# PUTTING THE 'PRIVATE' BACK INTO PRIVATE INTERNATIONAL LAW: DEFAULT RULES AND THE PROPER LAW OF THE CONTRACT*

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*[This article examines the proper law of the contract as a series of default rules and 'metadefault' rules which complete incomplete contracts. The common law's enforcement of express choices is shown to be efficient. The considerations relevant to the efficiency of selection methods in the absence of an express choice are explored. An argument is advanced in favour of selecting specific legal rules, rather than general legal systems, that correspond to the parties'* ex ante *intentions. This is based on the proposition that parties value contractual incompleteness, as evidenced in recent controversy regarding 'floating' choice of law clauses. The approach of English courts to these clauses demonstrates a dysfunctional species of formalism.]*

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## I INTRODUCTION

A major contribution of modern law and economics scholarship to the study of contract law, and other doctrinal areas explicable in terms of consensual exchange (such as the corporation and the trust), is the concept of the 'default rule'.[1] A default rule is supplied by the state to complete an agreement that the parties leave incomplete.[2] Although the default rule influences the form of the parties' exchange, the adjective 'default' emphasises that the rule merely supplements agreement; it does not thwart or override it. A default rule is distinguishable from a mandatory or an immutable rule. The normative thrust of law and economics research has been the advocacy of default rules, and the rejection of mandatory rules, at least in cases of bargains between persons of full capacity. Default rules can reduce the costs of contracting, whereas immutable rules increase those costs, if preferences for legal rules are not homogeneous.

Most research analysing the properties of default rules assumes a domestic or national setting. In other words, the situations in which a court might be called on either to apply a default rule, or to determine whether or not the default rule has been excluded by agreement of the parties, involve only a single body of law.[3] Little attention has been given to the extension of the default rule concept where another legal system, or other legal systems, make competing claims to supply legal rules for the resolution of the instant case. Private international law is the body of rules and principles which governs problems of this sort.

Private international law scholars have long recognised that resolving competitions between legal systems raises policy issues. However, economic analysis has been only infrequently used to theorise these competitions.[4] The purpose of this paper is to examine the application of default rule theory to choice of law in contract cases, and to explore the relevance of the normative aspects of that

[1] See, eg, Ian Ayres and Robert Gertner, 'Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules' (1989) 99 *Yale Law Journal* 87; Ian Ayres and Robert Gertner, 'Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules' (1992) 101 *Yale Law Journal* 729; Richard Craswell, 'Contract Law, Default Rules, and the Philosophy of Promising' (1989) 88 *Michigan Law Review* 489; Clayton Gillette, 'Commercial Relationships and the Selection of Default Rules for Remote Risks' (1990) 19 *Journal of Legal Studies* 535; Alan Schwartz, 'Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies' (1992) 21 *Journal of Legal Studies* 271; Robert Scott, 'A Relational Theory of Default Rules for Commercial Contracts' (1990) 19 *Journal of Legal Studies* 597.

[2] See, eg, Anthony Kronman, 'Specific Performance' (1978) 45 *University of Chicago Law Review* 351, 370.

[3] At the minimum, the literature assumes that the applicable body of law is clear. As will be noted, jurisdictional competition between American states for corporate charters is fundamentally an issue of contractual choice of law. However, in these cases, the state of incorporation, and therefore the applicable body of law, is known with certainty.

[4] See, eg, Lea Brilmayer, *Conflict of Laws* (2nd ed, 1995) ch 4 (application of game theory to critique government interest analysis); Henry Butler and Larry Ribstein, *The Corporation and the Constitution* (1995) ch 5 (comparison between choice of incorporation and choice of law in contract, positing that limits on party choice are inefficient); Larry Kramer, 'Rethinking Choice of Law' (1990) 90 *Columbia Law Review* 277 (application of game theory to endorse canons of construction in conflicts cases); Richard Posner, *Economic Analysis of Law* (4th ed, 1992) 587–8 (analysis of state interest in intra-US torts conflicts); Michael Solimine, 'An Economic and Empirical Analysis of Choice of Law' (1989) 24 *Georgia Law Review* 49 (economic arguments in favour of uniform national law in products liability and in favour of traditional 'territorial' methodologies).

theory when it is applied to a private international context. Modern theory differentiates between types of default rules, in particular between tailored and untailored defaults. It demonstrates the circumstances in which it will be efficient for a legal rule to take one of these forms. Do these insights apply equally when a court, having accepted jurisdiction, must decide not only what rule to apply, but also the system from which that rule is to come? This is an important question, since the latter inquiry is anterior (in a formalistic sense) to the former. We argue that the application of the theory reveals powerful normative insights into the judicial role in contract cases.

The paper consists of three substantive parts. Part II describes the legal rules that determine the law applicable to contracts where conflictual issues arise. Part III outlines the concept of the default rule. It distinguishes between tailored default rules and untailored default rules, with special attention being given to the 'penalty' untailored default rule. The circumstances in which the law might rely on one type of default rather than the other are examined. Part IV considers the implications of applying default rule theory to choice of law in contract cases. Part V is a conclusion.

## II CHOICE OF LAW IN CONTRACT CASES

### A *The Proper Law of the Contract*

At common law, choice of law issues in contract cases are resolved by determining the 'proper law of the contract'. How is the proper law ascertained? It is generally accepted that the forum applies its choice of law rules to determine the legal system whose laws dispose of the substantive issues in dispute between the parties. [5]

The proper law of the contract is, like its other terms, capable of being agreed upon by the parties. The parties may choose as the proper law a legal system which has no other connection with the parties or their contract.[6] The Privy Council in *Vita Food Products Incorporated v Unus Shipping Co*[7] said that it was well settled in English law that the

> proper law of the contract 'is the law which the parties intended to apply'. That intention is objectively ascertained, and, if not expressed, will be presumed from the terms of the contract and the relevant surrounding circumstances.[8]

[5] Australian choice of law methodology is characterised as 'jurisdiction selecting' — ie, the choice of law rule indicates the relevant jurisdiction without considering the substance of the rules so selected. See generally David Cavers, 'A Critique of the Choice-of-Law Problem' (1933) 47 *Harvard Law Review* 173. Although we refer to *a* 'jurisdiction', *depeçage* (choice of different legal systems to govern different aspects of the contract) is permitted by Australian law.

[6] *Vita Food Products Inc v Unus Shipping Co Ltd* [1939] AC 277, 290 (Lord Wright) ('*Vita Foods*'); *Suisse Atlantique Société D'Armement Maritime SA v NV Rotterdamsche Kolen Centrale* [1967] 1 AC 361.

[7] [1939] AC 277.

[8] Ibid 290.

Thus, express stipulations are generally dispositive. However, doctrine suggests that the parties' autonomy is not unfettered.[9] Unfettered autonomy would 'trivialise'[10] the mandatory rules of legal systems with an interest in the contract. The reconciliation of individual interests in party autonomy with state interests in the application of mandatory rules is problematic and often reflects the moral attitude of judges and commentators.[11] Party autonomy is treated as having the strongest claim to application where it appears to reflect genuine bipartite agreement,[12] and the weakest claim where it appears designed to evade the application of mandatory provisions.[13] We return to the issue of application of mandatory rules below.

The application of autonomy in international contract is unusual in Australian choice of law. Indicative rules which apply to resolve the choice of law question in other areas of private law generally centre upon identifying and applying the significant contacts (called connecting factors) between jurisdictions on the one hand and parties and activities on the other.[14] The connecting factors are sometimes assumed to indirectly encode state interests in regulating appropriately connected persons and activities.[15] Contract is unique in that these contacts may be irrelevant where the parties have expressly chosen the proper law of the contract.[16]

Where the parties have not expressly agreed on the proper law of the contract, the proper law will be determined in one of two ways. First, the court may

9 The exceptions to party autonomy envisaged in *Vita Foods* were limited in scope. Lord Wright stated that 'it is difficult to see what qualifications [to an express choice] are possible, provided the intention expressed is *bona fide* and legal, and provided there is no reason for avoiding the choice on the ground of public policy': [1939] AC 277, 290. These exceptions have seldom been applied. See generally Peter Kincaid, 'Choice of Law in Contract: the ALRC Proposals' (1995) 8 *Journal of Contract Law* 231, 237–8.

10 Bernard Black, 'Is Corporate Law Trivial?: A Political and Economic Analysis' (1990) 84 *Northwestern University Law Review* 542.

11 In Beale's view, the manner in which party autonomy enabled the parties to 'free themselves from the power of the law which would otherwise apply to their acts' was intolerable. He thought this an 'extraordinary power in the hands of two individuals' and noted that it was 'absolutely anomalous': Joseph Beale, *A Treatise on the Conflict of Laws* (1935) vol 2, 1079–80. Cf *Akai Pty Ltd v People's Insurance Co Ltd* (1996) 71 ALJR 156, 172 ('*Akai*'). For modern American views on party autonomy in contract cases, see Kramer, above n 4, 329–34.

12 The concept of non-equality in bargaining position appears to motivate s 8 of the *Insurance Contracts Act* 1984 (Cth), s 67 of the *Trade Practices Act* 1974 (Cth) and arts 5 (consumer contracts) and 6 (individual employment contracts) of the European Community: Convention on the Law Applicable to Contractual Obligations, 19 June 1980, 19 ILM 1492 ('Rome Convention'). It was regarded as significant by the Australian Law Reform Commission in its recommendations for reform of contract choice of law: Australian Law Reform Commission, *Choice of Law*, Report No 58 (1992) 87–9. In some countries, the use of standard forms may be a relevant consideration in reviewing an express choice of law.

13 In relation to the question of evasion in conflict of laws, see J Fawcett, 'Evasion of Law and Mandatory Rules in Private International Law' (1990) 49 *Cambridge Law Journal* 44.

14 For example, in areas of law which are based on status such as family law, most contacts are based on the personal law. In relation to immovable property, the significant contact is with the situation of property.

15 A Jaffey, 'The Foundations of Rules for the Choice of Law' (1982) 2 *Oxford Journal of Legal Studies* 368; Hessel Yntema, 'The Objectives of Private International Law' (1957) 35 *Canadian Bar Review* 721. Other objectives also underlie choice of law rules, including reasonable expectations, predictability, and uniformity.

16 See above n 6 and accompanying text.

attempt to infer the intention of the parties from the contract and extrinsic material.[17] In determining the parties' intentions, the court may consider various factors, including the existence of arbitration[18] or jurisdiction clauses.[19] Other relevant factors include the type of contract, the form of the contract documents and the language used.[20] The fact that one of the possible legal systems would invalidate the contract may be relevant to the issue of what the parties should be taken to have intended, although it is not dispositive.[21]

An implied intention may not be discernible, or the parties may not have shared a single intention.[22] In these cases, the proper law of the contract is the legal system with which the transaction has the 'closest and most real connexion'.[23] The law having the closest connection to the matter is sometimes treated by judges as the one that the parties would reasonably have chosen.[24] The following factors seem to be significant in determining the legal system having the closest connection: the place of contracting; the place of performance; the places of residence or business of the parties; and the subject matter of the contract.[25] The significance attached to each of these factors varies between cases. The jurisdiction exercised is one which involves balancing and subjective weighing. Several judges have recognised its indeterminacy in some cases.[26]

This three stage approach to ascertaining the proper law of the contract is a comparatively recent one, emerging in the latter half of this century. It supplanted an approach which involved the application of presumptions. These presumptions were that the law of the place where the contract was formed (*lex loci contractus*) was the proper law, except in cases where the performance of the contract occurred entirely in another place, in which the law of that place (*lex loci solutionis*) would apply.[27] The significance of these presumptions at common law

[17] In *Akai* (1996) 71 ALJR 156, 168, Toohey, Gaudron and Gummow JJ stated that express and implied intentions as to the proper law of the contract are 'but species of the one genus, that concerned with giving effect to the intention of the parties.' See also Australian Law Reform Commission, above n 12, Appendix B (Choice of Law Bill 1992), s 9(5)(a).

[18] The high water mark of the relevance of arbitration clauses was *Tzortis v Monark Line A/B* [1968] 1 All ER 949 ('an irresistible inference': 413 (Salmon LJ)); disapproved in *Compagnie d'Armement Maritime SA v Compagnie Tunisienne de Navigation SA* [1971] AC 572; *Hamlyn & Co v Talisker Distillery* [1984] AC 202, 208. See also *John Kaldor Fabricmaker Pty Ltd v Mitchell Cotts Freight (Aust) Pty Ltd* (1989) 18 NSWLR 172, 187.

[19] See, eg, *John Kaldor Fabricmaker Pty Ltd v Mitchell Cotts Freight (Aust) Pty Ltd* (1989) 18 NSWLR 172; *Akai Pty Ltd v People's Insurance Co Ltd* (1995) 8 ANZ Ins Cas 61-254.

[20] *Amin Rasheed Corporation v Kuwait Insurance Co* [1984] 1 AC 50.

[21] See, eg, *Lindsay v Miller* [1949] VLR 13; *Monterosso Shipping Company Co Ltd v International Transport Workers' Federation* [1982] 3 All ER 841.

[22] *Hellenic Steel Co v Svolamar Shipping Co Ltd* [1990] 1 Lloyd's Rep 541.

[23] *Bonython v Commonwealth of Australia* [1951] AC 201, 219; *Armadora Occidental SA v Horace Mann Insurance Company* [1977] 1 All ER 347 (cf on appeal [1978] 1 All ER 407); *John Kaldor Fabricmaker Pty Ltd v Mitchell Cotts Freight (Aust) Pty Ltd* (1989) 18 NSWLR 172.

[24] *The Assunzione* [1954] P 150, 176. Cf Kincaid, above n 9, 242 (the test is objective).

[25] *Re United Railways of the Havana and Regla Warehouses Ltd* [1960] Ch 52, 91; *Akai* (1996) 71 ALJR 156, 166.

[26] See, eg, *Coast Lines Ltd v Hudig & Veder Chartering NV* [1972] 2 QB 34, 44; *Stanley Kerr Holdings Pty Ltd v Gibor Textile Enterprises Ltd* [1978] 2 NSWLR 372.

[27] Other presumptions applied in specific instances, such as the *lex situs* applying to contracts regarding immovable property; and the law of the flag applying to contracts for the carriage of

is now minimal. Presumptions, however, are employed in the Rome Convention[28] and the Hague Convention on the Law Applicable to Contracts for the International Sale of Goods 1985[29] to determine the proper law in the absence of an express or implied choice. These Conventions use a three stage analysis analogous to that outlined above, but in the case of the third inquiry (ascertaining the system with which the transaction is most closely connected), the Conventions apply a rebuttable presumption which turns on the concept of characteristic performance.[30] In 1992, the Australian Law Reform Commission ('ALRC') recommended that, in the absence of an express or implied choice of the proper law, the law of the place with the most real and substantial connection to the contract should be presumed to apply. That place is defined as

> the place where the party to the contract that is to effect the performance that is characteristic of the contract habitually resides unless the contract has its most real and substantial connection with another place.[31]

This recommendation was clearly influenced by the Rome Convention.[32] The ALRC Report accepts the assertion that the presumption of characteristic performance allows more predictability and certainty than the objective balancing process entailed in identifying the system with which the contract has its closest and most real connection. The difficulty with this assertion is that in many kinds of contracts, it is no simple matter to identify the place of characteristic performance. Further, because the presumption may be rebutted, the possibilities of certainty and predictability are significantly undermined.[33]

### B *Mandatory rules*

The modern approach to choice of law in contract accepts that the application of the proper law of the contract, however that is determined, may be limited by mandatory rules. Mandatory rules may be of two types — substantive or choice of law.

Mandatory choice of law rules are less common. These preclude a free choice of the proper law of the contract.[34] An example is the *Carriage of Goods by Sea*

goods. The presumptions are based on the principle of territorial sovereignty: Gary Born, *International Civil Litigation in United States Courts* (1996) 664–5.

28 Rome Convention, above n 12.

29 Hague Conference on Private International Law: Convention on the Law Applicable to Contracts for the International Sale of Goods, 30 October 1985, 24 ILM 1575 ('Hague Convention').

30 See art 4(2) Rome Convention, above n 12. For example, the characteristic performance of a contract for the sale of goods is rendered by the seller; the seller's place of business should therefore be determinative: art 8(1), Hague Convention, above n 29. Some exceptions exist (art 8 (2), (3), (4)).

31 Australian Law Reform Commission, above n 12, 98.

32 Ibid 94–8. Cf Richard Plender, *The European Contracts Convention: The Rome Convention on the Choice of Law for Contracts* (1991) 108–13.

33 The question of whether the presumption applies or is rebutted is obviously one for a court and not the parties. For criticism of the utility of characteristic performance, see Kincaid, above n 9, 244–5; Brian Opeskin, 'The Use of Choice of Law Rules in Statutes Affecting Contracts: A Note on the Insurance Contracts Act 1984' (1996) 10 *Journal of Contract Law* 231, 240–1.

34 See generally Opeskin, above n 33.

*Act* 1991 (Cth), which applies to bills of lading relating to goods shipped ex-Australia. The bill of lading is governed by the laws of the place of shipment notwithstanding any express stipulation or implied agreement to the contrary.[35] The 1996 decision of the High Court in *Akai Pty Ltd v People's Insurance Co Ltd* [36] shows how such rules destroy choice of law clauses.

Mandatory substantive law rules purport to exist over and above the domain of private international law. A court may not apply a contractual choice of law if the substantive law chosen by the parties is inconsistent with a mandatory rule, just as it would ignore any other inconsistent contractual provision. For example, in *Golden Acres Ltd v Queensland Estates Pty Ltd*,[37] a court refused to enforce the parties' agreement that their contract should be governed by Hong Kong law.[38] Legislative provisions enacted in the forum (Queensland) regulated the commission payable to real estate agents. The choice of Hong Kong law was an attempt to contract inconsistently with that regulation. The court regarded this choice of law as being contrary to legislative policy. Sykes and Pryles argue that the basis of the decision was that the Queensland legislation applied as a mandatory rule of the forum.[39] That is, the choice of law clause was not ineffective as it would be with a mandatory choice of law rule. It simply yielded to the mandatory rule of the forum to the extent of any inconsistency.

Subject to normal questions of statutory interpretation, including issues of territorial application, courts will apply mandatory legislative provisions of the forum notwithstanding the choice of another legal system as the proper law of the contract. The issue of the application of mandatory rules of a foreign legal system is more complex at common law. Consistent with the courts' general wariness concerning the application of the 'public' laws of foreign jurisdictions,[40] it appears that at common law, forum courts generally do not treat themselves as bound to apply the mandatory law of a foreign state, even one interested in the transaction.[41] Where the foreign legal system which provides the mandatory rule is the proper law of the contract, it is more likely that the court will apply the

[35] *Carriage of Goods by Sea Act* 1991 (Cth) s 11. Cf *Insurance Contracts Act* 1984 (Cth) s 8; *Trade Practices Act* 1974 (Cth) s 67.

[36] (1996) 71 ALJR 156.

[37] [1969] Qd R 378; on appeal *sub nom Freehold Land Investments Ltd v Queensland Estates Pty Ltd* (1970) 123 CLR 418 ('*Queensland Estates*').

[38] Hoare J treated a clause stating that the the contract should be 'deemed to be entered into' in Hong Kong as an express choice of Hong Kong law: *Queensland Estates* [1969] Qd R 378, 383–4.

[39] Edward Sykes and Michael Pryles, *Australian Private International Law* (3rd ed, 1991) 599. See also Kincaid, above n 9, 236–7. This view is consistent with the approach taken in *Queensland Estates* by Menzies J (the only member of the High Court to consider the choice of law issue): (1970) 123 CLR 418, 424–7.

[40] *Attorney General (UK) v Heinemann Publishers Australia Pty Ltd* (1988) 165 CLR 30, 42 (Australian courts will not enforce 'the interests of a foreign sovereign which arise from the exercise of certain powers peculiar to government').

[41] See, eg, *Coast Lines Ltd v Hudig & Veder Chartering NV* [1972] 2 QB 34. Different considerations may apply in the case of intra-Australian disputes because of s 118 of the *Australian Constitution*: *Akai* (1996) 71 ALJR 156, 169. In *Kay's Leasing Corporation Pty Ltd v Fletcher* (1964) 116 CLR 124, the High Court evidently would have held that the Victorian courts were obliged to apply New South Wales legislation if it was applicable to the transaction in question.

mandatory law as part of the *lex causae*.[42] Also, where the mandatory law in question operates to render performance of the contract illegal in the place of performance, the mandatory rule will be observed by the forum.[43]

*Vita Foods*[44] is a classic example of a court refusing to give effect to mandatory provisions of foreign legislation. It was held that the mandatory law of Newfoundland did not apply in proceedings commenced in Nova Scotia as the parties had made an express choice of English law. The result in that case can be contrasted with the result in *Furness Withy (Aust) Pty Ltd v Metal Distributors (UK) Ltd (The Amazonia)*,[45] where an Australian mandatory law was applied by Gatehouse J to invalidate an express choice of law of English law by the parties.[46]

The lack of certainty relating to application of non-forum mandatory rules allows the possibility of contracting around the application of mandatory rules. This possibility, which is sometimes characterised as 'evasive', coupled with the increased tendency in the late twentieth century to allow state intervention in contracts, has drawn strong responses from a number of policy formulators. The American Law Institute's *Restatement (Second) Conflict of Laws*,[47] the Hague Convention and the Rome Convention provide that the proper law of the contract may in some cases be subjected to the application of mandatory rules, not only of the forum, but also of other 'interested states'.[48]

[42] It should be noted that courts may take the existence and effect of mandatory laws into account in determining the proper law of the contract: *Akai* (1996) 71 ALJR 156; *Coast Lines Ltd v Hudig & Veder Chartering NV* [1972] 2 QB 34.

[43] *R v International Trustee for the Protection of Bondholders AG* [1937] AC 500.

[44] [1939] AC 277.

[45] [1989] 1 Lloyd's Rep 403.

[46] However, the effect of the Australian law was avoided by Gatehouse J's finding that the parties had subsequently made an *ad hoc* agreement to submit their dispute to arbitration, which was effective: [1989] 1 Lloyd's Rep 403, 406.

[47] American Law Institute, *Restatement of the Law (Second) Conflict of Laws 2d* (1971) vol 1 ('*Restatement*'). The *Restatement* arguably provides the widest powers to review choice of law by the parties: s 187(2). In addition to allowing application of mandatory laws of legal systems other than that chosen by the parties (s 187(2)(b)), the *Restatement* allows the court in some circumstances to review the connection between the chosen legal system and the parties and the transaction. If the chosen legal system has 'no substantial relationship' to the parties and the transaction and there is 'no other reasonable basis for the parties' choice', the court may not apply its law: *Restatement* s 187(2)(a). For criticism, see Butler and Ribstein, above n 4, 109–10.

[48] The usual formulation is to subject the chosen law of the contract to the application of mandatory rules of the legal system with the closest and most real connection to the contract (sometimes referred to as the proper law of the contract). See arts 5(2), 6(1) and 7 of the Rome Convention, above n 12; *Restatement*, above n 47, s 187(2). See generally Opeskin, above n 33, 231–3. The Rome Convention, art 7(1), which is permissive, gives the discretion to apply the mandatory rules of another country where that country has a 'close connection' with 'the situation'. A number of contracting states, including the Federal Republic of Germany, Ireland, Luxembourg and the United Kingdom, have reserved the right to exclude this provision.

## III A Theory Of Default Rules

### A *The Coase Theorem and the Costs of Contracting*

The default rule concept finds its intellectual heritage in the Coase theorem, the cornerstone of modern law and economics. This theorem holds that where the costs of transacting are zero, the way in which the law assigns rights and liabilities will not affect the allocation of resources, although of course it may affect the distribution of income.[49] The parties will bargain around initial allocations, subject to transaction costs. In equilibrium, the parties consider all of the costs of their activity, so that their resource allocation decisions are controlled by the usual equation of costs and benefits at the margin. The significance of the Coase theorem to microeconomics and the law is its emphasis on the effect of transaction costs on exchange. Given that transaction costs will rarely be zero, the Coase theorem supplies a normative principle, namely that the law should be structured in a way which reduces the costs of contracting.

In corporate law scholarship, this normative principle has been closely considered. Scholars came to regard corporations as being bundles of contractual relationships.[50] The provision by the state of a low cost means of incorporation reduces the cost of organising business transactions. This 'contractarian' theory of corporations led inevitably to the view that the legal rules applicable to corporate contractual relationships should be suppletory. In other words, they should be default rules, in the sense outlined in our Introduction. The parties should be able to contract around those legal rules. Contracting around the default rules was regarded (consistent with the Coase theorem) as the parties' endeavour to maximise the exchange surplus, having regard to the circumstances and hazards of the exchange.

Corporate law initially paid little, or little sophisticated, attention to the question of what form the default rule should take. The Coasian insight that it should reduce the costs of transacting was easy to specify, but difficult to put into operation. The most obvious response was that the rules should take a form which could be justified by 'majoritarian' preference. That is, the default rule should be formulated in a way which appeals to more parties than any alternative formulation. Thus, contracting costs would be lower because fewer parties would want to opt out.

The problem, however, was that the costs of specifying rules to which a corporation's governance are to be subject border on the exiguous for larger corporations. The costs of specifying rules in the articles at the time it goes public (that is, by making a share offering) would be only a tiny fraction of the value of the flotation. If that were so, one would approach the Coasian ideal, where transaction costs were zero, and the form of the rules as a matter of indifference.

[49] Ronald Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1.

[50] See, eg, Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) *Journal of Financial Economics* 305; Frank Easterbrook and Daniel Fischel, *The Economic Structure of Corporate Law* (1991).

Bernard Black made this point in posing his entirely serious question, '[i]s corporate law trivial?'[51]

### B *An Economic Theory of Default Rules*

The failure of 'majoritarian' criteria to explain the form of default rules implied that theory needed to specify more precisely the source and incidence of the costs of contracting. In particular, it was necessary to understand why parties might leave contracts incomplete, even where the costs of formally specifying a rule are low. The resolution of this question was achieved by application of game theory. If the contract was perceived as a game, a party might find it a dominant strategy to stay silent concerning a term of the contract if, given the form of the default rule, a contractual gap favoured his or her interests. Implicit in this explanation is that parties may be imperfectly informed about the identity and attributes of their exchange partners. Imperfect information is a consequence of transaction costs. This idea was expounded by reference to the paradigm default rule: the prohibition of contractual damages for undisclosed consequential loss under the rule in *Hadley v Baxendale*.[52] By limiting damages to what can be foreseen, the law encourages one of the parties — the one hiring the services of the other (that being the miller) — to disclose to the other information concerning his or her type and attributes. The disclosure occurs as part of the process of contracting around the default rule for an allocation of rights and risks that is value maximising for the parties. The disclosure enables the counterparty to price the contract in a more informed, and therefore more efficient, manner. The efficiency results from a decrease in cross-subsidisation of high risk customers by low risk ones, so that each customer pays its marginal cost.

Ayres and Gertner incorporate this idea into a method for understanding and explaining default rules.[53] They assert that some default rules are *penalty* defaults, such as the one in *Hadley*. A penalty default is motivated by compelling parties to avoid leaving inefficient gaps in their contracts.[54] The 'penal' aspect derives from the fact that the rule penalises a party (such as the miller in *Hadley*) in whose interests it would be to remain silent about his or her type. It does this by giving that party a default term that he or she is unlikely to want. This encourages the party to contract around it, and in so doing, disclose information concerning his or her attributes.

Not all default rules are of this kind. Ayres and Gertner distinguish between *tailored* and *untailored* defaults. As the number of possible default rules rise, a single formulation will appeal to a progressively smaller percentage of contracting parties. However, courts could fill contractual gaps by supplying the rules the

[51] Black, above n 10.

[52] (1854) 9 Exch 341; 156 ER 145 ('*Hadley*').

[53] Ayres and Gertner, 'Filling Gaps', above n 1, 101–4.

[54] For analysis of the application of a theory of penalty defaults to corporate law, see Michael Whincop, 'Of Fault and Default: Contractarianism as a Theory of Anglo-Australian Corporate Law' (1997) 21 *Melbourne University Law Review* 187.

*actual* parties would want.[55] Ayres and Gertner describe these choices as being between tailored and untailored defaults. A 'tailored default' attempts to provide the parties with precisely the terms they would have contracted for. An 'untailored default', however, provides parties to all contracts with 'a single, off-the-rack standard'.[56]

Penalty defaults are, in general, a subset of untailored defaults. If the court attempts to tailor a legal rule to the circumstances of the parties, it will usually determine what the parties would have contracted for, if contracting was costless. To do that, it must make some determination of the knowledge possessed by the parties.[57] For instance, Easterbrook and Fischel have advocated that courts should apply defaults that the parties would have selected with full information and costless contracting.[58] A selection process predicated on full information may deter the party whose strategic interests are served by the existence of a gap from revealing his or her type.

There may of course be cases where the need for information revelation at the time of contracting is unimportant, because the parties are symmetrically informed. There may also be cases where, as a means of encouraging that party to produce it or to engage in some other socially valued activity of which the information is a byproduct, the law does not require a party with private information to disclose it.[59] In these cases, the value of non-penalty defaults and tailored defaults is evident. Corporate scholarship reveals two other purposes that tailored defaults serve.

First, some legal rules are difficult to affirmatively contract for. This may be because the 'rule' implies a process which is inherently tailored in nature, and requires a discriminating review of the facts and competing interests. Ayres has argued that these 'muddy' rules make logical defaults, since it is easy enough to opt out of them for a rule which makes precise allocations. The reverse however is not true: it would be difficult to opt out of a precise rule in favour of a muddy one, if it were necessary to describe what that muddy rule entails.[60]

Second, it is conventionally assumed that where the marginal benefit of one term over the other is greater than the incremental cost of contracting for such a rule, the parties will contract for it. However, the incremental contracting cost is not limited to the formal cost of drafting a provision opting out of the default. Some critics have explored the disincentives of opting out of a default. Goetz and Scott argue that parties who contract out of a standard form (ie, untailored) default face the prospect of misconstrued interpretation of their expressed

[55] See, eg, David Charny, 'Hypothetical Bargains: The Normative Structure of Contract Interpretation' (1991) 89 *Michigan Law Review* 1815. Cf Deborah DeMott, 'Beyond Metaphor: An Analysis of Fiduciary Obligation' [1988] *Duke Law Journal* 879, 890.

[56] Ayres and Gertner, 'Filling Gaps', above n 1, 91.

[57] See generally Charny, above n 55.

[58] Easterbrook and Fischel, above n 50, 15.

[59] See, eg, Anthony Kronman, 'Mistake, Disclosure, Information and the Law of Contracts' (1978) 7 *Journal of Legal Studies* 1.

[60] Ian Ayres, 'Making a Difference: The Contractual Contributions of Easterbrook and Fischel' (1992) 59 *University of Chicago Law Review* 1391.

intentions.[61] These ideas are formalised by Klausner, who argues that the value of some contractual terms is a positive function of the number of persons who use them.[62] This is described in economics as a 'network externality'. The problem with goods characterised by network externalities is that the socially optimal level of their production cannot be guaranteed by the usual forces of supply and demand. These externalities arise because some terms depend on factors including periodic judicial interpretations,[63] and the establishment of business practices.[64] The value conferred on the term by these factors rises as the number of users of that term rises. Klausner's analysis suggests that there may be a value in the use of tailored defaults. By increasing the number of available options, through tailoring, the law may be able to encourage an efficient blend of diversity in the usage of terms.

## IV DEFAULT RULES AND THE CHOICE OF LAW

### A *The Derived Demand for Private International Law*

Our basic proposition is that problems of choice of law arise from contractual incompleteness. Parties do not write completely specified contracts. They leave gaps in them, for reasons examined in Part III. It is the function of the law to complete gaps in contracts, which it accomplishes by the application of default rules. If it were costless to write contracts, and the parties were fully informed, choice of law issues would not arise. The parties' bargain would be fully specified.

The remaining sections of this part analyse how private international law, and the manner in which judges apply it, affect the costs of contracting. Section B addresses the case where parties specify the proper law of the contract. We argue that the common law's historical deference to, and enforcement of, choice of law clauses is efficient. Sections C and D address the more complex case where the proper law is unspecified. These sections explore the costs of different judicial approaches to these cases. We argue that the most efficient judicial approach would be the tailored selection of a proper law based on the legal rules that the parties would have contracted for, had they been fully informed and contracting was costless. Section E addresses the recent issue of 'floating' proper law, a subject which demands attention to a number of themes discussed in this part. As in Section D, we argue that parties value floating law because it is consistent with their desire to leave aspects of their contracts open. We criticise the conservative responses to floating law as costly attempts by judges to preserve the illusory formalism of classical contract law.

61 Charles Goetz and Robert Scott, 'The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms' (1985) 73 *California Law Review* 261.

62 Michael Klausner, 'Corporations, Corporate Law and Networks of Contracts' (1995) 81 *Virginia Law Review* 757.

63 Ibid 775–9.

64 Ibid 780–2. Many terms refer directly or indirectly to external business practice. An example might be a duty to take 'reasonable care'.

### B *Express Choice of Law*

In Part III, we examined some of the sources of contracting costs — the costs of formal contracting, the existence of asymmetric information, the form of the default rule itself, and the effect of network externalities associated with contractual terms. Choice of law is a means by which the costs of contracting can be reduced. Consider an example. We earlier discussed the network externalities associated with default rules. If there was only a single legal system, the parties may choose not to opt out of the default, given the positive externality associated with the default rule, and the costs (in particular, those associated with judicial misconstruction) of specifying a 'preferred' provision. However, the preferred provision may be the default rule applied in another legal system. The parties could then adopt the allocation of rights and risks they prefer by including in their contract an express stipulation that the law of the latter legal system shall govern the contract. There is no need to formally provide for the nature of that allocation of rights and risks, since the default fills the gap. In this way, choice of law can reduce the costs of contracting. The existence of a network externality provides a rational reason why parties would contract for *a* legal system, rather than simply emulate its provisions contractually.[65]

This analysis is familiar to American corporate law scholarship. One of the dominant features of American corporate law is the existence of multiple jurisdictions in which parties may choose to incorporate. Each state has its own corporations law. The State of Delaware has been for half a century the preferred state of incorporation. While in the 1970s, Delaware's hegemony was attributed to its 'collusion' with managers at the expense of shareholders,[66] most contemporary scholarship accepts that Delaware's advantage lies in its ability to supply the best package of contractual terms.[67] The concept of choice of incorporation is a parallel to express choice of law in international contracts.[68]

The description of choice of law doctrine in Part II emphasised that the central determinant of the proper law is the existence of a choice of law clause in the contract. This supports the notion that doctrine in this area is (or, at least, has been) predominantly default rules, which yield to express agreement. Historically, Anglo-Australian courts rarely refused to enforce express stipulations. This is consistent with what one would expect from theory: contracts have no external effects on those who are not parties to the exchange. However, as we noted above, at common law there are limitations placed on the parties' freedom to choose the applicable law, which are somewhat loosely based on preservation of

[65] *Accord, Siegelman v Cunard White Star Ltd*, 221 F2d 189, 195 (2nd Cir, 1955); Butler and Ribstein, above n 4, 115–6.

[66] See, eg, William Cary, 'Federalism and Corporate Law: Reflections upon Delaware' (1974) 83 *Yale Law Journal* 663.

[67] See, eg, Ayres, above n 60; Black, above n 10; Roberta Romano, 'Law as a Product: Some Pieces of the Incorporation Puzzle' (1985) 1 *Journal of Law, Economics and Organisation* 225; Roberta Romano, 'Corporate Law and Corporate Governance' (1996) 5 *Industrial and Corporate Change* 277.

[68] See generally Butler and Ribstein, above n 4.

the public policy of the forum.[69] This assumes either that one of the parties to the exchange requires protection or that contracts have a third party effect. In this case, courts might stand in the position of protecting the interests of those affected by contracts of the sort, even though at the time of contracting, the contract was presumptively in the interests of both parties.

A third party analysis explains decisions such as *Queensland Estates*.[70] We studied this case above as an example of a choice of law clause not being enforced. In that case commissions payable for real estate transactions were regulated, undoubtedly for the benefit of the industry, rather than for the benefit of the parties to the contract in that case (or the public, of course). Such restrictions on choice of law appear to be (and in our opinion should be) limited to situations where the mandatory rule is that of the forum.[71] Courts applying adversarial procedure are in a very poor position to make discerning judgments concerning the application of foreign mandatory rules. They are unfamiliar with the policy behind the rule.[72] The parties to litigation involving an express choice of law will have agreed *ex ante* that a contract excluding the law of the jurisdiction with the mandatory rule is in their mutual interests. *Queensland Estates* is an obvious example.[73] One party, however, may opportunistically defect from the agreement, since it may stand to gain more by doing so. That party will seek to convince the court that it was an intended beneficiary of the mandatory rule. However, this will almost always be a misrepresentation. If it were true, that party would not have judged it in its interests to opt out *ex ante*. Given the likelihood that applying that rule will be erroneous, and will encourage opportunistic litigation, courts should not enforce foreign mandatory rules in the majority of cases.

The selection of forum has a significant effect on the enforcement of the contractual choice of law as opposed to mandatory laws.[74] This was demonstrated by Lord Wright in *Vita Foods*.[75] Lord Wright juxtaposed two decisions to show that mandatory rules of another jurisdiction may not be enforced by the forum.[76] In *Liverpool & Great Western Steam Co v Phenix Insurance Co*,[77] the United States Supreme Court struck down an exemption for negligence in a bill of lading as being invalid under United States law. American law was the proper law of the

69 See above n 9 and Part II(B).

70 *Queensland Estates* [1969] Qd R 378; (1970) 123 CLR 418.

71 See references above n 39.

72 Brainerd Currie, *Selected Essays on the Conflict of Laws* (1963) 181–2. Cf Friedrich Juenger, *Choice of Law and Multistate Justice* (1993) 133–4.

73 *Queensland Estates* [1969] Qd R 378; (1970) 123 CLR 418.

74 Many of the leading cases in contract 'choice of law' are actually jurisdictional disputes. The comment in the text has obvious significance to a plaintiff's decision in which jurisdiction to commence proceedings. See *Akai* (1996) 71 ALJR 156 (express choice of England as the forum was not enforced because to do so would frustrate the remedial purpose of Australian legislation) and Andrew Bell, 'Jurisdiction and Arbitration Agreements in Transnational Contracts Part I' (1996) 10 *Journal of Contract Law* 53.

75 [1939] AC 277, doubting *The Torni* [1932] P 78, 298–300. See generally above nn 41–42 and accompanying text.

76 *Vita Foods* [1939] AC 277, 292.

77 129 US 397 (1889).

contract. By contrast, in *Re Missouri Steamship Co,*[78] an English forum, considering a similar case, held the proper law of the contract to be English; English law did not apply the American mandatory rule. Lord Wright said that:

> If [the forum] has before it a contract good by its own law or by the proper law of the contract, it will in proper cases give effect to the contract and ignore the foreign law.[79]

This type of forum-centricity is also evident in the High Court decision in *Akai.*[80] In that case, the parties to an insurance contract negotiated to opt out of Australian law in favour of English law. They also agreed to a jurisdiction clause that any dispute arising from the contract would be referred to the English courts. After a contractual dispute arose, the insured (an Australian resident company) commenced action both in the Supreme Court of New South Wales and in the English High Court of Justice. The Singaporean insurer, in reliance on the jurisdiction clause, sought a stay of the Australian proceedings. On appeal to the High Court of Australia, the stay order was denied, notwithstanding the jurisdiction clause. The court held by majority that the contract was subject to the *Insurance Contracts Act* 1984 (Cth) which did not permit opting out. Toohey, Gaudron and Gummow JJ held that the parties' choice of both applicable law and jurisdiction should not be upheld where to do so would frustrate the remedial purpose of forum legislation.[81] The case goes a long way towards permitting a party to defect opportunistically from express promises where the party can identify a mandatory rule in his or her interests in a forum. The case also has the effect of greatly increasing the value to a party of pre-empting disputes by commencing litigation in a favourable forum.[82] That result is inefficient.

### C *Courts Choosing Law for the Parties: The 'Metadefault'*

#### 1 *The Metadefault*

So far the analysis has considered contracts in which express choice of law clauses exist. However, much of the law in this area deals with cases where there is no express choice of law. This is an aggravated case of contractual incompleteness, compared to the case where the parties do not specify the rule, but specify the applicable law. Applying default rule analysis in such a case gains a new level of complexity, as there is not one question, but two: what is the applicable legal system, and what is the appropriate default rule? Choice of law doctrine in these

78 (1889) 42 Ch D 321.

79 *Vita Foods* [1939] AC 277, 296.

80 (1996) 71 ALJR 156. See also *The Hollandia* [1982] AC 565.

81 There is little authority in Australia on the application of the public policy exception to cases where the defendant is seeking a stay of local proceedings on the grounds of jurisdiction clauses. Obviously this question reveals the fundamental tensions between party autonomy and state interests: see above n 11 and accompanying text. See also Andrew Bell, 'Jurisdiction and Arbitration Agreements in Transnational Contracts Part II' (1996) 10 *Journal of Contract Law* 97, 104–8, and Born, above n 27, 414–30 (approach of US courts to application of public policy as a ground for refusing to enforce jurisdiction clauses).

82 Bell, 'Jurisdiction and Arbitration Agreements Pt I', above n 74, 104–8.

cases takes on the character of a 'metadefault' rule. That is, it provides a default rule[83] by which the appropriate rule completing the contract can be determined. The latter rule may be a default rule in the relevant legal system, although it might also be mandatory. Given that it partakes of the nature of a default, how should one theorise a choice of law question, based on the theory of default rules which we have examined? To answer this question, this section contrasts two analytical approaches — the tailored implied intention and connecting factors approach, and the untailored presumptions approach. While acknowledging the unlikelihood of the latter to generating results proximate to those the parties would have contracted for, we consider whether the presumptions function as a penalty defaults which deter inefficient gaps in contracts. A simple model of the costs of tailoring and of *ex ante* choice is used to show that the presumptions are not likely to be efficient penalty defaults. The section also considers the relationship between choice of law rules and true (substantive) penalty defaults that induce information revelation.

### 2 *Tailored and Untailored Metadefaults*

The analysis in Part II identified three approaches to cases where the parties have not included an express choice of law clause. The first inquiry is to ascertain whether there was an implied intention to choose one system of law. The second inquiry, which, according to some authorities, is undertaken if the first proves unyielding, is to determine the system of law which has the closest connection with the transaction. The third inquiry, which is said no longer to have a place in the law is the application of presumptions concerning the preference for the *lex loci contractus*, or the *lex loci solutionis*.

The first rule — which looks for the legal system which the parties impliedly intended — resembles a tailored default. That is, the court attempts to provide a legal system which the parties would have wanted, had they been able to contract at no cost. The second inquiry has some qualities of an untailored default.[84] It does not look to the intention of the parties. However, the practical task of determining the legal system having the closest connections to the transaction can be difficult. A number of factors are relevant, and judges have to determine in each particular case the weight that should be placed on each of those factors. The process seemingly involves a balancing, 'muddy' approach which is unlike an 'off-the-rack' default term. Moreover, there is an observable conflation of the two analyses. Brownie J recently described the closest and most real connection rule as a matter of 'impute[d]' intention.[85] In other words, parties would be presumed to intend that the contract be governed by the system with which it has the closest connection. This is true where the courts first look for an actual intention implied by the circumstances, but draw a blank.

[83] It is a default because it can be excluded by stipulation.

[84] An example of a genuine untailored default is where the forum applies the *lex fori*.

[85] *John Kaldor Fabricmaker Pty Ltd v Mitchell Cotts Freight (Aust) Pty Ltd* (1989) 18 NSWLR 172, 185; *Mount Albert Borough Council v Australasian Temperence & General Mutual Life Assurance Society Ltd* [1938] AC 224, 240. Cf *Akai* (1996) 71 ALJR 156, 168–9.

It may be that this tendency to tailoring in both approaches is inherent in private international law problems. The area does not lend itself to simple rules, such as 'no consequential damages unless foreseeable'.[86] The raw material on which private international law rules operate is competing legal systems, which change from case to case, rather than substantive rights and entitlements. The now rejected presumptions perhaps come closest to the spirit of an untailored default, given the following features: they are oriented towards a single system discoverable *ex ante*; they do not partake of any process of balancing the claims of competing systems; and they ignore the intention of the parties. While it is conceivable that there are cases where the rule they supply resembles the one the parties would have contracted for, the fact that they ignore intentions and the competing claims of other jurisdictions probably makes this coincidental. This may be particularly true of cases of long term relational contracts, where the original time of contracting is of less importance than ongoing sequential decision-making by parties within the exchange. Most issues of exchange are left for resolution in the future.[87] In these cases, the *lex loci contractus* is far more likely to provide an unsuitable guide to governance of contractual relations. The place of contracting would seem to be a merely adventitious consideration.

In cases such as these, the presumptions may end up giving the parties the rules they do not want.[88] However, such a result is by no means to be decried if transaction costs are low. Many penalty defaults are of this character. They deter the parties from leaving inefficient gaps in contracts. In so doing, they direct the attention of the parties to contract affirmatively for the rule that they *do* want. Ayres and Gertner contrast contracts for sale of goods which fail to specify a quantity, which are usually unenforceable (ie, the default is a zero quantity), with contracts where price is omitted (ie, the default is a reasonable price).[89] It is inefficient to cause a court to fill the former type of gap because it is more costly for it to do so. This logic may apply to justify the use of a penalty default in choice of law cases — it is more expensive for a court to attempt to fill gaps concerning proper law than it is for parties to contract affirmatively for the law they want. Such an assertion demands examination of the costs of the alternatives of *ex ante* contracting and *ex post* gap filling.

### 3 *A Model of the Costs of* Ex Ante *Choice and* Ex Post *Tailoring*

The costs of *ex ante* contracting for choice of law are threefold.[90] First, there are search costs for determining the possible systems which might apply, and the

[86] Apart from a 'chauvinistic' choice of law rule — to apply the *lex fori*. See above n 84 and accompanying text.

[87] Ian Macneil, *The New Social Contract: An Inquiry into Modern Contractual Relations* (1980). See also *Amin Rasheed Shipping Corporation v Kuwait Insurance Co* [1984] 1 AC 50, 62.

[88] In this regard, the presumptions resemble the effect of s 11 of the *Carriage of Goods by Sea Act* 1991 (Cth); see above n 35 and accompanying text. However, unlike s 11, the common law presumptions were rebuttable.

[89] Ayres and Gertner, 'Filling Gaps', above n 1, 95–7.

[90] In below Part IV(D), we introduce a fourth source of *ex ante* contracting costs, the value parties place on incomplete specification. The present analysis does not consider it, as it is irrelevant to demonstrating the functionality of penalty defaults in private international law.

default rules that each offer. Second, there are the costs of negotiating a choice of law clause. Third, there are the costs of contracting for the agreed choice of law provision. The third type of costs will border on zero, as these clauses are simple and brief, and courts do not require formalities provided the intention to choose law is well evidenced. At the *ex ante* stage, the parties have an incentive to opt for the 'best' legal system available. It is a basic principle of law and economics that the distributive implications of contractual rules and remedies are priced as part of the transaction. [91]

The costs of permitting the court to tailor a default rule *ex post*, either by the second (implied intention) or third (closest connection) methods fall into the following categories. First, the parties will again incur search costs. They will simply incur them at a different time (ie, when the contract becomes disputatious). Second, there are costs of judicial errors. Errors result where a court makes an inefficient decision concerning the proper law of the contract that does not maximise the value of the exchange. The rules the court selects may be inconsistent with those that the parties would have contracted for. For instance, even though the performance of the contract may have value, as we showed in Section C, it may be in the interests of one party to try to avoid his or her obligation. This might be achieved by arguing that a legal system which would excuse that party from performance provides the proper law. The cost of judicial errors is therefore influenced by the extent to which the parties make opportunistic use of litigation to expropriate an 'unbargained' share of the exchange surplus. The cost of judicial errors is also influenced by active favouritism by the forum of its subject in litigation with a non-subject. *Akai* may be an example.

The cost of judicial errors is bounded by the difference between the substantive law rules of the possible contender systems. If the legal rules in all applicable systems were identical, there would be no conflictual issue; the greater the difference in substantive law, the greater the amount of expropriable exchange surplus. Rule difference, however, is not the exclusive determinant. If courts consistently produce the results that the parties would have contracted for *ex ante*, the cost of judicial errors will be zero.

The third source of *ex post* tailoring costs arises from the fact that the litigation process will be longer and more protracted. Tailoring increases the length and complexity of litigation, compared to the case where there is an express choice of law.[92] Trials are longer if the parties must prove to a court what the legal rules are in the foreign system or systems.[93] A court undertaking the tailoring process must consider evidence concerning the sorts of rules the parties would have contracted for, or the intentions of the parties regarding legal systems. There is some trade-off between the costs of litigation and the costs of judicial error; that is, they are

91 See, eg, Mitchell Polinsky, *An Introduction to Law and Economics* (2nd ed, 1989) 122–3.

92 Note that some litigation costs are included in what we have described as the cost of judicial errors. For instance, laws which vary greatly between systems may motivate a party to litigate more often.

93 Although issues of foreign law only arise when foreign law is pleaded, the only way the parties can prevent each other from pleading it during any trial is by *ex ante* contracting.

inversely related. More costly litigation processes are more likely than abbreviated ones to produce accurate tailoring.

We can generalise our analysis as follows. The costs of *ex ante* contracting ($C_a$) are primarily $S$ (search costs) and $T$ (costs of transacting for choice of law).[94] Therefore:

$$C_a=S+T$$

The costs of *ex post* contracting ($C_p$) are search costs ($S$), the expected costs of judicial errors ($J$), and the expected costs of litigation ($L$). Therefore:

$$C_p=S+J+L$$

We observed above that $J=f(L)$, and is strictly decreasing in $L$. Additionally, $J=f(\sigma,\phi)$, where $\sigma$ is a measure of the variance of a party's outcomes under the default rules of all possible legal systems,[95] and $\phi$ is a measure of the favouritism by the forum for one of the parties.

Although search costs under the two different contracting approaches are incurred at different times and under different circumstances, we assume that the expected search costs are equal.[96] It follows that $C_a<C_p$, that is the costs of *ex ante* contracting will be less than the cost of *ex post* tailoring, where:

$$T<J+L$$

Given that we have observed that $J=f(\sigma)$, it follows that the efficiency of *ex ante* contracting is a function of the variance between legal systems. If one holds other influences on $J$ constant (such as $\phi$), then the greater the variance, the more efficient it is for the parties to contract *ex ante*, rather than *ex post*. In these situations, the use of a penalty default may be desirable, if it operates by motivating the parties to contract out of the default *ex ante*. Therefore, a penalty default can be justified if it deters inefficient gaps, and discourages reliance on tailoring.

The *lex loci contractus*, *lex loci solutionis* and characteristic performance presumptions are able to function as a penalty default in this sense, although only to a limited extent. They may possibly give the parties to the contract the rules they do not want. Therefore, they may encourage the parties to contract out of the default rule by including an express choice of law clause. It may be cheaper for the parties to spend $C_a$ than it is for the parties to have the court determine what the parties would have contracted for, which costs them $C_p$. However, this is not *necessarily* so. In particular, it depends on the existence of variance between the laws. The variance between legal systems is not constant over time. In particular,

[94] The cost of drafting the clause is assumed to be nil. T is therefore primarily negotiation costs.

[95] For instance, the exchange surplus might be +4. If courts divided it evenly under all possibly applicable rules, $\sigma=0$. If there was a fifty per cent chance of it being divided equally, and a fifty per cent chance of giving A 0, and B 4, then the variance (strictly, $\sigma^2$) of each party's return equals 1.

[96] That is, $E(S_a) - E(S_p)=0$.

phenomena such as globalisation reduce the variance ($\sigma$) between systems; accordingly, they make for relatively more uniform laws.[97]

$J$ is not fixed either. It is likely that parties may perceive particular courts as being able to determine at lower cost the appropriate default system and default rule, as well as having a greater ability to determine that one of the parties is seeking to act opportunistically. In corporate law, the Delaware courts are recognised as having such expertise. London's admiralty courts are a similar example in cases of maritime law. This is a matter which lies within the contractual competence of the parties, as they may include forum clauses in their contract. High quality courts themselves have incentives not to be observably favouritist, since favouritist judgments will endanger the revenues to the state from contractual choice of forum by parties.[98] Forum clauses therefore decrease both $J$ and $L$. As $J$ and $L$ fall, so too does the relative attractiveness of up-front contracting. It is in this sense that the High Court's sterilisation of the forum clause in *Akai* is so undesirable.

The larger problem with the default presumptions is that they operate in a clumsy manner. The presumptions operate whether or not the costs of tailoring ($C_p$) are high. The ability of the presumptions to encourage efficient *ex ante* contracting depends on two things. First, the law must 'get it wrong' by giving the parties the wrong system of rules. Second, the efficiency of the penalty default rule depends on the unsuitability of its allocation of rights being correlated with cases in which tailoring is inefficient (eg, because the costs of judicial error are highest). In other words, the presumptions should give the parties *more* unsuitable rules as the costs of tailoring rise. There is nothing in these presumptions which suggest they have sufficient sensitivity to these factors to function as an efficient penalty default.

This analysis shows the following things. First, it gives rise to a general argument in favour of tailoring, given the apparent lack of functional penalty metadefaults. Second, it shows that the demise of presumptions was efficient, a conclusion which reflects equally on the Australian Law Reform Commission's recent advocacy of a return to presumptions (specifically that of characteristic performance).[99] Third, it demonstrates the importance of forum clauses to efficient contracting. Fourth, it directs attention to factors that may influence the cost of judicial errors. Fifth, its rejection of the value of undiscriminating legal rules shows the inefficiency of arguments put in favour of mandatory rules by scholars such as Beale[100] and Fawcett.[101]

[97] On the other hand, they may not make for efficient laws. Standardised laws increase the contractual problems posed by network externalities: see above nn 62–64. This problem is greatly intensified if the standardised laws are mandatory, since the possibilities of inefficient selection of terms will rise: see generally Ayres, above n 60.

[98] That is, from the legal fees flowing into the system by parties adopting it as the forum.

[99] See above nn 30–32 and accompanying text.

[100] Beale, above n 11.

[101] Fawcett, above n 13.

4 *Choice of Law and True Penalty Defaults*

How does this analysis impact on the proposition that a particular purpose of many penalty defaults is their capacity to force *one* party to disclose his or her attributes? This type of penalty default has only limited application when applied to choice of law rules. We noted above that choice of law rules are in the nature of metadefault rules; that is, they are rules which provide for the selection of default rules. At this level, there are few relevant information asymmetries. The metadefault merely chooses between default rules, all of which are knowable by the parties. It would rarely be efficient for one of the parties to be under an obligation to inform the other about the substantive law of a contending legal system.

On the other hand, choice of law can have the effect of undermining penalty defaults, and the information revelation they induce. Consider a case where system A applies a *Hadley v Baxendale* type default to the award of consequential damages. System B does the opposite, and applies an untailored default permitting the recovery of consequential loss. Assume parties Y and Z are negotiating a contract. Party Z is a high risk contractor. If the substantive law in systems A and B were identical, except for the differences described, what would the course of the bargaining be? Z will not favour the *Hadley v Baxendale* default. Z has two choices. First, Z can disclose his or her status to Y and pay a higher price. Second, Z may seek to secure Y's agreement that the contract should be subject to the law of B. However, if as assumed, the systems differ in no other respect, Y will be able to unravel from the course of play that Z is a high risk contractor, and charge a higher price. In such a case, the existence of a penalty default in one system only serves its purpose, *even though that system does not provide the proper law of the contract.*

However, if there are a number of otherwise unrelated differences between the legal systems, apart from the treatment of consequential loss, this effect does not hold. The party is unable to unravel the information concerning Z's risk type from Z's preference for the law of system B.[102] This does not mean necessarily that Z will pay too low a price; neither does it mean that Y will be the loser. If Y cannot detect Z's type from the course of the play, then two things may occur. The first is that Y simply charges an average price that reflects the existence of unidentifiable high risk counterparties in the equilibrium. In other words, there is a 'pooling' equilibrium, not a 'separating' one. The second possibility is that Y offers his or her services on standard form terms which include an express provision denying the entitlement to consequential loss. In this latter case, the parties could still negotiate an appropriate choice of law clause, however the legal rule of the other system would yield to the express contractual provision of the parties.[103]

[102] Douglas Baird, Robert Gertner and Randal Picker, *Game Theory and the Law* (1994) 89–109.

[103] To state the analysis in this way presupposes that the system which is expressly included in the contract permits contracting around its legal rule on damages. If that rule were to be immutable, and the forum enforced that immutable rule, Y would lose. Nonetheless, information concerning immutable rules does not rest in the exclusive possession of Z.

If the contractual provision excluded liability for damages, but Z was willing to pay a higher price in order to transfer the risk to Y, then Z would nonetheless be able to bargain for that protection. However, Z's willingness to do this depends on the size of transaction costs. Z may not bargain around Y's standard form because the transaction costs may exceed the marginal benefit of so bargaining. Our analysis shows that judges need to be attentive to the impact the proper law has on the revelation of information by parties.

### D *Tailoring in Private International Law*

What does this imply for the process of a judge determining the proper law of the contract? How should this theory of default rules influence him or her? First, we have argued that courts have been correct to avoid untailored presumptions; and that penalty defaults seem to have comparatively little scope in private international law cases. But rejecting these does not of itself suggest what courts *should* do. We argue that the judge should fill gaps in the contract in a manner by reference to the contractual rules that the actual parties would have wanted. In other words, judges should attempt to tailor the proper law. This derives from the reasons for contractual incompleteness as regards proper law. Why don't some parties adopt a choice of law clause? As we have observed, $C_a$ must be greater than $C_p$, in order for parties to choose not to contract *ex ante*. According to the formula we presented earlier, this may be attributable to costly negotiations concerning proper law, a similarity of legal rules between legal systems, or the existence of a cost effective forum which is regarded as a 'low $J$' arbitrator. None of these factors tells us much about how a court should go about determining the proper law in order to economise on $C_p$. First, it is unlikely that the direct costs of negotiation are affected by different methods of determining the proper law *ex post*. Second, if legal rules were substantively similar, most conflicts cases would never get to trial. Finally, the forum's approach to minimising $J$ is precisely the issue we are looking for. It seems that a solution to how courts should tailor lies elsewhere. The solution which we endorse emphasises the *indirect* transaction costs of *ex ante* choice.

We suggest that the parties actually value incompleteness as to choice of law. A failure to contract implies that the costs of doing so are greater than the benefits. It may be that the benefits are low, because those provisions which fall to be dealt with under the gap filling rules of the proper law are by implication those which it is not cost justifiable to contract for explicitly. Therefore, aspects of the contract governed by the proper law are likely to be comparatively remote risks. In these cases, the parties may conclude that it is preferable not to contract *ex ante* in respect of these matters, either explicitly, or by specifying the proper law from which the rule should derive, but instead to commit to working out a problem co-operatively if and when the 'remote' risk actually crystallises. This may be so for several reasons. First, there is evidence that parties tend to under-

value remote risks.[104] If that were so, it would be sensible to leave a matter for decision when information concerning the risk became more easily available, consistently with the greater proximity of the risk. Second, the parties can have no good reason to believe that they will necessarily prefer the solutions offered by the law of one jurisdiction over others in all cases.[105] It therefore makes sense to leave matters open, so as to permit a wider, more informed negotiation. Third, a legal rule supplied by a single system may turn out, quite adventitiously, to be to the advantage of one of the parties. If the risk is remote, parties will not foresee this. The legal rule may give that party the bargaining position to extract an 'unbargained' share of the exchange surplus in contractual renegotiation. It follows that each of the parties may prefer to leave the contract open in order to prevent the possibility that it may be locked into such a rule in this way.

The practical implication of this analysis is that courts should be cautious in assuming *either* that parties impliedly intended that their rights should be governed by a single system of law, *or* that the parties should be imputed with the intention that the system with the closest connection to the facts should govern rights. In saying this, we therefore are inclined to doubt the practical utility of both accepted methods. To say in the first case that one system was impliedly intended by the parties to provide the proper law suggests that the parties had negotiated on this point, and had reached some form of agreement; or, alternatively, that there is something unequivocal in their agreement that suggests this to be the case. Courts should be careful of such assumptions. If this agreement did in fact exist, the costs of formally contracting in these terms would be negligible, almost zero.[106] Therefore the fact that they have *not* contracted, when to do so would be almost costless, suggests neither agreement nor intention are soundly based. 'Intention' would seem to point in the opposite direction, namely that the parties intended to commit to no one system of law.

In the second case, the idea that a contract should be governed by the system with which it has a close connection is also problematic. In particular, where the factors point very strongly to a single system, again, it seems remarkable that the parties did not themselves take that point and agree a choice of law clause, when the cost to do so is so small. In contrast, where the factors point equally to two or more systems, the test becomes indeterminate, and the courts must look elsewhere for solutions.

Our approach to tailoring rejects the value of choosing between systems, and instead emphasises choosing between rules.[107] We have argued that choice of law is primarily an issue of contractual incompleteness. Private international law is

[104] For a review of evidence, see Cass Sunstein, 'Behavioral Analysis of Law' (Working Paper, University of Chicago, 1997).

[105] Except where the alternatives are 'primitive' systems.

[106] This is because the cost of drafting a choice of law clause is almost zero, and it would very rarely be misconstrued in its meaning. An exception to our general analysis rejecting the value of implied intention would be in cases like *Akai* (1996) 71 ALJR 156, where choice of law clauses are invalidated by mandatory choice of law rules.

[107] This recommendation holds whether or not parties leave their contracts silent concerning the proper law of the contract by design or by inadvertence.

important because the law must supply rules to fill gaps in bargains which the parties leave incomplete. It follows that courts should consider the possible rules supplied by competing systems, and determine which rule the parties would have agreed to *ex ante*, had they been confronted with full information, and had contracting been costless. In reaching this conclusion, we are conscious that there may not be a single proper law of the contract for all purposes, because different systems may supply different rules. However, this is not problematic, because the parties may agree to such a result expressly, by means of the *depeçage* doctrine.[108] For instance, it is legitimate to make an express stipulation concerning the proper law of the contract, yet to provide also that the contract is to be governed by specified Acts of another jurisdiction.[109] Such a strategy is suited to the reduction of contracting costs, as it treats laws like off-the-rack contract precedents. If it is legitimate to permit the parties to select provisions from various laws, it follows that, in cases where the parties have not made express provision, the court should not assume the appropriateness of filling contractual gaps in an undiscriminating way.

As an example of our approach, consider *Mendelson-Zeller Co Inc v T & C Providores Pty Ltd.*[110] That case concerned the validity of a claim for set-off, which was based on a breach of implied warranties for merchantable quality and fitness. That term differed between the two jurisdictions, New South Wales and California. There was no choice of law clause. In that case, Rogers J sought to determine the issue by reference to the system with which the contract had its closest connection. We would argue that the appropriate analysis is as follows. The contract was incomplete concerning goods quality. It could be filled by one of two defaults, either the American or the Australian standard. Which would the parties have contracted for? To answer this question, we should remember that a warranty simply represents an allocation of risk to one of the parties; a more demanding warranty allocates it to the vendor, a less demanding warranty, to the purchaser. A vendor will charge more for a more demanding warranty, since the vendor is assuming greater risk. The way to tell which warranty the parties would have contracted for, is to compare the price of the goods with the price the vendor sells them for, where the American default applies, and no conflictual issue arises. If the price was the same (making due adjustment for shipping and other such costs), then the parties expected the American default would apply. If the higher Australian default applied, one would expect a higher price. In this way, one gives the parties the rule they would have contracted for.

We observed in the exposition of choice of law doctrine in Part II that courts have on occasions had regard to the fact that the contract would be invalid under one of the systems contending for the proper law.[111] This is a good example of tailoring the law by reference to the legal rules, not the legal systems, that the parties would want. For instance, if the reason for which such a system would

[108] See above n 5.
[109] See, eg, *Vita Foods* [1939] AC 277.
[110] [1981] 1 NSWLR 366.
[111] See above n 21 and accompanying text. See generally Kramer, above n 4, 329–34.

invalidate the contract had no application to the parties, it would make little sense for the parties to be caught in its net. However, in other cases, that may not be so. A contractual rule may invalidate the contract through operating as an information-compelling penalty default. Courts may hold that if this information had been revealed, at the time of contracting, the party would not have contracted at all. In these cases, that default may be justifiably applied. This illustrates that the tailoring of the proper law of the contract need not necessarily defeat the purpose of a penalty default. Our process asks not omniscience of the courts, but merely a willingness to think pragmatically about the parties' exchange and the effect of legal rules on that exchange. Contrast with this conclusion a slight variation on the facts of *Akai*. Assume that English law permits insurers to withhold indemnity where the insured failed to disclose material facts at the time the policy was formed. The Australian *Insurance Contracts Act* 1984 (Cth) does not.[112] In that case, the majority struck down the express choice of law, which the Act required, and the express choice of forum, which the Act did not. If that conclusion applied to the variation outlined, the court would undermine the power of the penalty default in England to compel a party to disclose asymmetric information relevant to the adverse selection problem in insurance.

### E *Formalism, Presentiation and the Puzzle of 'Floating' Law*

One difficulty of our theoretical argument concerning tailoring is the absence of information needed to apply it to many of the leading cases. Few of these cases give much factual information, making it difficult to demonstrate the rules the parties would have contracted for. However, our analysis has important insights for the concept of 'floating' proper law. It is conventional to require the proper law to be determined at the time of contracting.[113] However, since the 1980s, several cases have come before the courts in which parties have adopted clauses which seem to leave the proper law open, or which contingently specify the proper law. An example of the former is:

> Matters not provided for by [the York-Antwerp Rules 1950] to be adjusted, stated and settled according to the laws and usages at such port or place as may be selected by the carrier.[114]

An example of the latter is:

> [A]rbitration ... shall take place in Zurich and any question as to the construction or effect of this contract shall be decided according to the laws of England if the reference to arbitration shall have been made by the Purchasers and ac-

[112] *Insurance Contracts Act* 1984 (Cth) s 28.

[113] See, eg, *Rossano v Manufacturers' Life Insurance Co* [1963] 2 QB 352, 362. According to the 11th edition of Dicey and Morris, '[t]here must be a governing law at the outset of the contract, and the governing law cannot fall to be decided retrospectively': Lawrence Collins (ed), *Dicey and Morris on the Conflict of Laws* (11th ed, 1987) 1167. Evidently influenced by the Rome Convention's tolerance of variation of the proper law, the 12th edition significantly resiles from that view: Lawrence Collins (ed), *Dicey and Morris on the Conflict of Laws* (12th ed, 1993) 1220–2.

[114] The example is from *Armar Shipping Co v Caisse Algerienne d'Assurance et de Reassurance* [1981] 1 All ER 498, 500.

> cording to the laws of the Federal Republic of Germany if such reference shall have been made by the Sellers.[115]

Clauses such as the former show that the parties may find it desirable to leave matters open, even though they may wish to provide for a more specific solution should litigation actually take place. The latter clause shows the parties making more sophisticated contractual allocations of rights and duties in order to correspond with the particular circumstances of the exchange. Both examples show that the parties may not wish to commit themselves to a single body of law *ex ante*, apart from those provisions which they specify in their contracts. Such a perspective is consistent with the premises of relational contract theory. As noted above,[116] relational contract theorists reject the formalist concept (described by them as classical contract law) that contracts project exchange into the future by means of promises completely specified *ex ante*. They describe this formalistic concept as *presentiation*. Presentiation means that 'the course of the future is bound by present events, *and* that by those events the future has for many purposes been brought effectively into the present.'[117] Promise achieves presentiation because it enables a promisee to constrain the promisor's future conduct in accordance with the promise. Relational theory holds that contracts project exchange into the future partially by promise, but that exchange is heavily affected by the dynamics of the ongoing relation between the parties. Such a view rejects the utility of requiring complete promissory specificity *ex ante*.

How have the courts reacted to the parties' desire, manifested in the demand for floating law, for relational flexibility? The authorities are not particularly consistent. English judges have generally proclaimed the essentiality of the proper law being fixed at the time of making the contract.[118] The concept that the proper law could be indeterminate at some point in time was anathema. Contracts may impose obligations from the time of contracting, which depend on the proper law being determinate *ab initio*.

This analysis corresponds to a classical view of contract, in which promises are specified precisely and completely *ex ante*. However, this exaltation of formalism comes at a price — it creates bizarre inconsistencies in the doctrine. First, a claim that the proper law of the contract must be determinate at the time of the contracting must hold for all valid contracts. Yet, we have seen that parties may not specify the proper law of the contract *at all*, and that in many of these cases, the practical derivation of the proper law (through the law's implied/imputed intention principles) borders on the indeterminate. One need not go far down the path of legal realism to say of these cases that the proper law is only what the judge says it is. At the least, various possibilities of the proper law exist until the

[115] The example is from *Black Clawson International Ltd v Papierwerke Waldhof-Aschaffenburg AG* [1981] 2 Lloyd's Rep 446, 449.

[116] See above n 87 and accompanying text.

[117] Ian Macneil, 'Restatement (Second) of Contracts and Presentiation' (1974) 60 *Virginia Law Review* 589, 589 (emphasis in original).

[118] See, eg, *Armar Shipping Co Ltd v Caisse Algerienne d'Assurance et de Reassurance* [1981] 1 All ER 498, 505.

time of the decision, when they collapse into a single reality.[119] It seems an extraordinary thing to uphold these contracts, which are silent concerning the proper law, yet to reject the possibility that parties may wish to leave the proper law open, on the ground that a *hypothetical* legal question was insoluble at an *earlier* time.

Even if it occasionally turned out that the proper law had continued to float at a point in time needing decision, why should this occasion a problem? If the parties have not made a specific contractual provision for what should happen, then obviously enough there is a contractual gap. It can be filled like any other gap by a court applying a default rule.[120]

The ultra-formalism of some of these cases is relaxed in others. The English Court of Appeal upheld the second of the two floating proper law clauses quoted above.[121] The clause provided for English law, should a matter be referred to arbitration, but if the arbitration provision was held to be unenforceable, a different choice of law and forum clause should apply. The English Court of Appeal recognised that the fall back provision made commercial sense.[122] A more timid view was expressed in a later Court of Appeal decision. In *E I Du Pont De Nemours v I C Agnew*,[123] it was held that while there must be a proper law of the contract, it was 'theoretically possible' that a party could exercise a contractual option to retrospectively change the proper law.[124] In some ways this appears to be a formalist 'band-aid' applied to reconcile an emphasis on *ex ante* specification, while preserving the party's right to make choices necessary to relational flexibility. The substantive difference between these cases is minor.

The concept of floating law endorses our analysis that parties value open terms in contracts. This gives rise both to gaps concerning the proper law and express choice of law clauses that opt for flexible arrangements concerning proper law. Both arrangements conform to the need for flexibility, and they preserve scope for post-contractual bargaining. The response to floating law clauses — an endorsement of the need for the proper law of the contract to be determinate *ex ante* — is obviously related to the response to non-specification. In the latter case, judges treat the contract as having a proper law, and as having always been subject to that proper law. Both approaches decrease the flexibility that motivates these arrangements, and accomplish nothing of value other than the legitimation

[119] This is reminiscent of Schrödinger's famous quantum physics thought experiment, concerning his cat (the parties), an electron (the proper law), a bottle of cyanide (the legal rule), and an observer (the judge). Unlike Schrödinger and the Copenhagen school, formalists insist the cat was dead before the judge killed it!

[120] Precisely how that gap should be filled is the contribution of this section. We would argue that it should be filled by reference to the contractual rules the parties would have contracted for. If that is rejected, the proper law would be determined by applying the implied/imputed intentions, and then using the default rules of the proper law to fill the gap.

[121] See above n 115 and accompanying text.

[122] Cf *Dubai Electricity Co v Islamic Republic of Iran Shipping Lines* [1984] 2 Lloyd's Rep 380.

[123] [1987] 2 Lloyd's Rep 585.

[124] Ibid 592. The Hague Convention, above n 29, (art 7(2)) and the Rome Convention, above n 12, (art 3(2)) allow the parties to change the proper law at any time. This is plainly always possible in common law systems by means of variation of the contract: *James Miller & Partners Ltd v Whitworth Street Estates (Manchester) Ltd* [1970] AC 583, 603, 615.

of legal formalism. Our approach to cases where the contract is silent recognises that parties value flexibility, and that they recognise that future bargaining may produce better outcomes than *ex ante* contracting. In cases such as these, the aversion to inflexibility should be respected in determination of the proper law. Such a view compels the need to fill contractual gaps by reference to the rules that the parties would have contracted for. The court should prefer the default rule most consistent with the wishes of the parties and the circumstances of the exchange. In so recommending, we are conscious that we are treating legal systems in an instrumental way — as varied and diverse corpora, offering a choice of default rules. We consciously endorse such an approach as most consistent with the normative principle of party autonomy, and most supportive of private ordering and exchange facilitation. As our title suggests, it is a way to put the 'private' back into private international law.

## V CONCLUSIONS

The purpose of this paper is both constructive and critical. We believe that it is constructive in the sense that it provides new ways to conceptualise a complex area of the law. That conceptualisation offers the key to unlocking the area, and making it amenable to thorough policy analysis. More directly, the paper provides a new method by which judges can examine questions of proper law of the contract. We suspect that judges have long considered the effect of applicable legal rules when making their minds up concerning the proper law. However, that consideration was never explicated, remaining veiled by the accepted modes of doctrinal analysis. The value of our work is to show that choosing between legal rules need not stand condemned as 'results-oriented'. For pragmatists, an eye on results is the primary criterion of 'good' law, provided always one does not step over the line to partiality and unpredictability. We are innocent of any charge of favouritism, since our emphasis on hypothetical bargains derives, to the maximum extent possible, from what both parties would have assented to.

The critical value of this article may be difficult to assess independently of its constructive value. There is much that is counterintuitive, indeed iconoclastic, about this paper. Doctrinists may find impious and heretical our emphasis on the cost of judicial errors, our limited defence of legal rules that actually give parties the rules they do not want, our sanguine endorsement of choice of law and forum clauses as means for evading mandatory rules, and our rejection of the relevance (even the utility) of *ex ante* legal determinism in contracts. Yet these very concepts are tied up with what we put forward as the constructive side of this article.

Three ideas are central to our critique. The first is that bargaining around the law and opting out are themes that pervade private international law, just as the Coase theorem would predict. Given that contracts generally produce few externalities, courts should uphold bargaining rather than attempt to stifle it. Second, the reliance on classical, formalistic conceptions of law produces anomalies that limit rational choice. Courts must recognise that contracts are ongoing exchanges that project the present into the future by means that are not

restricted to past promises. Legal principles must accommodate relational flexibility, not *vice versa*. Third, courts make mistakes (although they have a better chance of getting things right than parliament), whatever principle they apply. It makes sense, however, to exercise a jurisdiction that operates to supplement parties' bargains, rather than one which ignores them. Ignoring the effects of choice of law on exchange is most likely to encourage opportunistic litigation, as in *Akai*, and increase the costs of judicial errors. Attempting to solve problems by reference to the parties' bargains systematically favours neither party, even if errors are made, and so encourages the parties to act in a way that maximises the joint value of the transaction. These ideas, combined with a recognition that contracting is costly and incomplete, have the potential to change the way we theorise, apply and advise on private international law. The area has for too long been a mystery, full of abstruse and formalistic concepts, overloaded by more French and Latin jargon than a guide to postmodernism. Kramer describes its perception by non-specialists as 'mystifying, frustrating and a bit silly.'[125] Viewing the proper law of the contract as a supplement to contractual bargaining is the first step in making it more transparent, more efficient, and more pragmatic.

[125] Kramer, above n 4, 344.