisees. Because franchisors are larger and transact more frequently than franchisees, franchisor cheating is more likely to become known than the cheating of a particular franchisee.

Id. (citations omitted); see also Alan J. Meese, *Regulation of Franchisor Opportunism and Production of the Institutional Framework: Federal Monopoly or Competition Between the States?*, 23 HARV. J.L. & PUB. POL'Y 61, 68 (1999).

174. Smith, *supra* note 143, at 129-30.

175. See Kohayashi & Ribstein, *supra* note 96, at 339 ("The potential for inefficient spillovers seems significant . . . franchisees within a given state may be more influential than the national franchisor organization . . . Thus, state laws may benefit local franchisees at the expense of national franchisors or consumers.").

176. In fact, I remain personally convinced that most laws contain a combination of private and public interest motivators. For a similar position, see JERRY L. MASHAW, *GREED, CHAOS, & GOVERNANCE* 37-38 (1997). An articulated, credible public interest reduces taxpayer/voter opposition, while a significant private interest ensures that some interest group will incur the organizing and lobbying costs necessary to secure passage.

C. Choice of Law with Single-Period Transfers

The public choice insights from Part II can be applied to the assumption that the laws transfer wealth from franchisor to franchisee. The greater the transfer, the more likely the franchisors will organize in opposition to proposed franchise regulations, and the more they are willing to spend to oppose their enactment. For present purposes, I am interested in the converse proposition: the lower the costs they expect to incur (all else equal), the less franchisors are willing to invest in opposing franchisees' regulatory efforts. And, the smaller the costs imposed on consumers, the more likely that legislators think they can support the legislation without losing voters' support.

Contractual choice of law becomes one way to lower the costs associated with franchise contract regulation because it enables the parties to opt out of the regulation in future periods. The intuition that exit can be a substitute for "voice," or participation, in the political or bureaucratic process is widely acknowledged,¹⁷⁷ and the reasoning here can be viewed as an application of that general principle. In other contexts, education vouchers for example, public policy makers become concerned that simplifying exit will generate less voice, which may have the effect of lower quality decision making.¹⁷⁸ Here, voice takes the form of opposition to proposed law. Enabling cheap exit can make this category of laws more likely.

Does the ability to opt out of state franchise laws eviscerate the value of the transfer itself by making it possible for the franchisors to evade the burden of the regulation? Not necessarily. Some wealth-transferring legislation confers benefits during each period that the legislation remains in force, at least so long as the beneficiary remains eligible for the benefits. Federal patent laws and the Food Stamp Act provide examples. Qualifying individuals earn monopoly profits or receive food stamps, respectively, and the beneficiaries are made better off during each additional period that they remain entitled to these benefits. Other transfers, however, provide only single-period gains no matter how long the conferring law remains in force. The reasoning is straightforward. Especially in the

177. Probably the best known work expanding upon this intuition is ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* (1970).

178. See *id.* at 45-46. Public school deterioration can cause parents to choose private schools, which may, in turn, cause a "loss to the public schools of those member customers who would be most motivated and determined to put up a fight against the deterioration if they did not have the alternative of the private schools." *Id.*

contractual context, the parties are often able to bargain around or otherwise exit from the effects of the law.¹⁷⁹

Here, even if the franchisors are subject to the regulations without the possibility of using contractual choice of law to opt out of them, the franchisors can typically recoup much of the future financial benefit conferred on the franchisees by raising the franchise fee or royalty rates. Moreover, a franchisor often can increase the rent on property it leases to franchisees, or it can raise the price it charges for equipment, uniforms, accounting or inventory services, and product supplies.¹⁸⁰ Even if designated third parties provide these supplies, the franchisors can recoup their losses by charging the third party more for the right to provide these goods and services to franchisees. In turn, the third parties could pass these costs on to the franchisees in the form of increased prices. In any event, the franchisors have ample means available to ensure that, in future contracts, the law does not have the effect of transferring surplus wealth to franchisees.¹⁸¹

The critical point is that the wealth-transferring aspect of many laws represents, at best, a "one-time" hit. Unless the regulation at issue is sufficiently pervasive or transactions costs otherwise sufficiently high to prevent Coasean bargaining, it becomes possible for the losing party to bargain around much if not all future-period transfers. For regulators concerned with this future "evasion," pervasive regulation might end up eliminating that form of contracting altogether. Here, for example, a state franchise commission could be set up to monitor individual relationships to ensure that franchisors are not bargaining around the financial advantage conferred on the franchisees. To do that, however, the commission must routinely conduct market studies in an effort to separate general infla-

179. See Kennedy, *supra* note 137, at 617-18 (discussing the ability of sellers with market power to raise prices in response to compulsory contract terms, thereby eliminating any redistribution from sellers to consumers); David Millon, *Default Rules, Wealth Distribution, and Corporate Law Reform: Employment-at-Will Versus Job Security*, 146 U. PA. L. REV. 975, 996 (1998) (noting that job security laws may result in lower wages).

180. Cf. Hadfield, *supra* note 146, at 935-36 (noting variety of ways in which a franchisor can collect revenues from its franchisees).

181. The laws may also have the effect of transferring wealth between franchisees. See Larry E. Ribstein, *Choosing Law By Contract*, 18 J. CORP. L. 245, 275 (1993). Those franchisees who deal primarily with non-repeat customers can more easily shirk with the legal protections than they could without them. See *id.* If the franchisor responds by raising the price of every franchise contract, then the repeat-customer franchisees end up paying for some of the shirking of the other franchisees. This transfer could persist over time, but because it requires a segregation of the small, local franchisee interest group, it is unlikely to be the primary motivation behind any of the termination laws.

tionary forces from franchisor usurpation. And, no doubt, it would end up mediating a large number of franchise disputes.

Our society makes significant efforts to prevent evasion in some areas, including labor disputes and employment discrimination. However, the more draconian the bureaucratic web built around a given industry or business form, the greater the risk that the industry or business form will be driven out of the market. In the franchising context this result is unacceptable,¹⁸² even to the franchisees seeking protection.¹⁸³ And, even if franchising remains profitable with pervasive regulation, taxpayers are much less likely to assent to paying large sums for fair franchising than they might for fair employment. The latter is a larger social problem that will likely directly touch the lives of many more voters. Because franchisors' *ex post* price increases cannot realistically be prevented, franchisees can expect only a single-period financial benefit.¹⁸⁴

Even this "single-period" transfer can be worth seeking, however, if it involves a large enough transfer or a long enough "period." Because franchise contracts are typically long-term,¹⁸⁵ the single-period transfer can entail an advantage for as long as twenty years.¹⁸⁶ Of course, in order for this transfer to be successful, the regulation must apply to existing contracts. And, the contracts

182. Sometimes complex regulations are put in place precisely to eliminate some product or service from the market. I once lived in a community with a "tenant's rights board," which had the authority to review virtually any landlord decision that a tenant disliked. It appeared as though the board was wasting both community time and tax dollars, given that the town had virtually no renters. But a tenant's right's board could be one means by which the community members maintained their property values. Straightforward exclusion of rental properties would be illegal, whereas efforts to "protect" the poor tenants would be applauded.

183. When franchisors threatened that the onerous Iowa law enacted in 1992 would drive them out of the state, for example, the legislature amended the law to temper its harsh effects. See Dennis E. Wiczorek, *The Iowa Franchise Law: 1995 Amendments and Some Proposals for 1996*, 15 FRANCHISE L.J. 43 (1995) (explaining the overhaul of the problematic 1992 law).

184. If franchisors can forecast the franchise regulations prior to their enactment, the franchisees may not benefit financially, because the franchisors may be able to recoup the transfer *ex ante*, in the initial contract. Alternatively, a franchisor that knew which states would refrain from regulating could evade the law *ex ante* with a choice-of-law clause, assuming that it would be enforced. In short, even this one-time financial advantage may occur only for those contracts that were not drafted with the subsequent legislation in mind. The theory that individuals will respond *ex ante* to predicted government acts is sometime referred to as "rational expectations." Cf. Geoffrey P. Miller, *An Interest-Group Theory of Central Bank Independence*, 27 J. LEGAL STUD. 433, 439 (1998). If purchasers of government debt know that the government can benefit by inflating its currency, the rational expectations model predicts that they will demand a higher interest rate *ex ante*, thereby defeating the government's benefit from inflation. See *id.*

185. See *supra* notes 167-68 and accompanying text.

186. Note that the long-term contracts, intended to reduce post-contractual opportunism by franchisors, end up creating a potential tool for post-contractual opportunism by franchisees.

clause can be a tool for franchisors to oppose¹⁸⁷ or courts to thwart¹⁸⁸ the transfer. But more than half of these states' regulations seem to have been applied to existing contracts,¹⁸⁹ and the mere possibility of its success can make lobbying efforts worthwhile.¹⁹⁰

Although the transfer itself may be a one-time hit, the regulation can create dead weight losses that linger throughout the life of the transfer. Franchise experts have concluded that the decreased ability to terminate franchises or refuse renewal decreases franchisors' ability to effectively monitor franchisee product and service quality.¹⁹¹ McDonald's and Dunkin Donuts both want to ensure that their retailers are providing clean establishments with friendly service and uniform products. General Motors wants its franchisees to provide effective service and repairs and to respect warranties. Franchisees who depend primarily on local clientele have strong incentives to provide high quality service and products. But, those who service transients or outsiders, or who otherwise engage in non-repeat trade, may have an incentive to free ride off the name brand capital developed by the franchisor and the other franchisees. Thus, the decreased ability to monitor the franchisees leads to inefficient consequences, including reduced numbers of

187. See Brickley et al., *supra* note 144, at 115 & n.25 (noting that franchisors managed to exclude existing contracts in the laws of six states, although the Wisconsin legislature later amended its language to leave the issue ambiguous).

188. Retroactive application of the Iowa statute was held to violate the state and federal contract clauses. See *McDonald's Corp. v. Nelson*, 822 F. Supp. 597, 609 (S.D. Iowa 1993), *aff'd*, *Holiday Inns Franchising Inc. v. Branstad*, 29 F.3d 383 (8th Cir. 1994); see also *Rolec, Inc. v. Finlay Hydrascreen USA, Inc.*, 917 F. Supp. 67, 69-70 (D. Me. 1996) (holding the retroactive application of Maine's Franchise Laws for Power Equipment, Machinery and Appliances unconstitutional).

189. See *supra* note 186. One state, Delaware, actually included an explicit provision that existing contracts were included in the regulation. See Brickley et al., *supra* note 144, at 115. Another court actually applied Wisconsin's regulations to a pre-existing relationship despite a statutory statement that they only applied to contracts entered into after the statute was passed. See *Reinders Brothers, Inc. v. Rain Bird E. Sales Corp.*, 627 F.2d 44, 53 (7th Cir. 1980) (involving a franchisor who sent superceding agreements, but no agreement had been signed by the parties after the effective date of the statute).

190. Cf. Brickley et al., *supra* note 144, at 115-16 ("[G]iven that the issue has been taken to court several times, there must have been at least some expectation that existing contracts were covered.").

191. See Beale & Muris, *supra* note 169, at 159-60 (discussing franchisee incentives to cheat and the importance of at-will termination to franchisor ability to discourage poor franchise performance); Klein, *supra* note 170, at 30 (concluding that statutes hinder self-enforcement of the contract relationship); cf. Millon, *supra* note 178, at 1003 ("[S]hirking and other misconduct will be harder to punish, and, therefore, more likely to occur under a job-security contract term than under an at-will term.").

franchises,¹⁹² or reduced output and value, and, sometimes, increased prices.¹⁹³ In addition, franchisors may shorten the franchise contract term if they fear enhanced future regulatory interference with existing contracts, and they may increase their lobbying efforts to prevent the future statutes.¹⁹⁴ At a minimum, the laws make it more costly for the franchisor to control for quality, making the franchise form less profitable.¹⁹⁵

The choice-of-law clause helps to eliminate these dead weight losses. To the extent that it does so effectively, both the franchisor and franchisee can be made better off in future periods. Since they can split the gains associated with increasing the value of their relationship, once the wealth transfer becomes a *fait accompli*, neither side wishes to prohibit enforcement of the clauses. Indeed, contractual choice of law may make some wealth transfers possible. Typically, an interest group would not press for a law that creates single-period benefits to its members if those beneficiaries will suffer losses in perpetuity. Potential future contract gains are likely the most promising means by which the parties are prevented from behaving opportunistically, in the legislature as well as in the marketplace.¹⁹⁶ The contractual choice of law option can, however, skew the costs and benefits of seeking legislative transfers to the point where the efforts become worthwhile to the proponents.

192. See Brickley et al., *supra* note 144, at 130 ("Our cross-sectional tests of the distribution of owned versus franchised outlets across states suggests that the laws reduce the amount of franchising relative to company ownership in industries where individual units are prone to serving transient customers. In contrast, most of the evidence suggests that the laws do not greatly affect other industries. These findings are consistent with the model that predicts that the laws increase the costs of franchising relative to company ownership by making quality control among franchises more expensive.").

193. See Smith, *supra* note 143, at 154 (providing an empirical study that indicates that automobile franchise regulations have significantly increased dealer prices and reduced new vehicle sales volume).

194. Cf. Brickley et al., *supra* note 144, at 116 ("Recently, termination laws have been considered by other states. For example, during 1986, lawmakers in Missouri, New York, Massachusetts, Alaska, and Tennessee introduced bills that would restrict franchise terminations to cases of good cause. The IFA lobbied intensely against these bills and none were enacted.").

195. See Richard A. Epstein, *Unconscionability: A Critical Appraisal*, 18 J.L. & ECON. 293, 314-15 (1975) (noting that contractual interference hurts both franchisors and franchisees, who profit from the goodwill of the entire enterprise); Rubin, *supra* note 145, at 232 (discussing economic effects of interference with franchise contracts).

196. See ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* 11-19 (1984) (arguing that cooperation can be sustained in an iterated prisoner's dilemma game); DAVID M. KREPS, *GAME THEORY AND ECONOMIC MODELLING* 65-89 (1990) (same); Steven Hetcher, *Creating Safe Social Norms in a Dangerous World*, 73 S. CAL. L. REV. 1, 32 n.129 (1999) (describing cooperation in an iterated prisoner's dilemma context); Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005, 2024 (1987) (discussing cooperation in long-term contracts).

Moreover, the dead weight losses associated with diminished monitoring ability also fall on consumers, who may end up paying more for lower quality goods and services. The possibility that franchisors may opt out in future periods therefore can also reduce taxpayer opposition to the transfer. In sum, although it appears that contractual choice of law has the effect of reducing the value of a regulation to its proponents, it does not always do so, and, the opt out can actually make it more likely that the law is enacted in the first place.

Not surprisingly, then, of the eighteen states that have enacted franchise protection laws, only two, Iowa¹⁹⁷ and Washington, prevent enforcement of both choice-of-forum and choice-of-law provisions.¹⁹⁸ Both, of course, are needed to prevent franchise contracts from opting out of the regulation, since a prohibition on choice of law could be evaded by choosing to litigate exclusively in the non-regulating state's courts. Moreover, Supreme Court precedent has expanded the ability of foreign states to exercise personal jurisdiction over franchisees, even in the absence of a choice-of-forum provision, as long as the contract includes a provision choosing the law of a state with substantial connection to the franchisor.¹⁹⁹

The analysis does not require that the reader believe that a particular regulation is "bad," but only that attempts to transfer future wealth through regulation are futile. If the state is unwilling or unable to monitor behavior along all possible margins, the regulation creates no more than a one-time benefit, and contractual choice of law becomes the best way to effectuate and preserve that one-time transfer while mitigating the dead weight costs associated with it. Suppose, for example, that one believes that franchise pro-

197. Interestingly, because retroactive application of the Iowa statute was held unconstitutional, *supra* note 187, any transfers to franchisees must come from subsequent contracts. The prohibition on both choice-of-forum and choice-of-law clauses, coupled with at least some franchisors' inability to recoup the transfer in future contracts, represent the only means by which wealth can be transferred as a result of the legislation. Because Iowa's law also appears to be much more restrictive than others, *see* Wiczorek, *supra* note 183, at 43 (noting that the 1992 law "was the most comprehensive" in the United States, although 1995 amendments watered down draconian effects), the legislature appears to have attempted to achieve the transfer by preventing all evasive efforts in future contracts. Consistent with the analysis in this Part, the franchisors claimed that the law "made it impossible for franchisors to operate in Iowa and consequently endangered Iowa residents' investments in franchised businesses." *Id.* Also consistent with the analysis, when franchisors' threats were perceived as credible, the law was watered down. *Id.*

198. *See* Kobayashi & Ribstein, *supra* note 96, at 343.

199. *See* Burger King Corp. v. Rudzewicz, 471 U.S. 462, 484-85 (1984) (holding that Florida courts could exercise personal jurisdiction over Michigan franchisee). The Court relied primarily on the facts that the franchisee entered into a long-term contract with the franchisor headquartered in Florida, and that the franchise agreement chose Florida law. *Id.*

tection laws attempt to correct disparities in bargaining power, and that even a one-time amelioration is better than nothing. If so, then that individual should embrace contractual opt outs because the opt out enhances the likelihood that the franchise protection law will be enacted.

Suppose instead that one is committed to the virtues of freedom to contract. Perhaps paradoxically, this individual may find himself opposing choice-of-law clauses because permitting them may enhance the likelihood that a given restrictive regulation is enacted. Thus, there exists an inherent tension between freedom to contract within individual transactions and freedom to contract in the sense of an absence of regulation. Regarding one-time wealth transfers, the Libertarian ultimately must choose among second-best worlds.²⁰⁰

There are, of course, other potential purposes served by franchise termination laws that this analysis does not address, at least not in any definitive sense. First, the laws could be intended to achieve what they claim—protection against opportunistic termination—without regard to wealth transfers or efficiency analysis. The drafters might simply wish to prevent these terminations and second-guess the parties' failure to bargain for these protections themselves.²⁰¹ Of course, if the proponents care about the substance rather than the effects of regulations, then they might prefer to prevent contractual opt outs. As indicated earlier, the conclusion may turn on whether proponents believe that prohibiting opt outs threatens the law's enactment.

Second, there is a possible efficiency justification for franchise termination laws. Termination protections could be the efficient means by which to balance post-contractual opportunism between the parties, especially if franchisees cannot bargain for the protections individually because of signaling difficulties. Any franchisee that requests protection from termination may signal that she intends to free ride off the franchised trademark, making bar-

200. Of course, whether contractual choice of law ultimately leads to greater or lesser regulation is an empirical question involving the relative elasticities of one-shot and continuing transfers. Cf. John R. Lott, Jr., *Does Political Reform Increase Wealth?: Or, Why the Difference Between the Chicago and Virginia Schools Is Really an Elasticity Question*, 91 PUB. CHOICE 219 (1997) (explaining that constitutional restrictions on wealth transfers increases the costs of those transfers but also eliminates some transfers, so that the net effect on social welfare is uncertain).

201. See Kennedy, *supra* note 137, at 624-49 (arguing that paternalism can justify interference with contract). On the subject of paternalistic contracting restrictions, see generally Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 YALE L.J. 763 (1983) (discussing three forms of paternalism).

gaining over this issue impracticable.²⁰² This potential market failure may be corrected with franchise termination laws. Of course, the efficiency argument does not resolve the issue of contractual opt outs, because, by switching the bargaining burden, a default rule could turn out to be the most efficient approach to this problem.²⁰³ In any event, this article is confined to the wealth-transferring rather than allocative aspects of the regulations.

Finally, some franchise protection laws provide territorial security to franchisees and prevent cross-selling and bootlegging of the franchised product.²⁰⁴ These laws create barriers to entry while enabling franchisees to provide higher quality customer service. To the extent that these laws simply transfer wealth from franchisor to franchisee, the above analysis applies. If instead these laws provide periodic benefits to both franchisors and franchisees by enabling the maintenance of trademark quality, the analysis in this Article is inapplicable.

D. Contractual Choice and Statutory Repeal Compared

The analysis of single-period transfers raises a final, interesting question: if Coasean bargaining confines the transfer to period 1 but the regulation creates future losses for both producers and consumers, why doesn't the legislature simply repeal the statute? If the benefits of a law have been exhausted but its costs remain, then would not the repeal represent a Pareto improvement, the type of action that Becker predicts from entrepreneurial legislators? As an alternative to contractual choice of law, statutory repeal also saves parties the costs (and potential uncertainty) of attempting to opt out of the law. Nevertheless, the proponents of regulatory transfers likely prefer choice of law to statutory repeal. Recall that the single-period transfers work best in the context of long-term contracts. Once a new long-term contract is drafted, those burdened by the law refashion the contract terms to undo future-period transfers. Under the new contract, then, a repeal of the statute would

202. Cf. Walter Kamiat, *Labor and Lemons: Efficient Norms in the Internal Labor Market and the Possible Failures of Individual Contracting*, 144 U. PA. L. REV. 1953, 1957-62 (1996) (discussing the comparable argument supporting employment termination protections); Milon, *supra* note 178, at 1021 n.162 (same).

203. See generally Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (discussing the theories of default behind the gaps found in contracts and the ways in which lawmakers should fill those gaps).

204. See Smith, *supra* note 143, at 133-35.

end up creating a transfer away from those initially benefited by the law.

A repeal of franchise regulations, for example, would generate a windfall in favor of the franchisor in all contracts that had been negotiated after the law took effect. Under these new contracts, franchisees pay more for their franchises than they otherwise would because they are paying for the protections from termination provided by the statute. Franchisees continue to pay for those protections in a variety of possible forms for the duration of the contract period, even if the protections disappear during the contract term. Without those protections, then, the franchisors receive a windfall for the remainder of the contract term. Consequently, the franchisees would oppose interim efforts to eliminate the very regulations for which they are paying. Because they had the political clout to generate the regulations, franchisees would, most likely, also have the ability to prevent their repeal. From the vantage point of the regulatory proponents, then, choice-of-law clauses are superior to regulatory repeal.²⁰⁵ The initial transfer is preserved when the regulatory reversal is prevented, and, simultaneously, the future inefficiencies are avoided.²⁰⁶

In addition, some franchisors may be unable to completely recoup future transfers created by the regulation. Market conditions and/or transaction costs may prevent them from passing all of their costs on to the franchisees. Moreover, even with contractual choice of law, the costs of opting out of the law may preclude some franchisors from using it. Recall that under the Second Restatement, for example, parties typically can choose alternative law to avoid mandatory rules only if the state whose law is chosen bears a substantial relationship to the parties or the contract.²⁰⁷ Franchisors might therefore be forced to change corporate headquarters in order to take advantage of opting out of the law. If some franchisors cannot prevent future transfers with Coasean bargaining or contractual

205. The textual explanation is an alternative to that offered previously in the public choice literature. See Robert E. McCormick et al., *The Disinterest in Deregulation*, 74 AM. ECON. REV. 1075 (1984) (discussing the little interest group support for deregulation due to the fact that rent-seeking expenditures, which can make up the bulk of the cost of laws, are already sunk). Unlike the McCormick explanation, my hypothesis does not require proof that rent-seeking expenditures are high relative to the transfers. See Dougan & Snyder, *Rents*, *supra* note 121, at 810 (noting that successful interest groups contain costs of rent-seeking).

206. The textual explanation might help explain why some seemingly inefficient or obsolete laws remain on the books. Politically, contracting around becomes more palatable, despite the transactions costs associated with doing so.

207. See *supra* note 44 and accompanying text.

choice of law, then their franchisees also can be expected to oppose the statute's repeal.

Interestingly, the contractual opt out might be the most effective means by which to ensure passage of a regulatory proposal. Because opt outs entail costs, they are more likely to be used by those who suffer most from the regulation. The more the loser will suffer from proposed regulation, the harder the fight to defeat its enactment. Contractual choice of law can therefore be a way to silence vocal opponents while transferring wealth from politically inactive losers. Contractual choice of law may therefore enable a kind of price discrimination between those regulated entities who suffer more and those who suffer less under the law.

CONCLUSION

According to public choice theory, regulation can be the most effective means by which interest groups obtain "non-equalizing" wealth transfers in the legislature. However, in the context of the regulation of contracts, future wealth transfers between the contracting parties can be eliminated if the loser can alter the terms of future contracts with the winner. In these circumstances, the regulation can transfer wealth only in a single period, and what remains of the legislation is a dead weight loss borne by the parties and by consumers.

Contractual choice of law can mitigate the dead weight losses associated with these laws, making it more likely that they will be enacted in the first place. Moreover, from the perspective of the law's proponents and supporting legislators (who attempt to aid their proponent constituents), contractual choice of law is preferable to the subsequent repeal of the law. And, by retaining these laws on the books, the legislature may enhance the public's perception that the government is actively promoting fair treatment for all.

The academic debate over contractual choice of law is somewhat misdirected because its function and effects can be misunderstood. Contrary to the assertions of its opponents, contractual choice of law does not always represent evasion of the law itself. Evasion of the wealth transfer can occur on its own through potential exit or alteration of the contract terms. In these cases, contractual choice of law instead mitigates the dead weight costs associated with the regulation. Moreover, contrary to the assertions of its proponents, contractual choice of law will not necessarily produce a decrease in rent-seeking legislation, at least in the short run. Instead, the availability of contractual choice of law can make it pos-

sible for inefficient interest group bargains to arise in the first place.