Judge-Made Contracts
Reconstructing Unconscionable Contracts

Aristides N. Hatzis* & Eleni Zervogianni**

Although unconscionability is thought to be a nearly exhausted topic, there are still some disputed issues regarding its remedies. This paper discusses one of these issues, namely the judicial reconstruction of unconscionable contracts or unreasonable contract clauses. More concretely, in many legal systems the judge is granted, at least in some cases, the power to revise the terms of unconscionable contracts: he may substitute “reasonable” terms for the “unreasonable” ones, so that the contract remains valid. Nevertheless, an attempt by the judge to adjust an “unreasonable” term will create opportunism from both sides and will lead to arbitrary judicial decisions, thus upsetting the security of transactions and inevitably leading to higher transaction costs. Hence we argue that, with a few exceptions pertaining to monopoly or collusion situations, the judge should only decide between enforceability and non-enforceability of the contract or the clause. If the parties wish their void contract to be enforced they can always renegotiate after the decision and modify it themselves.

**JEL Classification:** K12

**Keywords:** economics of contract law; unconscionability; judicial revision of contracts; modification of contracts; severance of contract clauses; comparative law

* Aristides Hatzis is an Associate Professor of Philosophy of Law & Theory of Institutions at the Department of Philosophy & History of Science, University of Athens. Email: ahatzis@phs.uoa.gr.

** Eleni Zervogianni is a Lecturer of Civil Law at the Aristotle University of Thessaloniki School of Law. Email: elzervog@otenet.gr.

Earlier versions of this paper have been presented in the 23rd Conference of the European Association of Law and Economics (Madrid, September 2006) and in the 3rd French-German Talks in Law and Economics (Kassel, December 2006). We are indebted to Emanuela Carbonara, Péter Cserne, Fernando Gómez, Mauricio Troncoso and Aspasia Tsaoussis for helpful comments.
1. Introduction

In both Common and Civil law there is a residual of contracts which do not seem to suffer from any clear formation defect (fraud, coercion, misrepresentation, etc.), but nevertheless do not look right to the outsider. They look extremely disproportionate, one-sided and they raise questions as to their fairness and consequently as to their validity.\(^1\) In almost all jurisdictions this residual category falls under the rubric of “unconscionability” in Common law\(^2\) or something similar to the contracts against *boni mores* in Civil law countries.\(^3\)

Under the assumption of rationality, the power of a judge to intervene in a contract based on his intuition of fairness and social justice and not on some specific formation defects is highly problematic from an economic perspective. The doctrine of unconscionability became the object of criticism on the part of law & economics scholars quite early.\(^4\) The question comes down to the broader issue of the relation between social justice and efficiency and especially to the issue of contract law's suitability for pursuing and achieving social justice.\(^5\) Although this is a nearly exhausted issue\(^6\) that we will not scrutinize in this paper, we wish to call attention to two points:

(a) Contract is an ingenious mechanism for the transfer of scarce resources and not a legal fiction, a Platonic Form, a “preexisting entity of fixed dimensions”\(^7\). The role of contract law and more generally the state's role should be to help this mechanism operate smoothly.

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3 § 138 German Civil Code, Art. 21 CO, Art. 179 Greek Civil Code, § 879 (2) Austrian Civil Code. Cf. also 1448 Italian CC and 1072 French CC.


According to economic theory, when applying their discretionary powers in order to resolve thorny issues, judges should not rely on analogical reasoning or their intuition (or even their sense of justice), but they should rather examine the business practice and the context of the particular situation, having only one concern in mind: to realize the wishes of the parties, given their reasonable expectations and viewing their actions as revealed preferences. These observations should not be taken to suggest that there is no place for the intervention of the state and of judges in particular. But such intervention should have as its only purpose to enforce and thus facilitate exchanges and to create, to the greatest extent possible, a “perfect market environment,” by helping the market correct its failures (mainly the problems generated by significant transaction costs and imperfect information), and not by patronizing the parties.8

(b) The state has numerous other opportunities for correcting injustices and pursuing “social justice” without distorting the market and harming people.9 Even if one doubts that the sole purpose of contract law is efficiency and the realization of the parties' wishes, one could more readily accept that other methods for the implementation of distributive justice, like taxation, are more efficient, but also more comprehensive, democratic and impartial.10

According to this approach, a judge should not intervene in a contract when there is no case of market failure (irrationality, externalities, market power, informational asymmetries, etc.).11 When there is such a case, i.e. once unconscionability is assumed, the problem is what a judge should do. Judicial intervention to contracts in general can be treated either from the perspective of a property rule or from the perspective of a liability rule.12 If a property rule is followed, the judge has the option of enforcing the agreement as a whole or considering it

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8 According to Parisi: “The patronizing is rationalized as an attempt to prevent people from harming themselves or as an encouragement to be more considerate of collective social values. The idea is that individuals should have less freedom to make mistakes than they currently have.” See Francesco Parisi, “Autonomy and Private Ordering in Contract Law”, European Journal of Law & Economics 1: 213-227, 223 (1994).


10 “[J]udges can, despite appearances, do little to redistribute wealth [...] Legislatures, however, have by virtue of their taxing and spending powers powerful tools for redistributing wealth.” See Posner supra note 19, pp. 359-360.

11 Schwartz is more liberal. His only requirement is informed consent by a rational party. See Alan Schwartz, “A Re-Examination of Nonsubstantive Unconscionability”, Virginia Law Review 63: 1053-1083 (1977) at 1083.

void. The **liability rule** on the other hand may appear in two main forms: Under the **first one**, which is often the case in standard-form consumer contracts, the judge enforces the reasonable terms of the contract and disregards the rest.\(^{13}\) Under the **second variation** of the liability rule, the judge may replace the unreasonable terms with others which he considers reasonable.

In this paper we discuss the scope of judicial revision of contracts or contractual terms which are considered unconscionable. We proceed to the analysis as follows: First we elaborate on this issue from a comparative law perspective, bringing out its practical relevance (section 2). Then we evaluate this rule from a law and economics point of view (section 3). We argue that the judge should not have the power to modify a contract, especially a business contract concluded by sophisticated parties. In the case of an inefficient and abusive contract clause, a judge should not enforce it. An attempt by the judge to adjust an “unreasonable” term will create opportunism from both sides and will lead to arbitrary judicial decisions, thus upsetting the security of transactions and inevitably leading to higher transaction costs. In the conclusion (section 4) we sum up the results and mention possible extensions of the paper.

### 2. Stating the Problem from a Comparative Law Perspective

#### 2.1. Earlier history

Historically, the substantial judicial supervision of contracts, in the sense that the judge controls the balance between the performances of the parties, dates from the third century, when the Roman Emperor Diocletian issued two prescripts in order to protect the small landowners from onerous deals.\(^{14}\) According to these rules, the seller was entitled to rescind the contract and reclaim the object of sale if the price was less than half the value of the thing sold. The stronger contractual party could prevent the rescission if he offered to pay the weaker party the market value for the thing sold. This doctrine, known as “*laesio enormis*”, i.e. huge loss, became a basic principle of Roman law of obligations. Later it was evolved by Thomas Aquinas and had great influence in law in Europe in the centuries to come.\(^{15}\) Such rules have been

\(^{13}\) This rule is actually on the verge between a liability rule and a property rule. On this issue, see Craswell, *supra* note 12, p. 17.


adopted by the French Civil Code of 1804\(^{16}\) and the Austrian Civil Code of 1811.\(^{17}\)

The objective control of the relation between the contractual performances of the parties was heavily criticized by the supporters of Natural law for being incompatible with the principle of freedom of will.\(^{18}\) This influenced more recent codifications like the German and the Swiss ones, according to which a contract is void or may be invalidated, only if the objective disproportion of the performances is coupled with additional (subjective) elements which lead to the conclusion that the weaker party has been exploited.\(^ {19}\)

2.2. Civil law countries

In Germany, according to §138 (1) BGB a legal transaction which contradicts the \textit{boni mores} is null. This provision typically applies in cases where the freedom of the weaker party is unduly restricted by means of a contract. Further, according to §138 (2) BGB, a legal transaction is void whereby a person exploiting the need, carelessness or inexperience of another, gets pecuniary advantages which exceed the value of his performance to such an extent that, under the circumstances, the pecuniary advantages are in obvious disproportion to his performance.\(^ {20}\)

In principle, such contracts are void as a whole.\(^ {21}\) Nevertheless, in some groups of cases, mostly in long term contracts, the judge may enforce the contract (contractual term) to the ex-

\(^{16}\) In French “lésion”. See Art. 1118 in combination with Art. 1674 CC on the sale of real estate and Art. 887 (2) on partition of a descendant’s estate between the coheirs. Identical provisions are also included in (the same articles of) the Belgian Civil Code.

\(^{17}\) In German “Verkürzung (or Verletzung) über die Hälfte”. See § 934 ABGB. Nevertheless, under Austrian law the objective relation of the contractual performances is not the only prerequisite for the rescission of a contract on the grounds of \textit{laesio enormis}. Rescission is possible only in the case of mistake of the weak party as far as the value of his performance is concerned. See Peter Bydlinski, in Koziol/Bydlinski/Bollenberger (eds.) \textit{Kurzkommentar zum ABGB} (Wien/New York: Springer, 2005) § 934 N. 2

\(^{18}\) Pichonnaz, \textit{supra} note 14, p. 146.

\(^{19}\) See § 138 (2) BGB, Art. § 21 CO, § 179, § 879 (2), Nr. 4 ABGB, Art. 179 GreekCC, Art. 1448 ItalianCC of 1942.

\(^{20}\) The exact same provision was also adopted by the drafters of the Greek Civil Code of 1940 (see 179 GreekCC).

\(^{21}\) See, among others, Rolf Sack, in \textit{Staudingers Kommentar} (Berlin: Sellier- De Gruyter, 13th ed. 2003) § 138 BGB N. 109. \textit{Cf.} § 139 BGB, according to which if a part of a legal transaction is void, then the whole legal transaction is void, unless it is presumed that it would have taken place regardless of the void part.
tent to which he considers it reasonable, and disregard the rest. 22 This way he can actually replace the unreasonable terms with others which he considers reasonable. Typical cases are those of beer supply contracts. 23 In the simplest version of these complex contracts, a brewery grants a favorable loan to an inn holder, under the condition that the latter will only serve drinks produced by this brewery for a certain period of time. German courts state that if, given all the relevant circumstances, the duration of this period is considered to be too long, it may be decreased by the judge, without the rest of the contract being affected. 24 Lease contracts with disproportionately expensive monthly rents are also treated in a similar fashion, i.e. the judge may adjust the rent owed. 25 Moreover, in certain cases, the judicial adjustment of contractual clauses is provided directly by the law, like for instance in §343 BGB, according to which the judge may reduce an excessive penalty clause. 26

However, the abovementioned practice is not followed consistently in all cases. When it comes to usury loans, the whole contract is considered null and eventually the loan becomes interest-free. 27 Likewise, non-competition clauses of excessive duration are considered totally void and may not be adjusted by the judge. The same holds for the clauses of standard form contracts. 28

Austrian law deals with the abovementioned issues along the same lines. Contracts which cannot be invalidated because of laesio enormis may be void on the grounds of §879

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22 In German, this is called “Quantitative Teilnichtigkeit”, which could be translated in English as “quantitative severance”.

23 In German, “Bierlieferungsverträg“.


25 Decision BGH 11.1.1984, BGHZ 89, 316 is particularly important. This was followed by numerous decisions of lower courts. In more detail, see especially Sack supra note 21, § 138 BGB N. 120.

26 See also § 1384 of the Italian civil code of 1942, § 409 of the Greek Civil Code of 1940, which are inspired by the BGB.

27 The creditor cannot demand from the debtor the return of the money he lent him (on the basis of unjust enrichment) prior to the due time because his claim is blocked under § 817 BGB. More concretely, according to this provision, payment made for immoral reasons may not be claimed back if the immorality attaches to the payer. On this issue, see Sack, supra note 21, N. 122-134, especially N. 127.

28 See Heinrichs in Palandt Kommentar (München: Beck, 62nd 2003) Vorb v § 307 N. 8; Basedow in Münchener Kommentar, supra note 24 (2002), § 306 BGB N. 20 and § 308 BGB N. 5. Nevertheless, both mention that the first Civil Chamber of the Highest Court (BGH) tends to admit a few exceptions to this rule.
The wording of §879 (2) Nr.4 ABGB, which was revised in 1916, is almost the same as that of §138 (2) BGB. Moreover, Austrian courts have dealt in a similar way with beer supply contracts, as well as with unconscionable lease contracts. In addition, §1336 (2) of the Austrian Civil Code on excessive penalty clauses is equivalent to the relevant German provision. Unlike in Germany though, according to §7 (2) of the Austrian Law against Usury, contracts with an excessive interest rate remain valid, but the interest rate is adjusted on the basis of the “Basic Interest rate” which applies at the time of the conclusion of the contract. Finally, Austrian Courts accept the quantitative severance of standard form clauses, in spite of their criticism by legal scholars.

In Switzerland, according to Art. 21 of the Code of Obligations of 1881, the aggrieved party may within a year from the formation of the contract proceed before the Court to claim the invalidity of an unconscionable contract. This article, which was inspired by the relevant German provision and became part of the Swiss law of obligations after its revision in 1911, does not touch upon the issue of the judicial adaptation of unconscionable contracts. According to the prevailing opinion in the legal literature, the adaptation of unconscionable contracts should be in principle possible. This position was finally adopted by the Highest Court, which in a leading case in 1997 analysed this issue at length. Besides, numerous specific provisions of Swiss law allow the adaptation of contractual terms by the judge, like Art. 163

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29 See Raimund Bollenberger in Kurzkommentar zum ABGB, supra note 17, § 879 N. 18


32 Wuchergesetz (WucherG)

33 More specifically, the interest rate of the contract in question will be double the basic interest rate.

34 On standard form contracts, see § 879 (3) ABGB.


(3) CO on the judicial adjustment of excessive penalty clauses, Art. 270 CO on the adjustment of the rent due in lease contracts and Art. 340a (2) CO on the limitation of the duration of non-competition clauses following the termination of an employment contract. Actually, in contrast with German law, where the intervention of the judge in drafting the contractual clauses remains - at least in theory - an exception, in Switzerland it seems to have been recognized as a rule.38

In France the judicial revision of contracts is quite common and it does not apply only in exceptional cases.39 Apart from the cases of *laesio enormis*,40 it is widely accepted that the judge may reduce excessive rents of lease contracts and excessive non-competition clauses,41 as well as substitute valid indexation clauses of contracts for invalid ones.42 There are also numerous relevant statutory provisions which refer to the adjustment of contractual terms, like for instance Art. 1152 CC concerning the reduction of an excessive penalty clause by the judge43 and Art. L. 313-4 of the Consumer Code, which applies regardless of whether this is actually a consumer contract or a contract concluded between professionals44 and provides for the cancellation of usurious interest rate clauses, only to the extent that they exceed the interest rate allowed by law.45

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40 See *supra* note 16 and Art. 1681 CC.


43 Cf. also Art. 1231 CC, according to which, where an undertaking has been performed in part, the agreed penalty may be lessened by the judge in proportion to the interest which the part performance has procured for the creditor, without prejudice to the application of Art. 1152 CC. The same provision is comprised in Art.1154 of the Spanish Civil Code.


45 The provision of § 294 of the Greek Civil Code is similar.
2.3. Common law

The scope for the application of the doctrine of unconscionability varies from one common law country to the other.\(^{46}\) According to an early definition, an unconscionable contract is, as Lord Chancellor Hardwicke put it, a contract which “[n]o man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other”.\(^{47}\) The remedy in such cases of abuse of bargaining position is the rescission of the contract. Partial rescission of unconscionable contracts is confronted with reluctance, let alone the judicial adjustment of contractual terms.

According to English law rescission is thought to be an all-or-nothing remedy, whose aim is to reinstate the parties to their former situation.\(^{48}\) Partial rescission is denied because the judge “[c]annot make a new bargain for the parties… No judge is competent to such an act”.\(^{49}\) Severance of a specific contractual term is likewise granted in very rare cases.\(^{50}\) Nevertheless, in the last few decades, this strict opinion which grants no flexibility to the judge\(^ {51}\) has been put into a new perspective in view of the consumer legislation.\(^ {52}\) The U.K. Consumer Credit Act of 1974 provided the courts with broad discretion in enforcing credit agreements.\(^ {53}\) In the recent case of Wilson v. First County Trust Ltd,\(^ {54}\) the court reduced an interest rate by about one-third (the APR was 94.98% and the woman had given her car as collateral


\(^{50}\) See Enonchong, *supra* note 48, N. 28-049.

\(^{51}\) For a critique of the all-or-nothing remedy of unconscionability, see Andrew Keyser & Jill Poole, “Justifying partial rescission in English law”, *Law Quarterly Review* 121: 273-299 (2005). See also Enonchong, *supra* note 48, N. 28-042 end 28-043, who refers to the High Court of Australia, which has recognized the possibility to award partial rescission in certain cases.

\(^{52}\) The most important ones are the Consumer Credit Act of 1974, as amended by Consumer Credit Act 2006, and the Unfair Terms in Consumer Contracts Regulations of 1999, which implements directives 93/13/EEC and 97/7/EC.

\(^{53}\) Consumer Credit Act 1974 s. 140 B, as amended by s. 20 of the Consumer Credit Act 2006. This provision corresponds to this of s. 139(2), before the amendment.

\(^{54}\) QB 407, CA [2001].
for a six-month loan of £5,000).

In the United States the doctrine of unconscionability was introduced with § 2-302 of the Uniform Commercial Code. The author of the code, Karl Llewellyn, was of German origin and his approach was influenced by the German Civil Code of 1900. In addition, the particular UCC article was strongly influenced by the pivotal decision of *Campbell Soup Co. v. Wentz*. In that decision, Judge Herbert Goodrich who wrote the opinion for the court found that a particular clause of the contract was “tough” for the growers (“carrying a good joke too far”). He emphasized (twice) that the contract was not illegal. Nevertheless he refused to enforce the problematic clause. This decision led to UCC §2-302 which (under the influence of BGB) gave the court the right to “limit the application of any unconscionable clause as to avoid any unconscionable result”. The clause was immediately criticized by one of Llewellyn’s (future) students at the University of Chicago Law School: “[t]rial court judges will be required to reach conclusions demanding an intimate knowledge of economics and requiring arbitrary value judgments.” In the same article we read that “[w]hether courts accept this invitation to interfere with private agreements is a matter of speculation” (id. 148) and that a rule of *laesio enormis* “is incompatible with the ideal of a modern competitive economy, and in practice it is condemned for leading to artificiality, confusion, and litigation” (id. 151). Despite UCC’s § 2-302, American courts are quite reluctant to use their power to reconstruct the contract even when they find that a price “far exceeded the fair market value of the goods delivered”.

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55 172 F.2d 80 (3d Cir. 1948).

56 Judge Herbert Goodrich was the Director of the American Law Institute which published and promoted the UCC.

57 “[T]he sum total of its provisions drives too hard a bargain for a court of conscience to assist.”

58 Note, “Policing Contracts under the Proposed Commercial Code”, *University of Chicago Law Review* 18: 146-153 (1950) at 152. The author criticizes the tentative draft that was published in May of 1950.

2.4. The Principles of European Contract law

When dealing with a problem from a comparative perspective, we should definitely refer to the projects of harmonization of law. In the field of contract law, one of the most ambitious unification works is the survey of the *Principles of European Contract Law*, which, in spite of its non-binding character, constitutes a benchmark, as it delineates to some degree the current discussion on European contract law.

As far as unconscionability and its legal consequences are concerned, the members of the Commission on European Contract law followed the predominant pattern of the civil law countries, which was also adopted by the *UNIDROIT Principles of International Commercial Contracts*. According to article 4:109 (Excessive Benefit or Unfair Advantage) of the Principles of European Contract Law:61

(1) A party may avoid a contract if, at the time of the conclusion of the contract:
   (a) it was dependent on or had a relationship of trust with the other party, was in economic distress or had urgent needs, was improvident, ignorant, inexperienced or lacking in bargaining skill, and
   (b) the other party knew or ought to have known of this and, given the circumstances and purpose of the contract, took advantage of the first party's situation in a way which was grossly unfair or took an excessive benefit.

(2) Upon the request of the party entitled to avoidance, a court may if it is appropriate adapt the contract in order to bring it into accordance with what might have been agreed had the requirements of good faith and fair dealing been followed.

(3) A court may similarly adapt the contract upon the request of a party receiving notice of avoidance for excessive benefit or unfair advantage, provided that this party informs the party who gave the notice promptly after receiving it and before that party has acted in reliance on it.

In the same spirit, Art. 9:509 (2) of the *Principles of European Contract Law* provides that “despite any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the loss resulting from the non-performance and the other circumstances”. This is in line with the provision of article 7.4.13. of the UNIDROIT Principles.

Nevertheless, the possibility of the judicial adjustment of terms in standard form contracts is not mentioned in article Art. 4:110 (“Unfair Terms not Individually Negotiated”), so

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61 See also Art. 3.10 of the Unidroit Principles (Gross Disparity). It is worth noting that until 2002, no court had adjusted a contractual term on the basis of the relevant Unidroit provision [Art. 3.10 (2 and 3)]. See Michael Joachim Bonell (ed.), *The UNIDROIT Principles in Practice* (New York: Ardsley, Transnational publishers, 2002) Art. 3.10, p. 147.
it could be *a contrario* concluded that it is excluded.\textsuperscript{62}

2.5. Evaluation of the results of the comparative analysis

In the foregoing analysis we showed that, at least in Europe, the judge is actively involved in the reconstruction of unconscionable contracts (or unconscionable contractual clauses) and thus functions in a way as a sort of “third contractual party”. His power to adjust unreasonable contracts or contractual terms varies from one legal order to the other. Nevertheless, there seems to be a tendency that this practice will be elevated to a rule. This is also manifested by the *Principles of European Contract Law*. Nonetheless, in all legal systems examined there is an evident lack of consistency when dealing with cases of unconscionability: Similar cases are treated in a different way without solid, or at least without comprehensively displayed, reasons.

On the basis of the above considerations, we believe that there is a need to develop a general theory according to which cases of unconscionability could be decided. This theory would provide answers to the questions if, when and why the judge should reconstruct contracts or adjust contractual terms. This paper aspires to constitute the first step in this direction.

3. A CRITICAL APPRAISAL OF THE JUDICIAL INTERVENTION TO UNCONSCIONABLE CONTRACTS

3.1. Introductory remarks

Unconscionability is a fuzzy concept. The reason for this fuzziness is the fact that it is based on two different grounds: economic inefficiency and unfairness. As Kaplow & Shavell (2002) have demonstrated, this is a deadly combination. A judge trying to assess a contract using the doctrine of unconscionability as this was developed in both Europe and the U.S. will soon discover that he has to do with criteria belonging to two different categories. He has to assess the efficiency of the contract (the absence of severe market failure) and its fairness (the

\textsuperscript{62} There is no relevant provision in the UNIDROIT principles, as consumer contracts do not fall within its scope.
bargain should not be incompatible with conventional morality). This bundling of two dissimilar criteria in one legal concept leads to the classical philosophical problem of “categorical mistake”, i.e. to mistake one category of things for another, confounding the one with the other. Categorical mistakes, besides being erroneous, also lead to indeterminacy. In the case of unconscionability the mistake has led to the indeterminate nature of the concept in almost all legal systems.

This dual nature of unconscionability was originally spotted by Arthur Leff. In a seminal article, he made the distinction between “procedural” and “substantive unconscionability”. Procedural unconscionability has to do with the defects in the bargaining and formation process and it largely coincides with the law & economics market failure analysis. Substantive unconscionability has to do with the result – if it seems unfair, unequal, and grossly disproportionate to the judge (or to the broader community). The first is a positive statement that can be falsified in theory or in a court of law; the second is a normative statement, thus not falsifiable.

From a law and economics perspective, in the case of a fair process, the intervention of the judge applying the doctrine of substantive unconscionability is paternalistic. Especially when it comes to business transactions, where parties are sophisticated, at least as concerns the demands of their ordinary business interests, rights and duties, substantive unconscionability should be excluded. If the judge decides to annul such a deal as unconscionable only because he does not feel right with the result, his decision will destroy the “insurance func-

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63 Of course a judge can assess a contract based on critical morality (e.g. Kantianism) or more often on his personal morality and sense of justice. However, for the purposes of our discussion we will assume that the judge is applying conventional morality with an impartial mind, and only when a clause or a general term specifically requires it.


66 It is not falsifiable as a normative statement. However, this statement can be based on a series of positive statements about conventional morality, business ethics, trade usage, etc.

67 The opposite assumption (business parties are by definition irrational or unsophisticated) is not made even by the hard-core behavioral economists.

tion” of contract, its use as a mechanism for risk allocation, as an *ex post* unreasonable clause may have been reasonable *ex ante*. Hence the American courts “have tended to avoid square holdings that an excessive price without more is unconscionable”.70 The rule of substantive unconscionability harms in particular young inexperienced professionals and new-to-the-job businesses that cannot signal their credibility by offering terms (*e.g.* they might offer a twice or thrice longer period of commitment in a relation-specific investment) which a court can always strike as unconscionable. It harms in general the classes of weaker parties since an indeterminate unconscionability clause creates a barrier to entry to those without reputation, collateral or expertise.71 In addition, a rule of substantial unconscionability may under certain circumstances prevent the production of socially valuable information.72

In the case of a **defective process**, the use of procedural unconscionability is rather redundant since the relief is based on the related formation defect. To this there is one possible exception, or rather redefinition: The concept of procedural unconscionability can be used as an all-encompassing term to describe the sum of minor formation defects, *i.e.* a situation with several minor formation defects which individually cannot justify a formation defense but as a whole permeate the entire contract, revealing a problematic bargaining environment. In this way the concept is transformed (elevated) from a residual category to a more general broad category.73

Further analysis of the above issues exceeds the scope of the paper. As already mentioned, in what follows we assume unconscionability, meaning that we concentrate on cases where the judge for whatever reason will consider a contract unconscionable. Irrespective of the justifiability of his decision on law and economics grounds, we examine his options, so that even if the judge may not be prevented from considering a contract unconscionable, at least he may be prevented from opting for an inappropriate remedy.

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3.2. The effects of unconscionability: A sketch of the options of the judge

The way in which the judge may deal with cases of unconscionability differs according to the nature of the defect:

(a) If the problem in a contract is a defect due to a critical market failure, or the whole bargaining was problematic due to a series of minor market failures, the judge should refuse to enforce the contract as it is. According to Craswell, if the costs of the stronger party to obtain a proper consent from the weaker party are low, then the whole contract should be void (property rule). If, on the other hand, taking into account the nature of the transaction, achieving the proper consent of the weaker party to all points of the agreement is costly (e.g. complex consumer contracts), then a liability rule according to which only reasonable rules are enforced is preferable (liability rule). Concerning the unreasonable terms, the judge has two options: either to ignore them or to replace them with reasonable ones. These solutions present an important advantage as compared to the property rule, namely flexibility.

(b) If the judge cannot strike a particular clause (since there is no clear defect) and he cannot strike the entire contract. This residual category has always to do with the “balance of the contract” which seems wide of the mark. The temptation of the judge to restore it (if the law permits it) is strong. If the judge gives in to this temptation, the easiest and less perilous way for him to restore its balance is to modify terms like the price, the duration of a contract (e.g. in beer supply contracts), or an interest rate agreement, since these terms most of the times can be easily modified and there is no danger of an accusation of judicial activism that a more qualitative intervention would warrant. Thus, it should be examined if through the revision of these terms it would be possible to restore the balance of the entire contract. It is worth noting that the abovementioned terms are key elements to the contract, meaning that no

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73 And again the danger of categorical mistake is lurking.

74 See Craswell, Craswell, supra note 12, especially pp. 7-8.

75 See, e.g. EC Council Directive 93/13/EEC.


77 The “qualitative” intervention is extremely rare in all jurisdictions, both in common law and in civil law countries. However, they are not unknown even in American law. See E. Farnsworth, supra note 70, p. 306 (4§ 28) (judges occasionally read their mandate to permit them to add terms into contracts).
contract of the same kind can exist without such a clause. Hence, a judge cannot just invalidate them and enforce the other terms of the contract (as he can with the other clauses); his only option is to modify them.

3.3. Judicial revision of key terms of the contract

No matter if the decision of the judge that a contract is unconscionable or not is justifiable, we concentrate on the examination of the effects of the different remedies he may opt for. We claim that unlike the annulment of a whole contract, the power of a judge to modify key contractual terms is problematic for several reasons:

(a) The adjustment of the price, the interest rate or other key elements of the contract by the courts leads to moral hazard by promisors who will enter frivolously into onerous agreements with the expectation that the judge will modify them in their favor, without affecting their validity. This judicial paternalism, which seeks to protect the weaker party in a specific case, will lead to irresponsible behavior by the parties, which in the long run is going to create the need for more judicial intervention and paternalism.

We believe that the judicial revision of contractual terms influences the incentives of the weaker party to a great extent, even if he is not perfectly rational. The danger of moral hazard is present in all cases, provided that a minimum of rationality is satisfied, namely when the imperfectly rational party positively knows that he can benefit in court by taking advantage of his irrationality, especially when taking into account that the exact extent of deviation of rationality of a party is extremely hard to prove.

(b) This intervention of the judge would also create incentives for opportunistic behavior by the stronger party in the contract: he can freely add one-sided terms to contracts, exorbitant price-terms, unreasonable duration clauses, since under the worst scenario he will get what he would agree with the other party in a perfect competition/contract environment.

Moreover, an attempt by the judge to adjust an “unreasonable” term leads to adverse selection since promisees, taking into account that not all cases will be brought before courts, will design even more one-sided contracts in order to spread their losses. This inevitably leads to a vicious circle (in combination with the mirror-problem of moral hazard) with more un-

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78 Cf. in Roman law “essentialia negotii”. The price is essentiale negotii for a sale or a rent contract. In the same sense, the interest rate is the price for the use of capital and can thus be seen as a key term of a credit contract. The function of the duration term in beer supply contracts is similar.

79 See Craswell, supra note 25, p. 16.
conscionable terms and more defaults by untrustworthy parties.

(c) Another major problem is the principal-agent problem: a judge will regulate an agreement with inadequate knowledge of the relevant circumstances. A judge by definition is not competent to decide what is best for both parties and socially efficient (either for the two parties as representatives of their respected classes or for the society as a whole). The modification of a price term makes the judge a “price commissioner”, the one who determines the value of a contractual performance he is not a part of. The problem of evaluation of the performance is also evident from the legal literature, where it is disputed whether the price of the contract should be adjusted according to the usual market price, the highest possible non-unconscionable price or even to the price that the parties would have agreed on, if the negotiation were not flawed. Even if this question is answered, further problems emerge concerning the exact calculation of the price in a specific case, especially if this is “the highest possible non-unconscionable price” or “the price to which the parties would have agreed, if the negotiation were not flawed”. Ultimately, the decision of the judge will not be based on economic grounds/efficiency considerations (due to the lack of expertise and also for the difficulty in measuring subjective valuation) but to indeterminate fairness considerations. In business contractual disputes this will inevitably lead to rent-seeking and corruption.

(d) A regime where judges can revise key elements in a contract like the price is bound to create too much uncertainty in the system and to undermine the security of transactions. This uncertainty creates the incentives for inefficient actions (wasteful litigation and rent seeking) and thus augments transaction costs.

The increase in transaction costs is due not only to increase in litigation but also to in-

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80 See esp. Benjamin E. Hermalin/ Michael L. Katz, “Judicial Modification of Contracts between Sophisticated Parties: A More Complete View of Incomplete Contracts and their Breach”, Journal of Law, Economics & Organization 9: 230-255 (1993) (since the courts are likely to have less information than the private parties, it is unclear that the courts would be able to improve upon the private parties’ contract).

81 In German, *Preiskommissar*. See Claus-Wilhelm Canaris, “Wandlungen des Schuldvertragsrechts. Tendenzen zu seiner ”Materialisierung“”, Archiv für die civilistische Praxis 200: 273-364 (2000) at 304. Cf. also Weill/ Lequette, *supra* note 39, N. 297, who mention that already in 1832 the *Cour de Cassation* (Cass. Civ. 17.5.1832, S. 32.1.849), in order to limit the expansion of the application of the *laesio enormis* rule, stressed that the judge should not be seen as a “Ministre d’équité”.

82 See, among others, Huguenin, *supra* note 35, Art. 21 CO N. 6-17 (referring to Swiss law) and Sack, *supra* note 21, § 138 N. 120 and 125 (referring to German law).

83 See Enonchong, *supra* note 48, N. 28-040 (referring to English Common law).

crease in search costs (finding a reliable partner who has the reputation of performing his duties without asking for relief when difficulties arise), negotiation costs (the threat point of the promisor is higher because of the power of a judge to put a cap on the price term; taking steps to avoid procedural unconscionability) and contract drafting costs (to ensure that the relevant clauses will not be characterized as unconscionable).

In addition, the rule of judicial adjustment of contractual terms leads to an increase in litigation costs. Even if it is assumed (for the sake of the argument) that the judge will eventually decide for the efficient term, this is much more costly for him than for the contractual parties. Under this assumption, the renegotiation of a null contract by the parties is preferable to its judicial revision. This is also the rationale of a rule adopted by many civil law systems, according to which in case the parties have not reached an agreement on key terms, such as the price term, it is assumed that no contract has been concluded. This rule could (should) apply in the cases we treat in this paper also, since a void agreement is a non-agreement.

(e) In the case of a doctrine of procedural unconscionability in contracts which lead to a price term modification by the judge, there is also a strong case for “second-best” arguments. This is also true for any judicial attempt to modify a contract or invalidate a clause; however, the problem is more acute in the case of modification of fundamental clauses such as price terms. Key elements to the contract are the most unlikely ones to be the result of a formation defect, since even unsophisticated parties give great emphasis to them during negotiations, especially in business contracts. Thus, a judicially reconstructed contract is in principle not the second-best solution after the perfect contract since, if the optimality condition is not satisfied, the second-best solution might require the changing of the other contractual terms (which are not optimal anymore).


86 For German law, see § 154 BGB and Heinrichs in Palandt, supra note 28, § 154 N. 1. For Greek law see Karassis, in Geordiades-Stathopoulos Astikos Kodix (Commentary on the Greek Civil Code), Vol. 1 (Athens: Ant. N. Sakkoulas, 1978) § 195 CC N. 3· for Swiss law see Art. 2 CO· for French law cf. Code Civil annoté (Paris: Dalloz, 102nd ed. 2003) Art. 1101 note 13 and Jean Carbonnier, Droit civil, Les obligations (Paris: PUF, 22nd ed. 2000) N. 34, p. 86. However, cf. UCC § 2-303, according to which “the parties if they so intend can conclude a contract for sale even though the price is not settled. In such case the price is a reasonable price at the time for delivery if (a) nothing is said as to price; or (b) the price is left to be agreed by the parties and they fail to agree; or (c) the price is to be fixed in terms of some agreed market or other standard as set or recorded by a third person or agency and it is not so set or recorded.” According to Ayres/Gertner, supra note 85, at 96 this rule is not formed as a penalty default rule, because “to estimate a reasonable price courts can largely rely on market information…”

87 This is also true for duration of contract or interest rate terms.
Nevertheless, long term contracts often lead to lock-in situations: even if before the conclusion of the contract the relevant market was competitive, after the performance of the contract the costs of the weaker party to switch to another contract are very high. Thus, the weaker party would be prevented from bringing his case before the court. In anticipation of this fact, the stronger party may impose even more unconscionable terms in order to prolong the contract or simply keep to it. Typically, such conditions arise in case of lease contracts.\textsuperscript{88} Under these circumstances, it is often claimed that the modification of the unconscionable price is preferable to its non-enforcement.\textsuperscript{89}

We believe that when dealing with such cases, a fundamental distinction should be made:

(aa) If the market is competitive, then the non-enforcement of the whole contract does not create problems, provided that the stronger party bears the switching costs. This could be the case if the strong party is held liable on the grounds of \textit{culpa in contrahendo} or tort and has to compensate the weaker party.\textsuperscript{90} If in spite of this possibility the weaker party does not wish to switch to another contract (\textit{e.g.} rent another apartment), this could be seen as a revelation of the fact that the subjective value he is willing to pay for the performance of the particular lease is high and therefore the contract is not unconscionable.

(bb) On the other hand, in the case of a monopoly or collusion, the weaker party has inadequate alternatives or will be unable to obtain better contractual terms. Under these conditions, adjusting the terms of the contract instead of annulling it might save on transaction costs (i.e. the costs of the new negotiations, which in any case do not have any prospects for better results than the first ones). Even in these cases however, the intervention of the judge in

\textsuperscript{88} See \textit{supra}, esp. under section 2.2.

\textsuperscript{89} This is the prevailing opinion in civil law countries. See \textit{supra} section 2.2.

\textsuperscript{90} Such liability may be found in most legal systems: in Germany this obligation could be based on the new § 311 (2) Nr. 1 BGB (\textit{culpa in contrahendo}) or 826 BGB (tort for intentional tort) in Greece on 197-198 CC (\textit{culpa in contrahendo}) or 919 CC (which is equivalent to § 826 BGB) in France and Belgium on 1382 CC (general clause for torts- it also includes precontractual liability) in Austria it is based on § 874 ABGB (see Bollengerber in Kurzkommentar ABGB, \textit{supra} note 17, § 874 N. 1) for Switzerland, see Huguenin, \textit{supra} note 35, Art. 21 CO N. 18, mentioning that under such conditions the strong party is liable because of \textit{culpa in contrahendo}. In common law countries, such cases may (but not always) fall within the scope of the tort of fraud. In the Principles of European Contract Law it is explicitly provided that the weaker party may claim damages from the strong one. According to art. 4:117 (a) “(1) A party who avoids a contract under this Chapter may recover from the other party damages so as to put the avoiding party as nearly as possible into the same position as if it had not concluded the contract, provided that the other party knew or ought to have known of the mistake, fraud, threat or taking of excessive benefit or unfair advantage. Likewise, according to article 3.18 of the UNIDROIT principles, “Irrespective of whether or not the contract has been avoided, the party who knew or ought to have known of the ground for avoidance is liable for damages so as to put the other party in the same position in which it would have been if it had not concluded the contract.”
the contract should not be seen as a durable solution. Cases of abuse of market power call for regulation, so that at least the security of transactions is safeguarded.

3.4. Judicial revision of non-key contractual terms

The notion of non-key contractual terms, as used in this paper, encompasses terms which regulate the legal implications of the agreement, like for instance the remedies for breach of contract, or append an extra clause to the contract, like for instance a penalty clause. If a non-key term is unconscionable, the liability rule can be applied in both its variations: The judge may either consider that the term in question is void and apply the relevant default rules, to the extent that such rules exist and this is necessary, or he may tailor the contractual term, so that it will no longer be unconscionable.

Under both variations of the liability rule, the moral hazard of the victim cannot be avoided; the weaker party may agree on disadvantageous terms, knowing that the judge will cover for him. Likewise, in all cases of partial nullity of a contract, the security of transactions is necessarily undermined and the transaction costs -especially negotiation and litigation costs- are increased. Nevertheless, a rule of non-enforcement of unreasonable terms is cheaper for the courts to enforce and does not lead to significant principal-agent problems.

The main difference between the non enforcement of a contractual term and its judicial revision lies in the incentives of the stronger party: if he knows that unconscionable contractual terms will be completely ignored by the court, he has no incentives to behave opportunistically. He would rather agree on reasonable and enforceable terms. On the other hand, a rule under which the judge substitutes reasonable terms for unreasonable ones does not have a deterrent effect: the stronger party will at least try to add one-sided terms to the contract, since he has nothing to lose – in the worst case he will get what he would have agreed on with the other party in a perfect competition/contract environment.

At this point it is worth mentioning that the deterrent effect of the non-enforcement of an unconscionable contractual term is weaker in case the void term is substituted by a relevant default rule. Take, for instance, the case in which the judge decides that a contractual term according to which the debtor, in order to terminate his two-year long contract, shall give notice to the creditor eighteen months in advance is non enforceable. Under these circumstances the time-clause of the relevant default rule will apply instead. Hence the creditor will not be

91 Cf. in Roman Law, “accidentalia negotii”.
any worse than he would be had he not acted unconscionably. Nevertheless, this solution is still preferable to the adjustment of the time clause by a judge, since statutory provisions do not jeopardize legal certainty.

4. CONCLUSION

Unconscionability is a doctrine which is to a great extent common to all legal systems. Nevertheless, its application varies considerably among different legal orders. The judicial reconstruction of unconscionable contracts or the adjustment of such clauses is often accepted in civil law countries. Common law countries are in principle more reluctant to grant such powers to the judge, but, as it seems, they are gradually becoming more receptive to these practices. Irrespective of the degree to which it is recognized that the judge may revise unconscionable contracts, in almost all countries inconsistencies are observed, in the sense that similar cases are treated legally in a different manner.

We claim that if the judge instead of refusing to enforce an inefficient contract or annulling an inefficient (abusive) clause he replaces it with a supposedly efficient judge-made one (for the sake of the argument let’s rule say that he can find the efficient clause and he will make an efficient contract), he creates incentives for opportunism from both sides, moral hazard and adverse selection situations, as well as second-best problems. This also leads to arbitrary judicial decisions, upsets the security of transactions and it will inevitably lead to higher transaction costs (litigation, judicial, and administrative costs).

Thus, the court, instead of modifying one of the terms, should decide between enforceability and non-enforceability based on the consent and the economic function of the clause. If the parties wish their (void) contract to be enforced, they can always renegotiate after the decision. If we limit the discretion of the judge to intervene in a contractual relationship, we achieve (among other things) two major goals:

- a substantial reduction of transaction costs
- an increase in responsibility which inevitably will lead to less need for paternalism.92

By way of an exception, the reform of an unconscionable key contractual clause may be justified in long term contracts under monopoly or oligopoly situations in extreme cases of market power abuse.

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92 We can also see the impact on the incentives of contractual parties under the “penalty rule” framework, developed by Ayres/ Gertner, supra note 85.
Further research on this topic definitely needs to be carried out. A next step could be the extension of the analysis, in order to take into account the risk attitude of the contractual parties, as well as different procedural rules. Finally, it would be interesting to reexamine this issue under the light of the results of studies in behavioral economics, after having relaxed the assumption of rationality.