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FROM EFFICIENCY TO POLITICS IN CONTRACTUAL CHOICE OF LAW

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Enforcing contract provisions that choose the law that applies to the contract can be efficient because these clauses reduce the uncertainty of vague conflict-of-laws default rules and help contracting parties avoid the application of inefficient mandatory rules. The latter effect is particularly important, since interest group theory suggests that economic regulation may serve relatively small but well-coordinated interest groups rather than overall social welfare. Enforcing contractual choice of law effectuates the power of exit by individual parties as a complement to the effect of political voice. Moreover, giving parties a choice among legal regimes activates a market for laws that, like markets generally, can be more efficient than leaving policy determinations to a single set of government agents. Thus, there is a strong normative case for enforcing contractual choice of law regardless of whether this suits the government's political objectives.[1]

But choice-of-law clauses present normative and positive analytical puzzles. From the normative standpoint of whether courts *should* enforce these clauses, if we reasonably assume that some mandatory laws are efficient, why should parties be able to evade them by the simple expedient of writing contracts providing for application of alternative law? This reasoning seems to underlie the traditional hostility to these clauses on the ground that government rather than private parties should determine the scope of application of its laws.[2]

From the standpoint of positive analysis, this Article reports on a study of approximately 700 cases involving choice-of-law clauses

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[1] *See* MICHAEL J. WHINCOP & MARY KEYES, POLICY AND PRAGMATISM IN THE CONFLICT OF LAWS 29 (2001); F.H. Buckley & Larry E. Ribstein, *Calling a Truce in the Marriage Wars*, 2001 U. ILL. L. REV. 561, 563; Andrew T. Guzman, *Choice Of Law: New Foundations*, 90 GEO. L.J. 883, 938 (2002); Erin A. O'Hara, *Opting Out of Regulation: A Public Choice Analysis of Contractual Choice of Law*, 53 VAND. L. REV. 1551, 1569 (2000); Erin A. O'Hara & Larry E. Ribstein, *From Politics to Efficiency in Choice of Law*, 67 U. CHI. L. REV. 1151, 1152 (2000); Larry E. Ribstein, *Choosing Law By Contract*, 18 J. CORP. L. 245, 297 (1993); Larry E. Ribstein & Bruce H. Kobayashi, *State Regulation of Electronic Commerce*, 51 EMORY L.J. 1, 78-79 (2002); Paul B. Stephan, *Regulatory Cooperation and Competition—The Search for Virtue*, *in* TRANSATLANTIC REGULATORY COOPERATION (2000).

[2] *See* 2 JOSEPH H. BEALE, A TREATISE ON THE CONFLICT OF LAWS § 332.2 (1935); H. GOODRICH ON CONFLICT OF LAWS 325-33 (3d ed. 1949); RALEIGH C. MINOR, CONFLICT OF LAWS § 167 (1901); Ernest G. Lorenzen, *Validity and Effects of Contracts in the Conflict of Law*, 30 YALE L.J. 655, 658 (1921).

that shows that such clauses are enforced in all but certain narrow categories of cases, and that the number of cases involving contractual choice is increasing significantly over time. This presents the additional puzzles of why courts enforce these clauses where the contracts would not be enforceable under the law applicable without the clause, and why legislators would not respond by adding provisions to individual regulations or global statutory provisions that prevent evasion through contractual choice. In short, while a normative analysis of contractual choice of law seems to require disregarding considerations of political power in deciding whether to enforce contractual choice,[8] a positive political analysis must account for these political considerations.

This Article seeks to reconcile the normative and positive analyses of contractual choice of law by examining the effect of party mobility on lawmakers' incentives. Choice-of-law clauses are not the only way parties can choose which jurisdictions regulate them. One can avoid being subject to a state's law by staying out of the state—that is, avoiding contacts with the state and its residents. Conversely, a firm can choose to reside in a state whose laws it prefers and designates in its contracts, thereby increasing the chances of being governed by those laws. Mobility, in turn, brings into play interest groups within the state, particularly lawyers, who may be helped or hurt when contracting parties choose either to adopt or avoid the state's law. These interest groups have an incentive to promote laws that would encourage parties to establish economically valuable contacts with the state.

Party mobility has four important implications for positive and normative theories of contractual choice of law. First, mobility helps explain why lawmakers enforce choice-of-law clauses in most cases, including cases where the clauses facilitate exit from local law. Second, mobility gives legislators an incentive to regulate efficiently in order to attract residents. Third, these explanations account for limitations on the enforceability of contractual choice of law in cases in which the designated state lacks a connection with the parties that would give that state's lawmakers incentives to regulate efficiently. Fourth, since party mobility causes state lawmakers to

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[8] *See generally* O'Hara & Ribstein, *supra* note 1.

internalize the costs of restrictions on contracting, including prohibitions on choice-of-law clauses, contractually designated states should enforce at least the most explicit of such prohibitions.

These positive and normative insights provide a basis for a model statutory provision on contractual choice of law. A statutory rule on contractual choice is potentially useful because of the importance of having a clear rule, and because of the differing incentives of state judges and state legislatures regarding enforcement of contractual choice. A model provision could be beneficial in promoting the spread of such statutes and useful in highlighting this Article's theoretical analysis. The provision this Article proposes would enforce express written choice-of-law clauses notwithstanding common law or statutory restrictions on enforcement, except when the clause is explicitly prohibited by a state where a contracting party resides and no party resides in the designated state.

This Article builds on my prior work both alone and with others examining the effects of party mobility, including contractual choice of law, in producing efficient state law.[4] This Article applies these insights in analyzing the distinct role of contractual choice of law in this process, and how the process can produce efficient rules on enforcing contractual choice.

This Article is organized as follows. Part I provides a brief overview of the current law on enforcement of choice-of-law contracts.[5] It shows that courts do, in fact, enforce contractual choice in many cases, including when the choice overrides regulatory law of the forum. This Article seeks to analyze and explain these results and rules.

Part II examines the normative arguments for and against enforcing parties' choices of the jurisdiction that will adjudicate their legal disputes prior to when the dispute arises.[6] It details the functions of contractual choice in addressing problems of inefficient

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[4] *See* Bruce H. Kobayashi & Larry E. Ribstein, *Contract and Jurisdictional Freedom*, *in* THE FALL AND RISE OF FREEDOM OF CONTRACT 325, 348 (F.H. Buckley ed., Duke 1999); Larry E. Ribstein, *Lawyer Licensing and State Law Efficiency* 4 (2002), *available at* http://www.ribstein.org (last visited Jan. 26, 2003); Ribstein & Kobayashi, *supra* note 1, at 78-79.

[5] *See infra* notes 17-108 and accompanying text.

[6] *See infra* notes 113-206 and accompanying text.

or unsuitable state laws and in promoting efficient enforcement of contracts and design of default rules.

Part III discusses a political theory of enforcement of contractual choice of law in which legislators permit enforcement of contractual choice of law only to further their own rent-seeking interests.[7] This suggests that the political and efficiency explanations of contractual choice may diverge.

Part IV discusses an alternative political theory of contractual choice in which courts and legislatures have an incentive to enforce contractual choice in order to encourage parties to establish contacts with the state.[8]

Part V shows how normative and positive aspects of contractual choice merge—that is, that lawmakers generally have incentives to enforce contractual choice of law in situations in which this is likely to be efficient, while refraining from enforcing in situations where this is likely to be inefficient.[9] It also shows how enforcing contractual choice can, in turn, provide incentives for efficient lawmaking.

Part VI discusses a framework for enforcing contractual choice of law, proposing a specific choice-of-law statute and showing how this rule might be adopted.[10]

Part VII discusses some conclusions and implications of the analysis.[11]

I. THE LAW OF CONTRACTUAL CHOICE

This Part reviews the law regarding enforcement of contractual choice-of-law clauses. In general, it shows that, despite early hostility to the clauses linked to territorial conflict rules discussed in Part I.A,[12] the courts now generally enforce these clauses except in specific categories of cases. Part I.B analyzes the case law on enforcement,[13] including the most important modern rule on

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[7] *See infra* notes 210-24 and accompanying text.
[8] *See infra* notes 231-329 and accompanying text.
[9] *See infra* notes 331-50 and accompanying text.
[10] *See infra* notes 351-448 and accompanying text.
[11] *See infra* notes 449-55 and accompanying text.
[12] *See infra* notes 17-25 and accompanying text.
[13] *See infra* notes 26-62 and accompanying text.

enforcement of contractual choice, section 187 of the Restatement (Second) of Conflict of Laws.[14] Part I.C discusses the case and statutory law regarding enforcement of contractual choice.[15] Part I.D discusses an important basis for expanding the enforcement of contractual choice—the corporate internal affairs rule.[16]

A. TRADITIONAL CHOICE-OF-LAW RULES

The legal rules regarding enforcement of contractual choice of law are best understood in the context of the territorial principles that prevailed in the United States through much of the twentieth century.[17] Under these principles, a jurisdiction had only the authority to regulate people and events within its borders. Pursuant to the "vested rights" theory, a dispute with links to several jurisdictions was adjudicated under the law where rights "vested."[18] Under the Restatement (First) of Conflict of Laws, which applied the vested rights theory, rights arise according to the law of the place of the last act or event necessary to create a cause of action, such as the place of contract formation for contract validity.[19] Since the First Restatement is primarily concerned with allocating powers among relevant sovereigns, it understandably lacks a provision enabling contracting parties to choose their governing law by contract.[20] Indeed, Joseph Beale, who developed the vested rights theory, explicitly condemned such contracts as impermissible private legislation.[21]

Brainerd Currie's government interest analysis, under which the applicable law turns on a state's legislative intent concerning the law's territorial scope,[22] is the twentieth century's major alternative to vested rights analysis.[23] Since this intent is rarely obvious,

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[14] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971).
[15] *See infra* notes 63-82 and accompanying text.
[16] *See infra* notes 83-108 and accompanying text.
[17] O'Hara & Ribstein, *supra* note 1, at 1152-53.
[18] *See generally* BEALE, *supra* note 2.
[19] RESTATEMENT (FIRST) OF CONFLICT OF LAWS § 332 (1934).
[20] *Id.*
[21] BEALE, *supra* note 2, at 1079.
[22] *See* O'Hara & Ribstein, *supra* note 1, 1169-72 (describing Currie's approach).
[23] Michael E. Solimine, *An Economic and Empirical Analysis of Choice of Law*, 24 GA. L.

Currie's analysis must construct it by guessing what the legislature would have preferred if it had thought about the problem. Many other approaches to conflict of laws are variations on interest analysis. William Baxter would have courts apply the law of the state whose interests would suffer the greatest "comparative impairment" if its law were not applied.[24] Larry Kramer proposed sophisticated tools for ascertaining legislative intent.[25]

Despite their apparent differences, both the vested rights and interest theories emphasize the political power of states to legislate concerning people and events within their borders. Their main difference concerns how this principle is applied, because vested rights theory looks to principles that yield objective rules, while interest analysis looks to legislative intent. Both approaches obviously support significant qualifications on contracting parties' power to make their own applicable law determination.

B. THE CURRENT CASE LAW

The courts generally have enforced contractual choice of law. This approach was endorsed in section 187 of the Restatement (Second) of Conflict of Laws, which pragmatically attempted to reflect what the courts actually were doing rather than adopting a specific theoretical approach.[26] The courts, in turn, have widely cited and endorsed this provision.[27] The increased prominence of this section may have further increased enforcement of contractual choice.

Section 187(1) uses the law selected by the parties as the starting point for determining the law applicable to a contract dispute and provides for unqualified enforcement of the choice as to issues such as interpretation that the parties could have settled themselves by drafting the contract more explicitly.[28] Section 187(2) provides that

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REV. 49, 52 (1989).

[24] *See generally* William F. Baxter, *Choice of Law and the Federal System*, 16 STAN. L. REV. 1 (1963).

[25] *See generally* Larry Kramer, *Rethinking Choice of Law*, 90 COLUM. L. REV. 277 (1990) (proposing use of "canons of construction" to determine legislative intent).

[26] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971).

[27] *See infra* note 38 and accompanying text.

[28] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(1) (1971).

the parties cannot choose their own governing law for mandatory rules if:

> (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
> (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.[29]

Thus, section 187 explicitly authorizes letting the contract override a mandatory law that would apply under the default

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[29] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2) (1971). If there is no enforceable contractual choice of law, Restatement § 188 determines the law applicable to the contract as follows:

> (1) The rights and duties of the parties with respect to an issue in contract are determined by the local law of the state which, with respect to that issue, has the most significant relationship to the transaction and the parties under the principles stated in § 6.
> (2) In the absence of an effective choice of law by the parties (*see* § 187), the contacts to be taken into account in applying the principles of § 6 to determine the law applicable to an issue include: (a) the place of contracting, (b) the place of negotiation of the contract, (c) the place of performance, (d) the location of the subject matter of the contract, and (e) the domicil, residence, nationality, place of incorporation and place of business of the parties. These contacts are to be evaluated according to their relative importance with respect to the particular issue.
> (3) If the place of negotiating the contract and the place of performance are in the same state, the local law of this state will usually be applied, except as otherwise provided in §§ 189-199 and 203.

Id. § 188. Application of this section is subject to § 6, which lists the following general factors that guide choice of law:

> (a) the needs of the interstate and international systems, (b) the relevant policies of the forum, (c) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue, (d) the protection of justified expectations, (e) the basic policies underlying the particular field of law, (f) certainty, predictability and uniformity of result, and (g) ease in the determination and application of the law to be applied.

Id. § 6.

choice-of-law rule where there is a "reasonable basis" for the contractual choice, unless the law of the nonchosen state represents "fundamental policy" and the nonchosen state "has a materially greater interest" than the chosen state in determining the issue.[30] The Restatement says that a "reasonable basis" may include the parties' desire to adopt a familiar legal system when a "strange" foreign law otherwise might apply,[31] citing the famous English case of *Vita Food Products, Inc. v. Unus Shipping Co.*[32] in which the court applied contracted-for English law to a shipment of goods from Newfoundland to New York.[33] Thus, "reasonable" clearly includes a contracting party's convenience. This means that the Restatement exceptions to enforcement focus on whether a closely related state has a "fundamental" policy that is closely enough related to the case that parties' contracts cannot displace them.[34]

The Restatement's general thrust therefore clearly favors enforcement of contractual choice. Indeed, the primary Restatement choice-of-law rule for contracts is that stated in section 187, which is based on explicit contractual designation, with the default rule in section 188 applying only if there is no such designation. Consistent with this general thrust, most courts enforce contractual choice of law as long as the designated state has some relationship with the parties or transaction.[35] One recent survey of the law showed that

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[30] *Id.* § 187(2)(a), (b).

[31] *Id.*

[32] 1939 A.C. 277 (P.C. 1938); *see also* Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 11-19 (1972) (focusing on choice of forum, but also supporting application of unrelated contractually selected English law).

[33] *Vita Food Prods.*, 1939 A.C. at 289-301.

[34] Comment g to § 187 states unhelpfully that a "fundamental" policy need not be a "strong" one, although it must be "substantial." RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 cmt. g (1971).

[35] For examples of cases refusing to enforce clauses that designated an unrelated state see Curtis 1000, Inc. v. Suess, 24 F.3d 941 (7th Cir. 1994); LaGuardia Assocs. v. Holiday Hospitality Franchising, Inc., 92 F. Supp. 2d 119 (E.D.N.Y. 2000) (designating former corporate headquarters); CCR Data Sys., Inc. v. Panasonic Communications & Sys. Co., No. CIV. 94-546-M, 1995 WL 54380 (D.N.H. Jan. 31, 1995) (invalidating clause despite fact that New York was designated as good commercial jurisdiction); Fuller Co. v. Compagnie Des Bauxites De Guinee, 421 F. Supp. 938 (W.D. Pa. 1976) (designating state of location of counsel). One commentator notes that no American court has upheld contractual choice of an unrelated state where the effect would be to override the mandatory rule of a related state. *See* Richard K. Greenstein, *Is The Proposed UCC Choice of Law Provision Unconstitutional?*, 73 TEMPLE L. REV. 1159, 1179 (2000) (noting parties' choice-of-law will not be followed where

courts almost uniformly have allowed the parties to evade state usury laws which might have been thought to involve fundamental policies of the enacting states.[36] Also, the last six years of Symeon C. Symeonides's surveys of selected American conflicts cases cite very few cases in which choice-of-law clauses were not enforced as to contractual issues that were within the clause.[37]

To get a fuller picture of overall enforcement of contractual choice of law, I gathered 697 cases involving an issue of whether or not to apply the law designated in a clause of a commercial contract in

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it would conflict with fundamental policy of state with materially greater interest); *see also infra* note 105 and accompanying text (discussing in more detail cases bearing on this issue).

[36] O'Hara, *supra* note 1, at 1564; *see also* William J. Woodward, Jr., *Contractual Choice of Law: Legislative Choice in an Era of Party Autonomy*, 54 S.M.U. L. REV. 697, 727 (2001) (noting that most courts enforce choice of law in usury cases). This may be attributable to the effect of the Uniform Commercial Code choice of law provision. *See infra* note 75 and accompanying text (discussing U.C.C. choice of law provision).

[37] *See* Symeon C. Symeonides, *Choice of Law in the American Courts in 1995: A Year in Review*, 44 AM. J. COMP. L. 181, 221-24 (1996) (finding that 26 of 200 contractual choice cases did not apply contractually designated law, but that most of these involved noncontractual tort and procedural issues; those dealing with contractual issues involved statute that expressly applied to contract at issue, state government agency, anticompetition clause, consumer fraud, or consumer lease); Symeon C. Symeonides, *Choice of Law in the American Courts in 1996: Tenth Annual Survey*, 45 AM. J. COMP. L. 447, 488-89 (1997) (noting that six of 100 cases failed to uphold clause on public policy grounds, and that courts determined coverage of noncontractual issues, such as statute of limitations as matter of contractual intent rather than as one of parties' power to contract); Symeon C. Symeonides, *Choice of Law in the American Courts in 1997*, 46 AM. J. COMP. L. 233, 273-75 (1998) (noting only two invalidating cases involving contractual issues, *Richards v. Lloyds of London*, No. 94-1211, 1995 WL 465687 (S.D. Cal. May 1, 1995), *rev'd en banc*, 107 F.3d 1422 (9th Cir. 1997), and *Param Petroleum Corp. v. Commerce & Indus. Ins. Co.*, 686 A.2d 377 (N.J. Super. Ct. App. Div. 1997)); Symeon C. Symeonides, *Choice of Law in the American Courts in 1998: Twelfth Annual Survey*, 47 AM. J. COMP. L. 327, 385-89 (1999) (discussing only one contract case in which clause was invalidated, *Application Group, Inc. v. Hunter Group, Inc.*, 72 Cal. Rptr. 2d 73 (Cal. Ct. App. 1998)); Symeon C. Symeonides, *Choice of Law in the American Courts in 1999: One More Year*, 48 AM. J. COMP. L. 143, 159 (2000) (discussing only one case in which clause invalidated); Symeon C. Symeonides, *Choice of Law in the American Courts in 2000: As The Century Turns*, 49 AM. J. COMP. L. 1, 37-40 (2001) (finding only one case invalidating contractual choice on contractual issue, specifically for lack of substantial relationship); Symeon C. Symeonides, *American Choice of Law at the Dawn of the 21st Century*, 37 WILLAMETTE L. REV. 1, 3-87 (2001) (discussing American conflicts of law in 20th century); Symeon C. Symeonides, *Choice of Law in the American Courts In 2001: Fifteenth Annual Survey*, 50 AM. J. COMP. L. 1, 21-40 (2002) (citing eight cases invalidating contractual choice, although one case involved validity of forum selection clause).

resolving one or more issues in the case.[38] The following are some highlights of the analysis:

1. Courts enforced the clauses in 590 cases, or approximately eighty-five percent of the total.[39]
2. There was a high ratio of federal to state cases (529/168).
3. There was a significantly lower proportion of nonenforcement in federal (65/529 or 12%) than in state (42/168 or 25%) court.[40]

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[38] The cases are listed and analyzed in more detail in an Appendix which is available on my website, www.ribstein.org. I read most of the cases but was assisted by law-student research assistants in reading and categorization. The research excluded areas of the law that have not been regarded as conventional contracts for choice-of-law and other purposes. Corporations are discussed in Part I.D. *See infra* notes 83-108 and accompanying text. Part VII discusses other possible extensions of the basic principles of contractual choice of law. *See infra* notes 449-55 and accompanying text. Also, these totals do not include cases dealing only with choice of *forum* and arbitration, which raise distinct issues. *See infra* notes 241-63 and accompanying text. The research covers the period through June 2002. I instructed student researchers to find all cases in Westlaw (not all of which have been officially published) citing the Contracts topic (number 95), key numbers 129(1) and 206, as well as all cases citing § 187 of the Restatement (Second) of Conflicts of Law. This approach was intended to concentrate the research on cases identified by an unbiased observer as having focused on the relevant issue. In order to catch cases excluded by the key number/Restatement-citing approach, I supplemented this research with cases from various sources, including the following: Symeon C. Symeonides's annual conflict of laws surveys, *supra* note 37; my prior surveys on the subject, Ribstein, *supra* note 1, and Kobayashi & Ribstein, *supra* note 4; cases gleaned from a survey of articles on franchising in the Franchise Law Journal, including those cited in the regular "Franchising Currents" feature; and certain specific articles. *See generally* Rossell Barrios-Amy, *Effect of Arbitration and Choice of Law Clauses on the Application of Puerto Rico's Dealers Act*, 16 FRANCHISE L.J. 3 (1996); Reva S. Bauch, *An Update on Choice of Law in Franchise Agreements: A Trend Toward Unenforceability and Limited Application*, 14 FRANCHISE L.J. 91 (1995); Larry C. Becnel et al., *Franchising Currents: Courts Reach Varying Decisions on Validity of Choice of Law Provisions*, 13 FRANCHISE L.J. 49 (1993); George F. Carpinello, *Testing the Limits of Choice of Law Clauses: Franchise Contracts as a Case Study*, 74 MARQ. L. REV. 57 (1990); Thomas J. Collin, *State Franchise Laws and the Small Business Franchise Act of 1999: Barriers To Efficient Distribution*, 55 BUS. LAW. 1699 (2000); James A. Meaney, *Choice of Law: A New Paradigm for Franchise Relationships*, 15 FRANCHISE L.J. 75 (1996); Thomas M. Pitegoff, *Choice of Law in Franchise Relationships: Staying Within Bounds*, 14 FRANCHISE L.J. 89 (1995); Thomas M. Pitegoff, *Choice of Law in Franchise Agreements*, 9 FRANCHISE L.J. 1 (1989). Although the research may not be exhaustive, it was reasonably thorough and unbiased as to result or type of case.

[39] Cases in which the court applied the clause to some issues but not to others, when the clause may have been inapplicable by its terms, are included in the clause-enforced category. *See infra* notes 53-62 and accompanying text.

[40] *See infra* notes 234-40 and accompanying text (discussing significance of federal forum).

4. Nonenforcement was concentrated in particular categories of cases: noncompetition clauses in employment agreements (29 of 71),[41] and franchise agreements (29 of 171).[42] Many of the cases in other categories involved regulatory statutes.[43]
5. States vary regarding the likelihood of enforcement. About half of the cases in which courts refused to enforce choice-of-law clauses are from the state and federal courts in six states, in all but one state constituting more than twenty percent of the total of cases on contractual choice of law decided in that jurisdiction, as compared with fifteen percent nationally. The six states, with the number of nonenforcement cases and the percentage of such cases of the total choice-of-law clause cases to jurisdiction, are: California (11 or 22%), Georgia (7 or 30%), Illinois (12 or 21%), Louisiana (8 or 31%), New Jersey (7 or 25%), and New York (6 or 7.4%). New York's nonenforcement percentage reflects the large total number of cases in that jurisdiction (81 or 12% of cases in the database).[44]
6. Courts rarely enforce choice-of-law clauses when enforcement is contested without some connection between the parties or the transaction and the designated state. Of the 590 cases in the database

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[41] *See* Bruce H. Kobayashi & Larry E. Ribstein, *Privacy and Firms*, DENV. U. L. REV. (forthcoming 2002); O'Hara, *supra* note 1, at 1565-67.

[42] The court applied a regulatory statute in twenty-one of the nonenforcement cases, but enforced choice-of-law clauses in seventeen cases in which the franchisee sought to rely on a regulatory statute of the forum or another state.

[43] *See, e.g.*, IHP Indus., Inc. v. Permalert, 947 F. Supp. 257, 260 (S.D. Miss. 1996) (using statute requiring application of Mississippi law to implied warranty claim); Turner v. Aldens, Inc., 433 A.2d 439, 442 (N.J. Super. Ct. App. Div. 1981) (applying retail sales statute); Ito Int'l Corp. v. Prescott, Inc., 921 P.2d 566, 570-72 (Wash. Ct. App. 1996) (applying state securities law).

[44] New York is also one of the four leading states selected as the applicable law in a review of actual contracts. *See infra* note 300 and accompanying text (discussing number of actual contracts with choice-of-law clauses). Contrary to the usual trend favoring enforcement in federal cases, only one of the New York nonenforcement cases was from a state court. *See* N. Am. Bank, Ltd. v. Schulman, 474 N.Y.S.2d 383, 387 (Westchester County Ct. 1984) (refusing to apply contractual choice of Israeli law to avoid usury statute).

enforcing the clauses, 429 opinions noted that one or both of the parties resided in the designated state. In 143 cases, the opinion did not clearly identify contacts with the designated state, usually because the parties did not contest enforcement of the choice-of-law clause. Only eighteen cases were identified as clearly not involving any parties that resided in the designated state, and in most of these there were significant contacts with the transaction. In a couple of cases, the only connection with the designated state was a party's place of incorporation.[45] In some of the few remaining cases, one of the parties succeeded to the claim of a resident of the designated state,[46] or the claim involved an indemnification or reimbursement arising out of another suit in which a party resided in the designated state.[47]

7. Most cases in which the clauses were enforced (319) involved contractual choice of a state *other than* the forum.
8. Cases involving application of choice-of-law clauses have significantly increased over time. The following chart shows the cases by year of decision, enforcement of the choice-of-law clause,[48] and whether the case was brought in federal court. It shows only about 100, or less than fifteen percent of the total, before 1985. There are several possible explanations for the increase in cases over time, including increasing state regulation of interstate business,[49] increased mobility of firms,[50] and the promulgation in 1971 of the procontract Restatement § 187.[51]

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[45] *See infra* note 105 and accompanying text.

[46] Lockheed Martin Corp. v. Gordon, 16 S.W.3d 127, 134 (Tex. App. 2000).

[47] N. River Ins. Co. v. Philadelphia Reinsurance Corp., 831 F. Supp. 1132, 1140-41 (D.N.J. 1993); Kreider v. F. Schumacher & Co., 816 F. Supp. 957, 960 (D. Del. 1993).

[48] *See supra* note 39.

[49] *See infra* notes 118-28 and accompanying text.

[50] *See infra* notes 231-33 and accompanying text.

[51] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971). Restatement § 187 might have provoked more litigation by increasing legal uncertainty as compared with the pre-

TABLE 1: LITIGATION OF CHOICE OF LAW CLAUSES OVER TIME			
Year	Total	Not Enforced	Federal
1924	1	1	1
1927	1	0	1
1939	1	0	0
1959	1	0	0
1961	1	0	0
1964	2	0	1
1965	1	1	1
1968	1	1	1
1971	2	1	1
1972	2	0	1
1973	3	0	1
1974	2	0	1
1975	3	2	2
1976	4	1	3
1977	5	1	1
1978	4	3	1
1979	11	2	4
1980	3	0	2

Restatement (Second) law under which enforcement was less likely. *See* George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 7-12 (1984) (showing that legal uncertainty may increase parties' gains from litigating rather than settling cases).

1981	9	4	5
1982	13	0	8
1983	13	2	12
1984	15	2	11
1985	29	3	25
1986	5	2	4
1987	16	0	12
1988	20	1	15
1989	22	4	17
1990	24	4	21
1991	24	2	8
1992	28	4	19
1993	28	5	23
1994	33	7	25
1995	44	11	32
1996	49	8	31
1997	44	3	31
1998	66	6	50
1999	46	3	32
2000	50	10	33
2001	52	7	39

2002[52]	19	4	10

Understanding judicial enforcement of contractual choice of law is complicated by nuances in interpreting and applying these clauses. Courts can, in effect, nullify contractual choice by interpreting the clauses narrowly rather than not enforcing them.[53] Courts also might avoid the issue by holding that the chosen state's law was similar to that in the other potential state.[54] Moreover, because judicial rules affect party behavior, these data probably understate the effect of nonenforcement. Parties favoring enforcement probably attempt to avoid adjudication in nonenforcing states. Also, the parties may narrowly draft clauses, creating nonseverability to against complete nonenforcement. The 124 cases in which the choice-of-law clauses arguably did not apply to one or more issues in the case include those involving the following issues: tort or other noncontract claims;[55] contract validity as distinguished from interpretation;[56] procedural issues;[57] application of a clause in

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[52] These numbers reflect cases appearing in the Westlaw database through approximately June 2002.

[53] *See infra* notes 418-29 and accompanying text.

[54] *See, e.g.*, Sarnoff v. Am. Home Prods. Corp., 607 F. Supp. 77, 79 (N.D. Ill. 1985) (noting no conflict between New York and Illinois law regarding noncompetition clauses).

[55] *See, e.g.*, Krock v. Lipsay, 97 F.3d 640, 642-48 (2d Cir. 1996) (fraud); Thompson & Wallace, Inc. v. Falconwood Corp., 100 F.3d 429, 429 (5th Cir. 1996) (tort); Politte v. McDonalds Corp., Nos. 92-1278, 92-1270, 1994 WL 18027, at *1-2 (10th Cir. Jan. 24, 1994) (promissory estoppel); Pepsi-Cola Bottling Co. v. Pepsico Inc., 175 F. Supp. 2d 1288, 1290-96 (D. Kan. 2001) (tort); *In re* Lois/USA, Inc., 264 B.R. 69, 77-141 (Bankr. S.D.N.Y. 2001) (tort); Trent Partners & Assocs., Inc. v. Digital Equip. Corp., 120 F. Supp. 2d 84, 89-113 (D. Mass. 1999) (tort); Schuster v. Dragone Classic Motor Cars, Inc., 67 F. Supp. 2d 288, 289-93 (S.D.N.Y. 1999) (fraud); Maltz v. Union Carbide Chems. & Plastics Co., 992 F. Supp. 286, 292-320 (S.D.N.Y. 1998) (tort); O'Neill v. JC Penney Life Ins. Co., No. CV-97-7467, 1998 WL 661513, at *3 (E.D.N.Y. Aug. 6, 1998) (tort); Shelley v. Trafalgar House Pub. Ltd., 918 F. Supp. 515, 518-24 (D.P.R. 1996) (tort); Morgan Guar. Trust Co. v. Republic of Palau, 693 F. Supp. 1479, 1480-99 (S.D.N.Y. 1988) (tort); Stagecoach Transp., Inc. v. Shuttle, Inc., 741 N.E.2d 862, 864-70 (Mass. App. Ct. 2001) (tort); Smith v. Foodmaker, Inc., 928 S.W.2d 683, 685 (Tex. App. 1996) (tort).

[56] *See, e.g.*, Valley Juice Ltd. v. Evian Waters of France, Inc., 87 F.3d 604, 606-14 (2d Cir. 1996) (noting that clause was limited to "agreement"); Unarce v. Staff Builders, Inc., Nos. 93-16984, 93-17094, 1995 WL 418322, at *1 (9th Cir. July 13, 1995) (involving duress); Brentwood Investors v. Wal-Mart Stores, Inc., No. C-95-0856, 1998 WL 337968, at *7 (N.D. Cal. June 19, 1998) (holding that clause applies except to extent that it conflicts with law of states where stores are located); Dunafon v. Taco Bell Corp., Bus. Franchise Guide (CCH) ¶ 10,919 (W.D. Mo. Mar. 13, 1996) (noting that clause limited to "construction and enforcement"

a related but separate agreement;[58] application to a nonparty to the agreement;[59] inapplicability of a designated state's regulatory law;[60] and a designated law that would invalidate the contract contrary to the parties' presumed intentions.[61] Also, several cases involved

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of contract did not preclude application of California franchise law); *In re* Centre of Mo. Ltd., 116 B.R. 138, 139-41 (E.D. Mo. 1990) (noting that loan provided for application of Massachusetts law "to the maximum extent permitted by law," and in other respects Missouri law, which court applied as locus of relevant property); Bush v. Nat'l Sch. Studios, Inc., 407 N.W.2d 883, 884-95 (Wis. 1987) (applying Wisconsin Fair Dealership Law where contract provided that it "shall be governed by the laws of the State of Minnesota unless otherwise required by the law of conflict of laws").

[57] *See, e.g.*, MRO Communications, Inc. v. Am. Tel. & Tel. Co., 197 F.3d 1276, 1278-84 (9th Cir. 1999) (attorneys' fees); Indus. Indem. Ins. Co. v. United States, 757 F.2d 982, 984-88 (9th Cir. 1985) (statute of limitations); Ramada Franchise Sys., Inc. v. Capitol View II Ltd. P'ship Venture, 132 F. Supp. 2d 358, 359-65 (D. Md. 2001) (statute of limitations); Sokoloff v. Gen. Nutrition Cos., No. CIV.A.00-641, 2001 WL 536072, at *6 (D.N.J. May 21, 2001) (attorneys' fees); Ribbens Int'l v. Transp. Int'l Pool, Inc., 47 F. Supp. 2d 1117, 1119-28 (C.D. Cal. 1999) (attorneys' fees); Ashland Chem. Co. v. Provence, 181 Cal. Rptr. 340, 340-42 (Cal. Ct. App. 1982) (statute of limitations); Belleville Toyota, Inc. v. Toyota Motor Sales, U.S.A., Inc., 770 N.E.2d 177, 181-208 (Ill. 2002) (statute of limitations); Consol. Fin. Invs., Inc. v. Manion, 948 S.W.2d 222, 223-25 (Mo. Ct. App. 1997) (statute of limitations); N. Bergen Rex Transp., Inc. v. Trailer Leasing Co., 730 A.2d 843, 847 (N.J. 1999) (attorneys' fees).

[58] *See, e.g.*, Quaker State Oil Ref. Corp. v. Garrity Oil Co., 884 F.2d 1510, 1511-18 (1st Cir. 1989) (involving choice in distribution agreement, but not notes that were main subject of case); Reading Metal Craft Co. v. Hopf Drive Assocs., 694 F. Supp. 98, 99-107 (E.D. Pa. 1988) (deciding clause in subagreement inapplicable to master agreement); S. Leo Harmonay, Inc. v. Binks Mfg. Co., 597 F. Supp. 1014, 1018-37 (S.D.N.Y. 1984) (involving subcontract); Sentinel Indus. Contracting Corp. v. Kimmins Indus. Serv. Corp. 743 So. 2d 954, 957-73 (Miss. 1999) (deciding clause in prime contract did not apply to subcontractor); J.M. Smith Corp. v. Matthews, 474 S.E.2d 798, 799-802 (N.C. Ct. App. 1996) (holding clause in security agreement did not apply to open account); Al Baraka Bancorp, Inc. v. Hilweh, 656 A.2d 197, 198-202 (Vt. 1994) (applying law of state of incorporation rather than that chosen for loan because of way agreement was structured).

[59] *See, e.g.*, *In re* Doughty's Appliance, Inc., 236 B.R. 407, 409-18 (Bankr. D. Or. 1999) (concerning buyers of collateral); *In re* Portnoy, 201 B.R. 685, 685-703 (S.D.N.Y. 1996) (deciding creditors' trust under New Jersey law affected U.S. creditors); Hong Kong & Shanghai Banking Corp. v. HFH USA Corp., 805 F. Supp. 133, 135-47 (W.D.N.Y. 1992) (involving security interest). Compare with *Portnoy* the application of the incorporating state's rule on limited liability of corporate shareholders.

[60] *See, e.g.*, Fred Briggs Distib. Co. v. Cal. Cooler, Inc., No. 92-35016, 1993 WL 306157, at *1-3 (9th Cir. Aug. 11, 1993) (California franchise law); Highway Equip. Co. v. Caterpillar, Inc., 908 F.2d 60, 61-65 (6th Cir. 1990) (Ohio franchise statute); Grand Kensington, LLC v. Burger King Corp., 81 F. Supp. 2d 834, 834, 835-40 (E.D. Mich. 2000) (Florida statute); Ward's Equip., Inc. v. New Holland N. Am., Inc., 493 S.E.2d 516, 518-21 (Va. 1997) (Michigan franchise law).

[61] *See, e.g.*, SEC v. Elmas Trading Corp., 683 F. Supp. 743, 750 (D. Nev. 1987) (stating that "where the chosen law declares contract invalid, the chosen law will not be applied"); Landi v. Arkules, 835 P.2d 458, 462 (Ariz. Ct. App. 1992) (stating that, if "parties choose the law of a state which would declare the contract invalid," "court will presume mistake and not

designated state laws that would conflict with the Federal Arbitration Act.[62]

Thus, judicial enforcement of choice-of-law clauses is now the norm. This Article seeks to explain both the general support for enforcement and the exceptions to enforcement.

C. STATUTES VALIDATING CONTRACTUAL CHOICE

Statutes in California, Delaware, Florida, Illinois, New York, and Texas explicitly validate choice-of-law clauses in certain circumstances while preserving default rules on enforcement in other cases.[63] These statutes bring greater certainty to enforcement of contractual choice of law than under the general cases discussed in

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apply chosen law"); Temp. Yours-Temp. Help Serv., Inc. v. Manpower, Inc., 377 So. 2d 825, 826-27 (Fla. Dist. Ct. App. 1979) (refusing to apply Wisconsin law, which may have invalidated restrictive covenant); *see also infra* notes 337-38 and accompanying text.

[62] *See, e.g.*, Mastrobuono v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 53-64 (1995) (holding chosen law clause did not restrict arbitrator's power to award punitive damages); Wolsey, Ltd. v. Foodmaker, Inc., 144 F.3d 1205, 1209 (9th Cir. 1998) (stating that parties can contract around FAA rules "by incorporating state arbitration rules into their agreements"); Quinn v. We Care Hair Dev., Inc., Bus. Franchise Guide (CCH) ¶ 11,701 (S.D. Ohio Sept. 20, 1999); Ohio Cas. Ins. Co. v. Southland Corp., No. CIV. A. 98-CV-6187, 1999 WL 236733, at *6 (E.D. Pa. Apr. 22, 1999) (noting interplay between FAA and choice-of-law provisions); Paul Davis Sys. of N. Ill., Inc. v. Paul W. Davis Sys., No. 98 C 2027, 1998 WL 749041, at *2 (N.D. Ill. Oct. 15, 1998) (harmonizing choice-of-law provision with state law provision); Prudential Real Estates Affiliates, Inc. v. Prudential Long Island Realty, Bus. Franchise Guide (CCH) ¶ 10,709 (C.D. Cal. June 12, 1995); Smith v. Pay-Fone Sys., Inc., 627 F. Supp. 121, 123-24 (N.D. Ga. 1985) (stating that "state law is inapplicable in cases falling within the coverage of the Act"); Rager v. Liberty Nat'l Ins. Co., 712 So. 2d 333, 335 (Ala. 1998) (stating that FAA preempted state law); Smith Barney Shearson Inc. v. Sacharow, 689 N.E.2d 884, 889 (N.Y. 1997) (concluding that New York choice-of-law provision should not be read to conflict with arbitration clause); Kamaya Ltd. v. Am. Prop. Consultants, Ltd., 959 P.2d 1140, 1142-48 (Wash. Ct. App. 1998) (noting that designated state law would conflict with FAA); *see also* Cont'l Ins. Co. v. Equity Residential Props. Trust, 565 S.E.2d 603, 604-05 (Ga. Ct. App. 2002) (applying nondesignated law invalidating arbitration clause contrary to designated law and to Federal Arbitration Act, but consistent with federal insurance law); *infra* notes 252-63 and accompanying text; *cf.* Asante Tech., Inc. v. PMC-Sierra, Inc., 164 F. Supp. 2d 1142, 1147-52 (N.D. Cal. 2001) (noting preemption of contractual choice by Convention on Contracts for International Sale of Goods).

[63] *See* CAL. CIVIL CODE § 1646.5 (West Supp. 2002); DEL. CODE ANN. tit. 6, § 2708 (1999); FLA. STAT. ANN. § 685.101 (West 1990); 735 ILL. COMP. STAT. ANN. 105/5-5 (West 2002); N.Y. GEN. OBLIG. LAW. § 5-1401 (McKinney 2001); TEX. BUS. & COMM. CODE ANN. §§ 35.51-.52 (Vernon 2002); *see also* Larry E. Ribstein, *Delaware, Lawyers and Choice of Law*, 19 DEL. J. CORP. L. 999, 1003-06 (1994) (discussing California, Delaware, New York and Texas statutes).

Part I.B,[64] particularly by eliminating the open-ended "fundamental policy" exception. All of these statutes apply to contracts involving large dollar amounts—$100,000 in Delaware, $1,000,000 in Texas and $250,000 in the others. Texas retains the requirement of a reasonable connection between the transaction and the state but, unlike the other statutes, provides for application of non-Texas law.[65] Florida requires a slight connection with the state,[66] while the others have no connection requirement.[67] Florida and Illinois except household and labor contracts from bright-line enforceability, while Texas includes more elaborate exceptions.[68] Illinois provides for enforcement of choice-of-forum clauses in contracts choosing Illinois law pursuant to the statute.[69]

Oregon, as part of a general law revision project, enacted comprehensive statutory choice-of-law rules for contracts in 2001.[70] The Act provides for enforcement of agreements on choice-of-law as to "contractual rights and duties" if they are "express or clearly demonstrated from the terms" in non-standard-form contracts or, in standard form contracts, "express and conspicuous."[71] The Act

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[64] *See supra* notes 27-62 and accompanying text.

[65] TEX. BUS. & COM. CODE ANN. § 35.51(b) (Vernon 2002).

[66] FLA. STAT. ANN. § 685.101(2) (West 1990). This statute does not require enforcement regarding a transaction that does not "bear a substantial or reasonable relation to" Florida when every party is a "resident and citizen of the United States, but not of this state" or "[i]ncorporated or organized under the laws of another state and does not maintain a place of business in this state." *Id.*

[67] The Delaware statute explicitly provides for enforcement of the choice of law clause even if the clause itself is the only connection the parties and transaction have with Delaware, and even if applying the chosen law would contravene the fundamental policy of a state with a materially greater interest than the chosen state. DEL. CODE ANN. tit. 6, § 2708(a). With respect to the New York statute, see Credit Francais Int'l, S.A. v. Sociedad Financiera de Comercio, C.A., 490 N.Y.S.2d 670, 675-76 (N.Y. Sup. Ct. 1985) (stating that "the enactment of the statute now puts beyond argument the policy question of whether New York courts should burden themselves with litigation involving non-residents where the only nexus is the contractual agreement to designate New York as a forum"). *See also* Supply & Bldg. Co. v. Estee Lauder Int'l, Inc., No. 95 CIV. 8136, 1999 WL 178783, at *2, 3 (S.D.N.Y. Mar. 31, 1999), *aff'd on reh'g*, No. 95 CIV. 8136, 2000 WL 223838 (S.D.N.Y. Feb. 25, 2000) (stating that if statute's requirements are met, choice-of-law provision is given binding effect).

[68] These include real property transfers, contracts for construction or repair of real property, validity of a marriage or adoption, or rights under a will. TEX. BUS. & COM. CODE ANN. § 35.51 (Vernon 2002).

[69] 735 ILL. COMP. STAT. ANN. 105/5-10 (West 2002).

[70] H.B. 2414, 71st Leg. Assem. (Or. 2001) (to be codified at OR. REV. STAT. § 81.120).

[71] *Id.* § 7.

requires the application of Oregon law to Oregon-connected services, construction, employment, and consumer contracts,[72] and overrides the contractual choice where it would contravene requirements or prohibitions at the place of performance or "established fundamental policy embodied in the law that would otherwise govern."[73]

Some uniform laws include provisions dealing with enforcement of contractual choice in the specific types of contracts covered by the laws.[74] Most importantly, the Uniform Commercial Code provides, "[W]hen a transaction bears a reasonable relation to this state and also to another state or nation the parties may agree that the law either of this state or of such other state or nation shall govern their rights and duties."[75] Thus, the UCC does not currently include the Restatement (Second) "fundamental policy" exception.[76] Also, the Uniform Computer Information Transactions Act (UCITA) would enforce a choice of law clause in electronic—as distinguished from physical—consumer software sales unless it would vary a mandatory rule in the licensor's state.[77]

The American Law Institute made significant changes in enforcement of contractual choice in its UCC revision.[78] The revision sharply distinguishes consumer and nonconsumer transactions.[79] For business-to-business transactions, the revision eliminates the "reasonable relationship" requirement,[80] but adds the qualification that the choice "is not effective to the extent that

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[72] *Id.* § 3.

[73] *Id.* § 8. Section 8(2) provides that a policy is fundamental if it "reflects objectives or gives effect to essential public or societal institutions beyond the allocation of rights and obligations of parties to a contract at issue." *Id.*

[74] *See, e.g.*, UNIF. CONSUMER CREDIT CODE § 1.201(8), 7 U.L.A. 316 (2002) (recognizing limited use of choice-of-law provisions in commercial leases); UNIF. PREMARITAL AGREEMENT ACT § 3(a)(7) (1983), *available at* http://www.law.upenn.du/bll/ulc/fnact99/1980s/upaa83.pdf (last visited Fed. 2, 2003) (providing that choice-of-law provisions are valid for some purposes).

[75] U.C.C. § 1-105(1) (2002).

[76] *See supra* note 29 and accompanying text.

[77] UNIF. COMPUTER INFO. TRANSACTIONS ACT § 109, 7 U.L.A. 252 (2002).

[78] *See* U.C.C. § 1-301 (2002).

[79] *Id.*

[80] *Id.* If the contract bears no reasonable relationship to any foreign country, then the parties would be required to choose the law of a United States jurisdiction. *See id.* § 1-301(b)(1) (requiring choice of state law in "domestic" transaction); *id.* § 1-301(a) (defining domestic transaction to be one that does not bear reasonable relationship to foreign country).

application of the law of the State or country designated would be contrary to a fundamental policy of the State or country whose law would govern in the absence of agreement."[81] For transactions in which one of the parties is a consumer, however, the revision requires that the transaction bear a reasonable relationship to the designated state or foreign country, and it refuses to enforce the clause where the chosen law would:

> deprive the consumer of the protection of any rule of law . . . not be varied by agreement: (A) of the State or country in which the consumer principally resides, unless subparagraph (B) applies; or (B) if the transaction is a sale of goods, of the State or country in which the consumer makes the contract and takes delivery of those goods, if such State or country is not the State or country in which the consumer principally resides.[82]

D. THE CORPORATE MODEL OF CONTRACTUAL CHOICE

Under the so-called corporate "internal affairs" rule, the law of the incorporating state determines rights among parties regarding the internal governance of a corporation.[83] Incorporating state law applies not only to matters among the shareholders such as participation in management and profits,[84] but also to shareholders' liability to creditors.[85] Except for law in two states involving firms that are closely connected with the forum but incorporate elsewhere,[86] which the Restatement characterizes as "unusual" and

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[81] *Id.* § 1-301(f).

[82] *Id.* § 1-301(e)(2).

[83] *See* MODEL BUS. CORP. ACT § 15.05(c) cmt. (1998); RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302(2) (1971). For a recent analysis of the rule, see Note, *The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for its Continued Primacy*, 115 HARV. L. REV. 1480 (2002).

[84] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 304 (1971).

[85] *Id.* § 307. For other rules recognizing the applicability of the law of the state of incorporation concerning particular matters, see *id.* § 296 (concerning requirements for incorporation); *id.* § 297 (concerning states' recognition of foreign incorporations); *id.* § 303 (concerning determination of who is shareholder); *id.* § 306 (concerning liability of majority shareholder).

[86] *See* CAL. CORP. CODE § 2115 (West 1990) (discussing foreign corporations subject to

"extremely rare,"[87] courts apply the law of a nonincorporating state only to issues relating to a firm's torts or other "external" acts in the forum.[88]

The internal affairs rule is essentially a rule regarding enforcement of contractual choice of law in a particular setting.[89] But it differs from general contractual choice rules that qualify the enforcement of a contract with relatedness requirements, and for fundamental or mandatory rules in nonchosen states. It is not immediately obvious why a special choice-of-law rule should apply to corporations.[90] Although a corporation may have a particular type of contract in the sense that it is based on the power of control of a master or employer in an agency relationship,[91] these characteristics do not obviously relate to the enforceability of contractual choice of law, especially among the owners. A shareholder's decision to buy an interest in a corporation subject to a particular state's law resembles the decision to buy any bundle of contract rights.

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corporate laws of state); N.Y. BUS. CORP. LAW § 1320 (McKinney 1986) (allowing exemptions from certain provisions if less than one-half of corporation's business income allocable to New York); *see also* Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317, 321 (5th Cir. 1959) (stating that "where neither the charter nor the statutory laws of the incorporating state are applicable, and *all* contact points are in the forum, we believe that the laws of the forum should govern"); Wilson v. Louisiana-Pacific Res., Inc., 187 Cal. Rptr. 852, 858 (Cal. Ct. App. 1982) (stating that "the legislature has resolved the conflicts issue by mandating application of this state's law under certain conditions"); W. Air Lines, Inc. v. Sobieski, 12 Cal. Rptr. 719, 726 (Cal. Ct. App. 1961) (noting foreign corporations must conform to state laws in sales of stock and business affairs).

[87] *See* RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 302(2) (1971) (providing that "[t]he local law of the state of incorporation will be applied to determine such issues, except in the *unusual* case where, with respect to the particular issue, some other state has a more significant relationship to the occurrence and the parties, in which event the local law of the other state will be applied") (emphasis added); *id.* cmt. g (stating that this will happen only in "the *extremely rare* situation where a contrary result is required by the overriding interest of another state in having its rule applied") (emphasis added).

[88] *See id.* cmt. e (noting that matters such as corporate torts and ownership of property and share transfer rights do not have to be subject to single state's law).

[89] The contractual theory arguably is undercut by *Rosenmiller v. Bordes*, 607 A.2d 465, 468-69 (Del. Ch. 1991) which applies Delaware law to Delaware corporation with shareholders' agreement that contained New Jersey choice-of-law clause. *See* Note, *supra* note 83, at 1484 n.35 (arguing that court's finding in *Rosenmiller* weakens contractual justification for internal affairs doctrine). For an analysis reconciling the two contractual choices in this situation, see Ribstein, *supra* note 63, at 1022-25.

[90] *See* Ribstein, *supra* note 1, at 267.

[91] *See id.* at 270; *see generally* Scott E. Masten, *A Legal Basis for the Firm*, 4 J.L. ECON. & ORG. 181 (1988).

The normative case against applying forum-state corporate governance rules is not clearly stronger, and the case for enforcing the parties' choice of the incorporating state is not clearly weaker than the analogous arguments concerning other types of choice-of-law contracts.[92] With respect to arguments against enforcement, rules regarding information and voting rights seem no less "fundamental" than those protecting consumers in noncorporate transactions. Also, an ordinary shareholder would seem to know far less about voting and financial rights in a corporation than consumers would know about the types of transactions covered by general choice-of-law rules.

With respect to the arguments for enforcing the choice-of-law contract, while there is a significant benefit to giving all shareholders—or at least those in the same class—identical rights,[93] these problems exist in other situations and can be addressed by complying with the most stringent rule.[94] Moreover, the single rule could be that of the corporation's headquarters, as under the European "seat" rule,[95] rather than that of Delaware or some other state that lacks any real connection to the corporation, its shareholders, or its business. While these rules may inefficiently constrain state competition, the same could be said of nonenforcement of other choice-of-law contracts, as discussed in Part II.[96]

The corporate versus noncorporate distinction might owe to the long acceptance of the legal fiction that a corporation is a legal "person," created and endowed with certain attributes by the chartering state as distinguished from a mere contract.[97] But the legal fiction of state creation does not in itself give the incorporating state an "interest" in its corporate creations that justifies applying that state's law under general choice-of-law principles[98] or that

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[92] *See* Ribstein, *supra* note 1, at 269-73.

[93] *See infra* notes 120-22 and accompanying text.

[94] *See infra* notes 126-27 and accompanying text.

[95] *See generally* Werner F. Ebhe, *"Real Seat" Doctrine in the Conflict of Corporate Laws*, 36 INT'L LAW. 1015 (2002) (discussing history, law, and policy of "real seat" rule).

[96] *See infra* notes 113-206 and accompanying text.

[97] Larry E. Ribstein, *The Constitutional Conception of the Corporation*, 4 SUP. CT. ECON. REV. 95, 97-100 (1995).

[98] For critiques of the internal affairs rule from the standpoint of interest analysis, see generally Note, *supra* note 83; Jack L. Goldsmith III, Note, *Interest Analysis Applied to*

constitutionally compels this result.[99] At most, this fiction may have created a kind of legal momentum that helped insulate the internal affairs rule from interest group opposition.

The lack of a strong policy basis for distinguishing corporations and other contracts helps explain the spread of that distinction outward from its corporate origins. The corporate rule originally differed from that traditionally applied to other business associations.[100] For example, partners' liability is determined under the basic Restatement rule by application of the general conflict-of-law criteria.[101] However, state legislatures have increasingly provided for application of the formation state's law for limited liability partnerships, limited liability companies, and other unincorporated firms.[102] Also, courts now usually enforce contractual choice of law in general partnerships.[103] Since general partnerships can be quite small and informal, enforcement of contractual choice in this context provides a bridge to enforcement in other contexts.

The spread of the corporate rule might be accomplished, not only by applying the rule to noncorporate business associations, but also by applying the incorporation state's law to non-internal affairs issues. It is still unclear whether the courts will accept the state of incorporation as a sufficient contact to satisfy Restatement section 187 in providing the reasonableness threshold under section

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Corporation: The Unprincipled Use of a Choice of Law Method, 98 YALE L.J. 597 (1989).

[99] For analysis doubting the constitutional basis of the internal affairs rule, see Ribstein, *supra* note 1, at 287-99; Note, *supra* note 83, at 1490-96.

[100] *See* Greenspun v. Lindley, 330 N.E.2d 79, 80 (N.Y. 1975) (holding Massachusetts law does not necessarily control Massachusetts business trust, although applied in present case in absence of showing concerning firm's contacts with New York); Means v. Limpia Royalties, 115 S.W.2d 468, 475 (Tex. Civ. App. 1938) (holding Texas law controls limited liability of Oklahoma trust); *cf.* Abu-Nassar v. Elders Futures, Inc., No. 88 Civ. 7906, 1991 U.S. Dist. LEXIS 3794, at *14-16 (S.D.N.Y. Mar. 28, 1991) (applying Lebanese law to determine compliance of limited liability company with formalities of organization, but New York law to determine whether corporate veil should be pierced).

[101] RESTATEMENT (SECOND) OF CONFLICTS § 295(3) (1971) (referring to general rule stated in § 294). Note, however, that comment d to § 295 states that a limited partner should be compared to a corporate shareholder, indicating that a court should apply the same choice-of-law rule despite the difference in black letter law. *Id.* cmt. d.

[102] *See* BROMBERG & RIBSTEIN ON LLPS, RUPA AND ULPA ch. 6 (2002); BROMBERG & RIBSTEIN ON PARTNERSHIP § 1.04 (1998 and Supp. 2002); RIBSTEIN & KEATINGE ON LIMITED LIABILITY COMPANIES ch. 13 (1998).

[103] *See* BROMBERG & RIBSTEIN ON PARTNERSHIP, *supra* note 102, § 1.04 n.16.

187(2)(a) or overriding another state's fundamental policy.[104] Some cases have enforced clauses in which the only contact with the designated state was the place of incorporation.[105] However, in *Curtis 1000 Inc. v. Suess*,[106] Judge Posner rejected the contract's choice of the law of Delaware, the employer's state of incorporation, to govern a noncompetition provision in an employment contract on the ground that the state of incorporation was insufficiently related to the contract, reasoning that:

> Businesses incorporate in Delaware in order to take advantage of that state's corporation law, and its judicial expertise concerning corporate governance, rather than to conduct business there. Curtis's headquarters are in Georgia, and it has no offices or operations in Delaware. Suess of course has no contacts with Delaware. Curtis and Suess are operating in Illinois, so Illinois has an interest in applying its law to their relations. If the choice-of-law provision in the covenant not to compete had designated Georgia law we assume the Illinois courts would defer to that designation, recognizing that Georgia has as much interest in regulating the out of state operations of "its" firm as Illinois does in protecting its citizen, Mr. Suess. But that is not the case here.[107]

This reasoning is unpersuasive because it fails to distinguish the internal affairs situation from other choice-of-law contexts. Why should the law of the state of incorporation trump the law of the state where the shareholder resides on such fundamental shareholder rights as voting and fiduciary duties, if the same state's law cannot trump the state law of an employee's residence on employment issues? To be sure, the argument for having a single rule govern noncompetition clauses in two-party employment agree-

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[104] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971).

[105] Ciena Corp. v. Jarrard, 203 F.3d 312, 332-34 (4th Cir. 2000); Dopp v. Teachers Ins. & Annuity Ass'n, No. 91 Civ. 1494, 1993 WL 404076, at *2-4 (S.D.N.Y. Oct. 1, 1993); Nedlloyd Lines B.V. v. Superior Ct., 834 P.2d 1148, 1153 (Cal. 1992).

[106] 24 F.3d 941 (7th Cir. 1994).

[107] *Id.* at 948-49.

ments may seem less compelling than that for common internal governance terms in multiparty corporations. But a nationwide employer is likely to have as much need for a single term applicable to all of its employees as a closely held firm has regarding at least some types of governance rules. Moreover, it is not clear why the firm should be able to choose the *unrelated* state of Delaware to govern its *corporate* internal affairs if it cannot choose such a state to govern its noncompetition clauses, assuming the firm concludes that Delaware has expertise in such matters.

In general, it is not obvious why corporate governance contracts should be treated differently from other contracts for choice-of-law purposes. We will return to this question below following this Article's analysis of the positive and normative considerations underlying contractual choice.[108]

II. EFFICIENCY AND CONTRACTUAL CHOICE

This Part presents an efficiency analysis of enforcement of contractual choice. Part II.A discusses the use of contractual choice to avoid inefficient, wealth-transferring regulation.[109] Part II.B discusses jurisdictional choice as a way that parties can ensure application of legal rules that best suit their particular needs.[110] Part II.C discusses the effect of jurisdictional choice in reducing the uncertainty costs associated with choice of law.[111] Part II.D discusses the potential effect of exit in making laws more efficient.[112]

A. AVOIDING MANDATORY LAWS

Contractual choice of law provides exit from state laws that would otherwise impose costs on the parties. This avoidance function of choice-of-law clauses matters most regarding mandatory rules that cannot cheaply be avoided by simply drafting alternative

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[108] *See infra* notes 325-26 and accompanying text.
[109] *See infra* notes 113-56 and accompanying text.
[110] *See infra* notes 157-63 and accompanying text.
[111] *See infra* notes 164-67 and accompanying text.
[112] *See infra* notes 168-73 and accompanying text.

contact provisions.[113] Choice-of-law clauses address three types of inefficiency. Part II.A.*1* assumes that state lawmakers are faithfully serving their constituents but imposing costs on those in other jurisdictions.[114] Part II.A.*2* discusses the additional problems that result from rent-seeking by politicians.[115] Part II.A.*3* shows how contractual choice of law can deal with legislators' limited knowledge and foresight.[116] Part II.A.*4* discusses the tradeoffs between avoidance of mandatory rules by selecting alternative forms of contracting, and avoidance through choice-of-law clauses.[117]

1. Interstate Firms and Spillovers. State laws pose particular problems for interstate firms. In general, an interest group that is powerful in a given state may be able to effectuate wealth transfers from interest groups that are relatively weak because they are based out of state. In other words, regulatory effects "spill over" the state's borders.[118] An interest group may have substantial national resources but nevertheless lose to groups that are stronger in individual states.

Choice-of-law rules affect the extent of regulatory spillovers.[119] Vague default conflict-of-law rules may cause over-regulation because many different state rules potentially apply to a particular transaction or interrelated set of transactions. The classic example is what would happen if different rules on such issues as shareholder voting or distribution applied to shareholders in different states.[120] For example, it would be infeasible for a firm to conduct a director election in which some shareholders can cumulate their

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[113] This function technically applies to avoiding otherwise applicable default, as well as mandatory, rules. However, this is more appropriately discussed in connection with choosing, rather than avoiding, a specific regime. *See infra* notes 156-63 and accompanying text.

[114] *See infra* notes 118-28 and accompanying text.

[115] *See infra* notes 131-39 and accompanying text.

[116] *See infra* note 142 and accompanying text.

[117] *See infra* notes 143-56 and accompanying text.

[118] *See* Richard A. Posner, ECONOMIC ANALYSIS OF LAW 699-700 (5th ed. 1998). *See generally* Saul Levmore, *Interstate Exploitation and Judicial Intervention*, 69 VA. L. REV. 563 (1983).

[119] For a formal analysis of this point, see generally Guzman, *supra* note 1, at 897.

[120] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 302 cmt. e (1971); P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1, 49; Willis L.M. Reese & Edmurd M. Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith & Credit*, 58 COLUM. L. REV. 1118, 1124-28 (1958); Note, *supra* note 83, at 1486-87.

votes for directors while others can cast only one vote for each director. Similar problems can occur with other types of contracts in which it is necessary to coordinate the rights of parties in different states, including ethical rules affecting the structure of multistate law firms[121] and franchisee protection statutes.[122] To the extent that nonuniformity across contracts is costly and a state forbids a useful contract term, the parties must find a second-best alternative that is allowed everywhere.

The potential application of different state rules to the same firm or transaction is increasing with the interstate scope of transactions and firms. Communications media such as the Internet, mobile telephones, and computer networks decrease the costs of interstate transactions. Firms are forming new kinds of interstate alliances, spurred by reduced regulatory and international barriers to competition, as well as fast-paced technological innovation.[123] This resembles the situation the courts confronted in the nineteenth century during the development of the corporate internal affairs rule, when the scope of corporations greatly expanded.

The courts have recognized the desirability of enforcing contractual choice of law to deal with the problem of regulation by multiple states. For example, in enforcing a clause in a student loan agreement choosing the laws of the lender's jurisdiction against a student who resided in the forum, a court noted that "[i]t is both rational and reasonable for a lender to operate consistently under the laws of its home state, rather than be forced to operate under 51 different laws depending upon the location of the 'object of the loan contract.'"[124] Also, the Uniform Computer Information Transactions

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[121] *See generally* Larry E. Ribstein, *Ethical Rules, Law Firm Structure, and Choice of Law*, 69 U. CIN. L. REV. 1161 (2001).

[122] *See* Carlock v. Pillsbury Co., 719 F. Supp. 791, 808 (D. Minn. 1989) (stressing need for national franchise to be subject to single law); Francine LaFontaine & Joanne Oxley, *International Franchising: Evidence from US and Canadian Franchisors in Mexico*, National Bureau of Econ. Research Working Paper No. W8179 (Mar. 2001), *available at* http://nber.org/papers/w8179 (last visited Feb. 2, 2003) (showing that franchisors use same terms in United States and Mexico, despite different regulatory regimes, in order to have uniformity across franchisees).

[123] *See* Larry E. Ribstein, *Limited Liability Unlimited*, 24 DEL. J. CORP. L. 407, 415-16 (1999).

[124] Armstrong v. Accrediting Council for Continuing Educ. & Training, Inc., 980 F. Supp. 53, 59 (D.D.C. 1997).

Act reporter's notes cite the costs of complying with the inconsistent laws of many jurisdictions in a global "information economy" as the reason for mandating application of the law of the licensor's state in electronic transactions.[125]

The problem, however, is not really one of coordinating parties' rights across different states as much as it is one of preventing a single state from imposing its law nationwide.[126] People and firms usually can deal with multiple state regulations, either by complying with the law of the most stringent state, or by avoiding enough contacts with a stringent state not to be subject to jurisdiction there. For example, in a classic case of this type, the Supreme Court struck down on dormant commerce clause grounds a state rule requiring that interstate truckers use mudguards.[127] Truckers could have complied with the law in all states by installing mudguards since there were no states that forbade mudguards. Even if a state did have such a law, and even if adding and removing mudguards at state lines is costly, many truckers might deal with the laws by avoiding traveling either through mudguard states or no-mudguard states. Analogously, Internet vendors can comply with different state laws applying to Internet sales by following or avoiding contact with the most burdensome laws.[128]

Contractual choice of law addresses the multiple-regulation problem by letting parties choose the law with which they must comply based on the law's characteristics rather than where their customers are located. Indeed, when enforcement of choice-of-law clauses depends on a firm's contacts with the designated state, interstate firms actually may be better able than single-state firms to escape undesirable state regulation. Part II.E discusses the potential converse spillover problem in which contractually designated states benefit from, while other states bear the costs of, under-regulation.[129]

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[125] UNIF. COMPUTER INFO. TRANSACTIONS ACT § 109, Reporter's Note 2, 7 U.L.A. 252 (2002).

[126] *See* Ribstein, *supra* note 1, at 252-53.

[127] Bibb v. Navajo Freight Lines, Inc., 359 U.S. 520, 530 (1959).

[128] *See* Jack L. Goldsmith & Alan O. Sykes, *The Internet and the Dormant Commerce Clause*, 110 YALE L.J. 785, 806 (2001).

[129] *See infra* notes 174-206 and accompanying text.

2. Rent-seeking. Part II.A.*1* assumes that lawmakers act faithfully on behalf of local interests but impose costs on those in other jurisdictions.[130] An additional inefficiency problem arises from lawmakers acting on behalf of specific interest groups rather than the public interest. Specifically, legislators can earn campaign contributions and other benefits, commonly referred to as "rents," by brokering wealth transfers that favor the paying interest groups at the expense of others.[131] The interest groups that are able to provide the highest rents are those that can organize most cheaply and effectively to raise and spend money, or to mobilize votes and other political resources.[132] In particular, interest groups succeed based on their ability to prevent members from free riding off of expenditures and other political efforts by others. This may depend, for example, on whether an interest group has developed an organization for nonpolitical purposes, such as providing services to its members that can then be used for political purposes. Whether a group has such an organizational capability is not likely to correlate with its alignment with the "public" interest. Instead, relatively small and homogeneous interest groups can be more influential than larger and more diverse groups, other things equal, and the winning interest group's gains from a law may be less than society's losses.[133]

Because legislators control judges' salary and tenure, judges may have incentives to increase the durability and value of legislators'

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[130] *See supra* notes 118-28.

[131] *See* Robert D. Tollison, *Public Choice and Legislation*, 74 VA. L. REV. 339, 361-62 (1988). *See generally* ROBERT E. MCCORMICK & ROBERT D. TOLLISON, POLITICIANS, LEGISLATION AND THE ECONOMY (1981).

[132] *See generally* MCCORMICK & TOLLISON, *supra* note 131; MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1971); Sam Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Richard Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGT. SCI. 335 (1974); George Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGT. SCI. 3 (1971).

[133] The fact that legislators earn rents by brokering interest group deals does not make them "venal" or somehow evil as argued by some. *See* Woodward, *supra* note 36, at 759. It merely means that legislators are like everyone else in serving their own interests to some extent. Moreover, public choice theory recognizes that politicians, much like everyone else, sometimes may act for idealistic reasons rather than for short-term self-interest. Ironically, this can be viewed as a political "agency cost" in the sense that the politicians are indulging their own preferences rather than acting on behalf of their principals who have elected or funded them.

interest group deals by enforcing them.[134] Moreover, courts themselves may be a source of rent-seeking activity. Elected judges may seek campaign contributions from frequent litigants such as manufacturers and trial lawyers. Interest groups may engage in strategic litigation, as has occurred in areas such as product liability and school desegregation.[135] Judges also may decide cases and write opinions in ways that expand their power and prestige.[136]

Interest-group motivated legislation and judicial decisions do not simply transfer wealth from one group to another. They can reduce social wealth by encouraging parties to use resources on political transfers rather than for more productive purposes. Rent-seeking costs therefore can be characterized as "deadweight" social costs.[137]

Allowing members of politically weaker interest groups to contract for the law of nonregulating states can reduce politicians' ability to transfer wealth, and therefore rent-seeking costs, by enabling regulated parties to exit oppressive laws.[138] As long as this choice relies on contracts between parties who are motivated to act in their own interests, bargain freely, and internalize the costs and benefits of the deal, enforcing contractual choice produces "Pareto" wealth maximization. In other words, individuals either have more wealth, or are at least no worse off, than in a world in which such contracts are not enforced.[139] Part II.E considers the effect of relaxing these assumptions.[140]

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[134] *See* Gary M. Anderson et al., *On the Incentives of Judges to Enforce Legislative Wealth Transfers*, 32 J.L. & ECON. 215, 217 (1989); W. Mark Crain & Robert D. Tollison, *Constitutional Change in an Interest—Group Perspective*, 8 J. LEGAL STUD. 165, 171-73 (1979); William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest—Group Perspective*, 18 J.L. & ECON. 875, 885 (1975).

[135] *See* Paul H. Rubin & Martin J. Bailey, *The Role of Lawyers in Changing the Law*, 23 J. LEGAL STUD. 807, 804-18 (1994). Courts also may be subverted by antiregulatory business groups. *See* Edward L. Glaeser & Andrei Shleifer, *The Rise of the Regulatory State* (Oct. 2001), *available at* http://papers.ssrn.com/paper.taf?abstract_id=290287 (last visited Feb. 2, 2003) (citing this subversion as reason for rise of government regulation in United States during Progressive Era).

[136] *See* Richard A. Epstein, *The Independence of Judges: The Uses and Limitations of Public Choice Theory*, 1990 B.Y.U. L. REV. 827, 831-38.

[137] *See infra* note 219 and accompanying text.

[138] *See* WHINCOP & KEYES, *supra* note 1, ch. 3.

[139] This contrasts with the weaker "Kaldor-Hicks" standard that balances winners against losers.

[140] *See infra* notes 174-206 and accompanying text.

The rent-seeking problem is not completely distinct from the spillover problem discussed in Part II.A.*1*.[141] The latter problem can be viewed as an aspect of the former one in which the power of interest groups depends partly on their location. Enforcing choice-of-law clauses addresses both problems in the same way by using the power of contractual exit to substitute for problems of political voice.

3. Limited Knowledge and Foresight. Laws may be inefficient not only because of legislators' and courts' incentives to seek rents rather than serve the public interest, but because even perfectly motivated courts and legislators have imperfect knowledge and foresight. It may not be clear how the law will operate under future circumstances and conditions, as when new technologies render a statute obsolete. Also, the statute may interact in unforeseeable ways with existing or future business practices and laws. And even if the law increases social wealth over the whole population, it may affect different people or firms in different ways. Rather than leaving it to lawmakers to decide which rules should apply to whom, jurisdictional choice would leave the ultimate decision to the parties of the regulated transaction.[142] The parties could make this decision in light of their superior knowledge of their own circumstances and their strong incentives to get the applicable rule right.

4. An Illustration. This subsection gives a specific example of the potential social benefits of enforcing contractual choice in enabling low-cost exit from inefficient laws. Laws regulating the franchise relationship, including preventing termination in bad faith, requiring franchisers to give franchisees an opportunity to cure defects, and requiring disclosure and registration of companies that sell franchises, address concerns that franchisers will use their leverage to extract most of the profit from the franchise relationship.[143] Franchisees pay fees and make other investments

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[141] *See supra* notes 118-28 and accompanying text.

[142] *See* Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431, 433 (1985); Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 33-35 (1983); Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 227-28 (1985).

[143] *See* Collin, *supra* note 38, at 1745-48; Kobayashi & Ribstein, *supra* note 4, at 339-46.

that become worthless if the franchise is terminated. This theoretically enables franchisers to threaten termination in order to force the franchisee to consent to modifications in the relationship.

The benefits of franchisee-protection laws are unclear. Even without such laws, franchisees can insist on contractual provisions that protect against opportunism, coordinate resistance to franchiser opportunism through franchisee associations,[144] and pay less to opportunistic franchisers when they attempt to sell or renew franchises. Moreover, if franchisees are helpless both at the time of contracting and at the time of the franchiser's conduct, it is not clear how a statute can redress the problem since the franchiser presumably can use its bargaining advantage to negotiate one-sided terms that the statute permits, such as price.[145]

Franchisee protection statutes also impose costs on franchisers, franchisees, and consumers, depending on each group's ability to substitute for the products, services, and contract terms inhibited by regulation. This is particularly a problem when legislation interferes with existing contracts in which the franchiser has paid the franchisee for a right to terminate that is cut off by new legislation.[146] Franchise regulation also restricts parties' ability to enter into efficient contracts. For example, termination provisions in franchise contracts enable franchisers to prevent franchisees from free-riding on and decreasing the value of the franchiser's brand name.[147] Franchisers need to monitor franchisee quality and punish

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[144] *See, e.g.*, W. John Moore, *Franchisers are Sizzling*, 24 NAT'L J. 340, 340-41 (1992).

[145] *See generally* James A. Brickley, *Royalty Rates and Upfront Fees in Share Contracts: Evidence from Franchising*, 18 J.L. ECON. & ORG. 511 (2002) (showing evidence that franchisees pay more for franchises in states with franchisee protection laws).

[146] *See infra* notes 221-23 and accompanying text.

[147] *See generally* James A. Brickley et al., *An Agency Perspective on Franchising*, 20 FIN. MGMT. 27 (1991); James A. Brickley & Frederick H. Dark, *The Choice of Organizational Form: The Case of Franchising*, 18 J. FIN. ECON. 401 (1987); W. Dnes, *"Unfair" Contractual Practices and Hostages in Franchise Contracts*, 148 J. INST. & THEORETICAL ECON. 484 (1992); Patrick J. Kaufmann & Francine Lafontaine, *Costs of Control: The Source of Economic Rents for McDonald's Franchisees*, 37 J.L. & ECON. 417 (1994); Francine Lafontaine, *Contractual Arrangements as Signaling Devices: Evidence from Franchising*, 9 J.L. ECON. & ORG. 256 (1993); Francine Lafontaine, *Agency Theory and Franchising: Some Empirical Results*, 23 RAND J. ECON. 263 (1992); Robert E. Martin, *Franchising and Risk Management*, 78 AM. ECON. REV. 954 (1988); G. Frank Mathewson & Ralph A. Winter, *The Economics of Franchise Contracts*, 28 J.L. & ECON. 503 (1985); Seth W. Norton, *Franchising, Labor Productivity, and the New Institutional Economics*, 145 J. INST. & THEORETICAL ECON. 578 (1989); Paul H.

poor performance to prevent franchisees from charging brand name prices for low-cost service. The franchiser can monitor franchisees by threatening nonrenewal or termination if the franchisee shirks, thereby causing the franchisee to lose the remaining value of its franchise-specific investments. Thus, statutes that reduce franchisers' ability to penalize franchisees, as by requiring "good cause" for termination, can dilute the effectiveness of the termination sanction.

Franchisee protection statutes not only impose costs based on the circumstances that exist when enacted, but also can inhibit parties from adopting flexible contract provisions that accommodate a changing business environment. For example, franchisers may be unable to predict, at the time of entering into franchise contracts, the optimal number of franchises for a given geographic area. Statutes that prohibit the franchiser from "encroaching" on franchise territories prevent franchisers from allocating franchises in light of new information, as well as inhibiting monitoring of franchisees.[148] Second-best types of modifications in the franchise relationship may be necessary to accommodate new business practices.

Franchisee protection statutes may be inefficient because of legislators' shortsightedness, or because the statutes reflect interest group influence. For example, a coalition of in-state franchisees and trademark owners who sell through owned outlets might have been able to out-lobby franchisers who were based out-of-state.

Any net social costs of franchisee protection statutes depend on *both* the costs of compliance by parties in relationships analogous to those regulated by the statute *and* on the parties' ability to avoid compliance through waiver, contractual choice of law, or other methods. Trademark owners may be able to use several alternative compliance and avoidance methods, including owning rather than franchising outlets; avoiding restrictions on termination without cause by entering into contracts with shorter terms; avoiding application of the statute by not charging franchise fees, or by using

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Rubin, *The Theory of the Firm and the Structure of the Franchise Contract*, 21 J.L. & ECON. 223 (1978).

[148] *See generally* Benjamin Klein & Kevin M. Murphy, *Vertical Restraints as Contract Enforcement Mechanisms*, 31 J.L. & ECON. 265 (1988); Benjamin Klein & Lester Saft, *The Law and Economics of Franchise Tying Contracts*, 28 J.L. & ECON. 345 (1985).

multibrand franchisees; or by granting nonexclusive territories.[149] But each of these alternatives has potential costs and restrictions. For example, ownership, rather than franchising of outlets, may give the franchiser more power over the outlet, but may give the retailer-managers of outlets less incentive to manage efficiently; nonexclusive territories can reduce the franchisees' incentives to develop their territories; and using multibrand franchisees reduces the franchisers' leverage over and therefore ability to monitor each franchisee effectively. Avoidance can include remaining outside the geographical reach of state statutes. Since state franchise regulation probably does not apply to franchisees located outside of the regulating state,[150] franchisers will avoid having franchises in that state if compliance or other avoidance costs are high enough.

Given the variety of compliance and avoidance methods, the effects of franchise statutes on franchise-type relationships may vary from one contract to another depending, for example, on how much the owner of the brand name relies on the incentives provided by local ownership[151] or on regulated terms such as termination without cause. Thus, studies of franchisee termination statutes show that franchising decreased, compared to ownership of outlets, most significantly in industries characterized by nonrepeat business in states with franchisee termination laws.[152] Also, franchisers lost share value around the adoption of the California law,[153] indicating

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[149] Collin, *supra* note 38, at 1756-60.

[150] *See infra* note 276. However, it has been held that state franchise regulation can be applied to the out-of-state franchises of a local franchisee. *See* Instructional Sys., Inc. v. Computer Curriculum Corp., 35 F.3d 813, 824-27 (3d Cir. 1994) (involving New Jersey Franchise Practices Act); Morley-Murphy Co. v. Zenith Elec. Corp., Bus. Franchise Guide (CCH) ¶ 11,046 (W.D. Wis. Sept. 30, 1996) (involving Wisconsin Fair Dealership Law).

[151] Operators who rely on local repeat business are less able to free-ride off of the franchiser's brand name, and thus require less monitoring and fewer incentives than those who rely on transient business. *See generally* Brickley & Dark *supra* note 147; Matthewson & Winter, *supra* note 147; Norton, *supra* note 147; Rubin, *supra* note 147.

[152] *See* Brickley et al., *supra* note 147, at 115-16; Timothy Muris & Howard Beales, *State Regulation of Franchise Contracts*, Working Paper, George Mason University Law School (1994) (showing that these effects depended significantly in both repeat and nonrepeat industries on whether statute mandated franchisee right to cure, which reduces deterrent effect of termination power by letting franchisees cheat without fear of punishment).

[153] *See* Brickley et al., *supra* note 147, at 126-30.

that the contract forms that the statute permitted were not fungible with those it precluded.[154]

By contrast with the avoidance techniques just discussed, unqualified enforcement of contractual choice reduces avoidance costs to near zero and thereby eliminates the need to comply. Avoidance costs rise depending on the qualifications on enforcement, such as the Restatement's contact and "fundamental policy" tests.[155] The difference between these costs and the compliance and avoidance costs that the law otherwise would impose determines the significance of enforcing contractual choice in each transaction. Enforcing contractual choice may matter little if the trademark owner can, for example, cheaply switch to owned outlets, eliminate the franchise fee, or avoid contacts with or dealing with franchisees in regulating states. Conversely, enforcement of contractual choice may significantly reduce the law's social costs if this enforcement is unqualified and other avoidance is limited.

In short, courts enforcing choice-of-law clauses can complicate theoretical and empirical analyses of state statutes. A statute might seem to impose significant costs on the regulated industry, but may be innocuous or even beneficial taking into account the opportunity of avoidance through contractual choice. Full enforcement of contractual choice might mean that all of the costs the statute imposes may result from retroactive application of the statute when any avoidance is impossible.[156]

B. CHOOSING STATE DEFAULT REGIMES

Apart from or in addition to *avoiding* rules, contracting parties would want to *choose* regimes that economize on transaction costs, either by enforcing express contract terms or by adding default or mandatory terms that suit the parties' needs.[157] This raises two

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[154] *See* Kaufmann & Lafontaine, *supra* note 147, at 447-48. Since the loss in share value indicates that franchisers could not use their supposed leverage to impose all of the costs of the statute on franchisees, this data indirectly shows that franchisees do not need protection from franchisers.

[155] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971).

[156] *See infra* notes 221-23 and accompanying text.

[157] *See generally* Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369 (1995) (discussing statutes' function in providing

types of questions. First, why might it not be enough for parties simply to opt out of the statute into customized or privately provided terms? Second, why choose among states as distinguished from a given state's menu of alternative terms?

With respect to the first question, opting out of statutory default terms requires parties to substitute customized terms. Alternative statutes have several potential advantages over drafting customized terms. First, legislatures may be able to offer better solutions to complex drafting issues than the parties practicably could provide for themselves. The benefits of customized contract terms usually are limited to a particular transaction, while legislatures can spread the benefits across parties and transactions. This is particularly important when there are advantages to choosing a coherent *set* of default rules. Contract terms, and therefore default rules, involve tradeoffs at the margin. For example, it is inefficient to combine two or more costly monitoring devices when the marginal cost of each additional device exceeds its marginal benefit. Thus, firm owners might substitute direct management power for the ability to protect against opportunism with a strong liquidation right. Rather than analyzing these complex tradeoffs, parties might prefer to choose from various ready-made sets of terms. This may be particularly important for trade creditors and parties to small or routine transactions that do not justify the costs of drafting customized sets.

Second, a statutory standard form potentially offers benefits similar to those of an online computer network or telephone network in the sense that other users of the network supply a complementary "product" in the form of judicial precedents, business practices, and legal advice that help interpret and apply the standard form. These materials can increase the clarity of contracts by reducing errors of ambiguity, inconsistency, and incompleteness.[158] The

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contractual standard form terms for business associations).

[158] Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 774-89 (1995). *See generally* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985) (discussing tradeoffs between express and implied terms in reducing these errors).

parties cannot obtain these benefits simply by opting out of a statutory default rule.

Third, contracting parties may want to choose a particular legal regime on which they can rely to enforce their agreement consistent with their intent. Courts may have the same incentive to restrictively interpret an apparent "default" term as they have not to enforce a clearly "mandatory" term.[159] In particular, retroactive changes are a significant source of political wealth transfers because contracts can price and otherwise adjust for existing legal rules.[160] But states may be able to offer assurances against such wealth transfers by posting reputational bonds that the state will forfeit if it reneges on its promise not to behave opportunistically.[161] Contracting parties may want to choose one of these states rather than trusting the lawmakers in their home state.

Instead of choosing among state laws, parties might select forms that are not furnished by the government such as the American Bar Foundation Model Debenture Indenture, or repeat players such as franchisers might develop their own forms. An industry or firm can internalize costs and benefits while eliminating rent-seeking legislators as well as interference by interest groups opposed to the industry's objectives. But published statutes have several potential advantages over private standard forms, including greater assurance of enforcement, greater public awareness, and availability of more "network" benefits such as judicial precedents, customs, and practices that help in interpreting the terms.[162] In any event, private standard forms are not necessarily an alternative to enforcing contractual choice of law, since parties adopting a privately promulgated form may want to choose the law of a state that is likely to enforce it.

Enforcing contractual choice of law in order to enable the parties to choose their preferred default rules therefore often has significant benefits. At the same time, since the rules discussed in this subpart

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[159] *See supra* notes 134-36 and accompanying text.

[160] *See infra* notes 221-23 and accompanying text.

[161] *See* Romano, *supra* note 142, at 238-42 (reasoning that investors can rely on Delaware not to tamper with its statute because of Delaware's dependence on franchise tax revenue and side benefits from incorporation).

[162] *See supra* note 158 and accompanying text.

are by definition *default* rules (*i.e.*, non-mandatory rules), it follows that enforcing contractual choice of law in this context normally will not impose significant social costs. Indeed, since these provisions are generally gap-fillers, the Restatement indicates that contractual choice of law should be enforced in this situation.[163]

C. INCREASING CERTAINTY OF CHOICE-OF-LAW

The parties want to know at the time of entering into a contract which state's law will be applied, rather than waiting for the judge to tell them when deciding a contract dispute. Certainty allows parties to conform their conduct to the law,[164] and to price contract rights and duties. For example, a franchiser who knows that a terminable-at-will provision in the contract will be enforced can rely on the term as a monitoring device. But if the franchisee might be able to circumvent such terminability by litigating in a forum that does not enforce it, the franchiser will attempt to negotiate a price that reflects this uncertainty or include a back-up monitoring mechanism. The parties therefore may lose the value of being able to rely on at-will terminability.[165] Although parties may be able to reduce uncertainty by complying with the most stringent law that might be applied,[166] contractual choice enables the parties to reduce uncertainty costs without having to substitute a suboptimal contract term for one that some states do not enforce.

The ability to determine the applicable law also reduces the parties' costs of resolving disputes because parties will have less need to adduce facts and legal arguments relevant to determining the law under vague default rules. Furthermore, it may reduce the need for litigation because greater certainty about their rights gives parties more incentive to settle.[167]

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[163] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(1) (1971).

[164] *See* Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 14 (1972) (dealing with forum selection clause, citing "strong evidence that the forum clause was a vital part of the agreement, and [that] it would be unrealistic to think that the parties did not conduct their negotiations, including fixing the monetary terms, with the consequences of the forum clause figuring prominently in their calculations") (footnote omitted).

[165] *See* Ribstein, *supra* note 1, at 253-54.

[166] *See supra* notes 126-28 and accompanying text.

[167] *See* Priest & Klein, *supra* note 51, at 24.

D. PROMOTING EFFICIENT SUBSTANTIVE LAW

The discussion thus far shows that contractual choice can match legal rules with the needs of specific parties, which is consistent with Tiebout's argument that taxpayer mobility constrains public expenditures.[168] This matters most for parties who are on the margin with regard to the effect of legal rules in the sense that the costs are high enough to motivate them to select the applicable law. Tiebout implicitly assumes that taxes and spending by government units are fixed and that governments do not change in response to exiting individuals.[169] Jurisdictional selection therefore would seem mainly to help affected parties make the best of a bad lot.

Under an alternative view, marginal parties' actual or potential choices can produce legal improvements that benefit even infra-marginal parties for whom avoidance is not cost-justified. These effects may occur because contractual choice of law promotes active competition among state lawmakers.[170]

By promoting experimentation, and by promoting discovery of which laws work and which do not, enforcing contractual choice may lead to more efficient laws even without active competition among lawmakers.[171] For example, the first limited liability company

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[168] *See* Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416, 418 (1956).

[169] *See* Henri I.T. Tjiong, *Breaking the Spell of Regulatory Competition: Reframing the Problem of Regulatory Exit*, Max-Planck Project Group Preprint No. 2000/13 (Aug. 2000), *available at* http://papers.ssrn.com/paper.taf?abstract_id=267744 (lasting visited Feb. 3, 2003) (discussing Tiebout model). *But see generally* Bruno S. Frey & Reiner Eichenberger, *Competition Among Jurisdictions: The Idea of FOCJ*, *in* COMPETITION AMONG INSTITUTIONS 209 (Lüder Gerken ed., 1995) (suggesting that exit does not motivate competition under Tiebout model); Wolfgang Kerber & Viktor Vanberg, *Competition Among Institutions: Evolution within Constraints*, *in* COMPETITION AMONG INSTITUTIONS 35 (Lüder Gerkin ed., 1995) (same).

[170] *See infra* notes 344-50 and accompanying text.

[171] *See* Goldsmith & Sykes, *supra* note 128, at 821 (discussing benefits of state experimentation); Jack Knight, *A Pragmatist Approach to the Proper Scope of Government*, 157 J. INST. & THEORETICAL ECON. 28, 35 (2001):

> One of the arguments in support of federalism is that it provides the context in which different institutional forms can be tested to see which does the better job of resolving collective problems over time. In situations in which the future implications of a particular institutional choice are unclear, pragmatism dictates that experimentation in contexts such as this be undertaken.

(LLC) statute was adopted almost by accident in Wyoming, far outside the mainstream of business innovation, at the request of one influential firm.[172] But because parties could choose to be governed by LLC laws in any state, LLC formations in early adopting states led ultimately to proliferation of the LLC form.[173] Without this process, even the most sophisticated state legislators could not have known whether the concept of LLC statutes would meet the needs of firms given future tax and business developments, or how such statutes should be changed in light of such developments.

E. ENFORCING CONTRACTUAL CHOICE AND UNDER-REGULATION

Enforcing choice-of-law clauses might cause under-regulation in the sense that the social benefits of the regulation that are avoided by the clauses outweigh the social costs of regulation that would result if the clauses were not enforced and the case were decided under default choice-of-law rules. In other words, enforcing contractual choice of law might lead to a "race to the bottom" in which the most lax laws tend to dominate.[174] This is a potential problem with any conflict-of-laws rule.[175] The question in the present context is why the risk of under-regulation would increase

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Id.; Marti Vihanto, *Competition Between Local Governments as a Discovery Procedure*, 148 J. INST. & THEORETICAL ECON. 411, 411-36 (1992) (explaining that "competition can also produce hitherto unknown and often quite surprising discoveries"); *see also* Armen Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 213-14 (1950) (observing that "adaptive mechanism" of market is more important than "individual motivation and foresight").

[172] *See* William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 857-59 (1995); Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193, 1199-1206 (1995); Susan Pace Hamill, *The Origins Behind the Limited Liability Company*, 59 OHIO ST. L.J. 1459, 1463-69 (1998).

[173] For a discussion of the evolution of partnership-type firms, see generally Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819 (2001).

[174] This refers to the famous debate in corporate law between those who believe that Delaware law is a race to the bottom dominated by self-seeking corporate managers, *see* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974), and those who think it is a race to the top because efficient capital markets discipline the selection of corporate terms, *see* Romano, *supra* note 142, at 233-35; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254-58 (1977).

[175] *See* Guzman, *supra* note 1, at 913-15.

with enforcement of contractual choice of law, particularly since it can be assumed that parties generally look out for their own interests when they contract out of the protection of a regulatory statute.

One possible problem is that, as discussed in Part II.E.*1*,[176] enforcement of the choice-of-law clause indirectly affects nonparties to the contract. For example, the parties to a firm might contract for application of a state law that exempts shareholders from personal liability to tort victims. Also, for reasons discussed in Part II.E.*2*[177] and Part II.E.*3*,[178] contracting parties may not be fully capable of looking out for their own interests. Part II.E.*4* considers the specific question of how enforcement of opt-out through contractual choice might be reconciled with the justifications for mandatory rules.[179]

1. Externalities. Contractual choice may be inefficient because it imposes costs on nonparties who are indirectly affected by the contract. Externalities-based arguments may, however, be elusive.[180] First, "third parties" often have low-transaction cost ways to protect themselves. For example, although terminating franchises might affect the franchisee's creditors, long-term creditors such as banks are aware of this potential problem at the time of the loan and can take it into account in negotiating terms and charges with the franchisee.[181] Trade creditors may not have this information, but only because their exposure to risk does not justify the costs of investigating the borrower's business arrangements.

Choice-of-law clauses sometimes might seem to affect third parties who lack low-transaction cost means of self-protection. For example, enforcing noncompetition clauses in employment agreements might be said to injure the employees' would-be employers, and indirectly to impose social costs by impeding the flow of human

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[176] *See infra* notes 180-83 and accompanying text.
[177] *See infra* notes 184-93 and accompanying text.
[178] *See infra* notes 194-203 and accompanying text.
[179] *See infra* notes 204-06 and accompanying text.
[180] *See* David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701, 723-26 (1987) (criticizing externalities-based arguments in corporate law).
[181] Ribstein, *supra* note 1, at 260-61.

capital to its highest-value uses.[182] But it is necessary to take both positive and negative externalities into account. Thus, it is not clear why the potential harm to the out-of-state employer should be accorded greater weight than noncontracting parties' benefit from the noncompetition agreement. Among other things, noncompetition agreements, by protecting employers' rights in the firm's information, encourage the development of socially beneficial intellectual property.[183]

2. Choice-of-Law Clauses as Adhesion Contracts. Choice-of-law clauses are rarely the subject of bargaining, particularly in merchant/consumer contracts. This suggests that the seller is choosing a law that favors its interests and foisting it on the buyer. In other words, choice-of-law clauses appear to be classic "adhesion" contracts. Similar arguments have been made concerning commercial law generally[184] and in the corporate context when the terms of the corporate contract, including the designated law, appear to have been unilaterally imposed by managers on shareholders.[185]

The absence of bargaining does not, however, mean that the seller imposed the deal on the buyer. Buyers shop for competing bundles of contract terms rather than bargaining over each term, just as they shop for whole cars rather than negotiating over each part. In other words, consumer "exit," or choice of another product, replaces "voice," or interaction concerning the specific terms of the deal.[186]

Absence of bargaining alone clearly does not invalidate a consumer contract. The Supreme Court has upheld choice-of-forum and arbitration clauses in form contracts entered between consumers and employees.[187] Federal and state courts have rejected

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[182] *See* Application Group, Inc. v. Hunter Group, Inc., 72 Cal. Rptr. 2d 73, 84-88 (Cal. Ct. App. 1998) (refusing to enforce noncompetition agreement in order to protect interests of California company that sought to hire employee covered by agreement).

[183] *See generally* Kobayashi & Ribstein, *supra* note 41.

[184] *See generally* Friedrich Kessler, *Contracts of Adhesion—Some Thoughts about Freedom of Contract*, 43 COLUM. L. REV. 629 (1943).

[185] *See* Cary, *supra* note 174, at 610; Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1487 (1989).

[186] *See generally* ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINE IN FIRMS ORGANIZATIONS AND STATUTES (1970) (explaining that management finds out failings when customers either stop buying product or vocally express dissatisfaction).

[187] *See supra* notes 27-62 and accompanying text.

adhesion arguments in upholding arbitration clauses in consumer contracts for goods purchased over the telephone or Internet. For example, in *Hill v. Gateway 2000, Inc.*,[188] and *Brower v. Gateway 2000, Inc.*,[189] federal and state courts held that an arbitration provision in Gateway's mail order and telephone computer sales was not unenforceable as an unconscionable "adhesion" contract even if the clause was part of detailed terms enclosed with the computer, there was inequality of bargaining position between the seller and the consumer, the consumer did not read the agreement or claimed that he did not understand it, and the agreement foreclosed a low-cost class action remedy.[190] The unconscionability remedy was limited to ensuring that "the more powerful party cannot 'surprise' the other party with some overly oppressive term."[191] It was enough to satisfy this test that the consumer had thirty days after receiving the computer and agreement to return it, and that the agreement was not unduly lengthy (*i.e.*, three pages and sixteen paragraphs, all in the same size print).[192]

In any event, unconscionability goes to the enforceability of the general contract of which the choice-of-law clause is a part.[193] If the contract is enforceable despite the adhesion argument, then it arguably follows that it should take more to strike the choice-of-law clause than the mere fact that it was not the subject of explicit bargaining.

3. Information Asymmetry. The more serious market-related problem with choice-of-law clauses concerns asymmetry of information between buyer and seller. Unlike other contract terms, a choice of law clause hides the relevant terms in the chosen law.[194]

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[188] 105 F.3d 1147 (7th Cir. 1997).

[189] 676 N.Y.S.2d 569 (N.Y. App. Div. 1998).

[190] *See Hill*, 105 F.3d at 1148; *Brower*, 676 N.Y.S.2d at 572.

[191] *Brower*, 676 N.Y.S.2d at 573.

[192] *Id.* at 573.

[193] Thus, since application of the choice-of-law clause depends on the enforceability of the contract, the court should determine this issue under forum law, rather than the law selected in the choice-of-law clause. *See, e.g.*, Ting v. AT&T, 182 F. Supp. 2d 902, 921 (N.D. Cal. 2002) (holding that issue of unconscionability of contract was governed by California law rather than contractually selected New York law).

[194] *See* Jack L. Goldsmith, *Against Cyberanarchy*, 65 U. CHI. L. REV. 1199, 1215 (1998); David R. Johnson & David Post, *Law and Borders—The Rise of Law in Cyberspace*, 48 STAN. L. REV. 1367, 1395-1400 & nn.102-03 (1996).

Nonlawyers may be unable to understand what they find or to evaluate the effect of the applicable law on the given transaction.[195] This asymmetry is particularly acute in consumer transactions where buyers usually cannot justify the cost of hiring legal help, but sellers are repeat players who can invest in legal expertise about various state laws.[196] These problems may underlie statutory restrictions on enforcement of contractual choice in consumer transactions.[197]

There are, however, several problems with this information asymmetry argument. First, the choice-of-law clause does not mislead the buyer where its effect is simply to select a legal regime that enforces the contract. The buyer might be surprised by the application of a *default* rule as a result of the choice-of-law clause, but enforcement in this situation is not controversial.[198]

Second, most firms will not lightly devalue their reputations by relying on a legal trick, such as a hidden or obscure choice-of-law clause, to frustrate buyers' expectations.[199] For example, in *Hill v. Gateway 2000, Inc.*,[200] Gateway explained a change in its arbitration provision to consumers in the magazine Gateway voluntarily sends to its customers as a way of building customer loyalty and goodwill.[201] Consumers can choose to confine their dealings to reputable merchants or demand significant discounts when dealing with merchants who have not established strong reputations.

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[195] Woodward, *supra* note 36, at 761 (arguing that only experts who engage in large or mass transactions can carry costs of figuring out which law is best, and that it is "very difficult to conceive of a more complex legal judgment than whether one legal regime will be 'better' for a given transaction than another").

[196] *Id.* at 741.

[197] *See infra* notes 344-50 and accompanying text.

[198] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS, § 187(1) (1971).

[199] With respect to the role of reputational capital in constraining merchants, see generally Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981); Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978).

[200] 105 F.3d 1147 (7th Cir. 1997).

[201] *See* Woodward, *supra* note 36, at 762 n.287 (noting that Gateway continued selling its computers with arbitration clauses without apparent damage to its reputation, even after these clauses were subject to widely publicized litigation in *Hill* and *Brower*, thereby suggesting that market does not punish miscreants). However, Woodward offers no evidence of the effect on Gateway's sales, or that consumers viewed Gateway's use of the arbitration clause as improper. *See id.*

Vendors who are not deterred by reputational constraints also may ignore the regulation that would apply if the choice-of-law clause were enforced.

Third, buyers are not as helpless as they might appear regarding choice-of-law clauses, even in consumer-merchant transactions. While many buyers do not take the time to be informed, prices are likely to reflect knowledgeable consumers' awareness of the effect of the choice-of-law provision because sellers cannot easily adjust prices and terms to reflect each buyer's knowledge and sophistication.[202] Although critics question the efficiency of consumer markets,[203] consumers have cheap access to many sources of buyer-oriented information about sellers, including third-party rating services such as Gomez, competitors, consumer magazines such as Consumer Reports, and the Internet. These media and services have incentives to report on problems with vendor misuse of choice-of-law clauses if such misuse is a potential problem. Even if consumer markets do not perfectly discount product information into prices, they may do so well enough that the costs of regulation outweigh the benefits.

Fourth, choice-of-law clauses may not be very different from many other obscure details about products that consumers seem to be able to evaluate. The purchase of complex products such as computer software or automobiles necessarily involves product features that most consumers do not understand. For example, while a computer's clock speed, a television's scanning mechanism, or countless other product characteristics might seem beyond the

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[202] *See* Stephan, *supra* note 1, at 41. *See generally* Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES IN LAW 387 (2001) (focusing on regulatory choice in securities regulation context); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979) (discussing legal implications of imperfect information).

[203] *See* Mark R. Patterson, *On the Impossibility of Information Intermediaries*, Fordham Law and Economics Research Paper No. 13 (July 2001), *available at* http://papers.ssrn.com/abstract=276968 (last visited Feb. 3, 2003) (arguing that information intermediaries cannot create fully efficient Internet markets, because—among other reasons—consumers will not pay for accurate information about specific products, support by advertisers skews recommendations, and low-marginal cost nature of market limits number of competitors); *see also* Woodward, *supra* note 36, at 762 (noting that "[t]here are no consumer groups or other services that give parties to form contracts meaningful information through which they can easily compare the terms of the form contracts").

understanding of most consumers, computer and electronics magazines, websites, and other media profit from making these details accessible to consumers.

4. Negating Mandatory Rules. Enforcing contractual choice presents a quandary when it negates explicit protection in a mandatory law. This seems most problematic when enforcing the choice-of-law clause would apply the law of a state where neither party resides over the mandatory law of the domicile of a party the law seeks to protect.

Enforcing contractual choice-of-law does not, however, create problems resulting from the limited jurisdictional reach of mandatory rules. Even if choice-of-law contracts are not necessarily efficient, default choice-of-law rules are often at least equally suspect. Territorial rules that apply state laws based on the occurrence of certain acts often seem arbitrary. The various forms of interest analysis, although they attempt to resolve these problems by looking to legislative intent, in fact may rely on assumptions concerning that intent that are as arbitrary as territorial rules, such as that a legislature wants to protect its own residents rather than promoting broader state interests.[204]

Most importantly, it is not even clear that state legislative interests *should* control over an efficiency analysis that emphasizes the ability of the parties to make choice-of-law decisions at the time of their contract or other relevant conduct.[205] For example, although a state legislature might clearly intend to protect its residents from an out-of-state manufacturer, casino operator, or the like, this law might be inefficient precisely because its enactment favored locally influential parties at the expense of out-of-state parties who lacked local political clout.[206] Applying the law of the protected party's residence does not obviously serve social welfare better than applying the law of the state where the regulated party resides or, for that matter, the law of a third state where neither party resides but that the parties designate at the time of contracting.

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[204] *See* O'Hara & Ribstein, *supra* note 1, at 1165-84 (analyzing critically traditional choice-of-law rules).

[205] *Id.*

[206] *Id.* at 1171-72.

Courts might reconcile interest and efficiency analyses by assuming that legislatures intend application of their laws only to the extent they are consistent with social welfare. But this assumption is no more realistic than the residence-based assumptions of interest analysts.

Although enforcing contractual choice of law is not necessarily less efficient than enforcing default choice-of-law rules, it is also not always more so. Because states often have strong justifications for regulating contracts, it may be inefficient to let contracting parties nullify the regulation by the simple expedient of contracting to apply nonregulatory law. We are therefore left with the question of the appropriate limits on enforcement of choice-of-law contracts. This Article resolves this question by combining interest group and efficiency analysis in Parts IV[207] and V.[208]

III. EFFICIENCY VS. POLITICS IN CONTRACTUAL CHOICE

Part II indicates that enforcing contractual choice of law can be efficient in many circumstances.[209] But why would lawmakers enforce contractual choice if this would undercut legislators' rents from brokering wealth transfers between interest groups?[210] The remainder of the Article addresses this question. This Part discusses a political theory of enforcement of contractual choice that focuses on the incentives of those who are regulated and those who are the direct beneficiaries of state laws. The next two Parts show how party mobility gives lawmakers incentives to enforce contractual choice of law by activating interest groups other than those the regulation directly affects. The former story suggests that enforcing contractual choice may lead to inefficient results, while the latter presents a more optimistic scenario.

Before beginning the analysis, it is important to define the issue. Even without enforcing contractual choice, courts probably will not apply their law to cases that are not sufficiently connected with the

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[207] *See infra* notes 231-329 and accompanying text.
[208] *See infra* notes 331-50 and accompanying text.
[209] *See supra* notes 113-206 and accompanying text.
[210] *See supra* note 131 and accompanying text (discussing legislative rent-seeking).

forum to affect any local legislative interest groups. Thus, the important question is not why lawmakers permit any evasion of state regulation, but why they apply the parties' *contractually* chosen, nonmandatory rule, rather than the mandatory rule that would apply under default choice-of-law rules. In other words, if a court would have applied the mandatory law in the absence of a choice-of-law clause, why should it do otherwise just because the parties have indicated that they do not want the law to apply? If anything, it would seem that the choice-of-law clause signals to lawmakers that they can earn rents by extending the regulation to the contract.

One possible answer to this question is that courts, not legislatures, enforce contractual choice of law. But state legislatures control their courts' pay and tenure[211] and can explicitly prohibit enforcement of choice-of-law clauses as to individual laws or across the board.[212]

Another possible answer to the puzzle of enforcement of contractual choice is that courts do not enforce contractual choice to permit override of *forum* state regulation. In other words, courts' enforcement of contractual choice reflects parties' ability to litigate in nonregulating states.[213] But, significantly, courts enforcing contractual choice to permit evasion of other states' laws apply a general rule that may be used against their own regulation by courts in those other states. Given the generality of rules regarding enforcement of contractual choice, any enforcement, even if applied mainly to other states' mandatory rules, potentially undermines the enforcing state's regulation.

If choice-of-law clauses can evade legislative policy, and courts are constrained to effectuate legislative intent, why do lawmakers tolerate these clauses to the extent that they do?[214] One political

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[211] *See supra* note 134 and accompanying text.

[212] *See supra* notes 63-82 and accompanying text. For example, a legislature could enact a general rule specifying that a prohibition on waiver prevents contractual designation of a more permissive state law. This rigorous approach may be necessary because adding the antichoice provision only to some statutes could indicate legislative intent to construe the remaining statutes to permit contractual choice of law.

[213] *See supra* notes 231-70 and accompanying text.

[214] The inherent difficulty of analyzing lawmakers' incentives arguably supports Guzman's more modest approach of proposing alternative assumptions about legislative behavior

theory of contractual choice of law suggests that enforcing the clauses helps serve the objectives of interest groups that *favor* the legislation that would be avoided by contractual choice, because this reduces their costs of securing passage of wealth-transferring legislation.[215] Put simply, interest groups trade easier adoption of weaker regulation for harder adoption of stronger regulation.[216] More specifically, proponent groups give up prospective regulation by permitting avoidance through choice-of-law clauses, but get retroactive regulation of existing contracts. Prospective regulation may have little value for its proponents if the opponent can adjust the contract along other margins that the statute does not address, such as by raising prices or substituting other provisions.[217] Given these adjustments, the proponents of the regulation may gain little, while the opponents lose because their adjustments are second-best contracting mechanisms. For example, a franchiser's unfettered power to terminate a franchisee might be worth more to the franchiser than the additional amount the franchiser could charge for a franchise without the termination provision.[218] Retroactive regulation, by contrast, can be quite valuable for proponents, and equally costly for opponents, because it is not easily avoided. Because retroactive regulation mainly transfers wealth from opponent to proponent interest groups, it reduces social welfare if one takes into account "deadweight" lobbying and other expenditures incurred to make the transfer.[219]

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regarding conflict-of-laws rules. *See* Guzman, *supra* note 1, at 900-04. However, this Article attempts to overcome this inherent difficulty by relying on evidence of actual lawmaker behavior regarding enforcement of contractual choice and willingness to compete. *See supra* notes 27-51 and accompanying text; *infra* notes 298-319 and accompanying text. Moreover, this Article's analysis raises doubt concerning Guzman's assumption that lawmakers have a perverse incentive not to enforce contractual choice of law. *See* Guzman, *supra* note 1, at 915.

[215] *See* O'Hara, *supra* note 1, at 1584, 1587.

[216] This assumes that opponent interest groups will find it more worthwhile to incur organization and lobbying costs as the law imposes higher costs on them. *See generally* Gary S. Becker, *A Theory of Competition Among Pressure Groups for Political Influence*, 98 Q.J. ECON. 371 (1983).

[217] O'Hara, *supra* note 1, at 1595.

[218] This follows from the above analysis of why contractual choice of law is valuable even against a background of other contracting devices. *See supra* notes 143-56 and accompanying text.

[219] *See* James M. Buchanan, *Rent Seeking and Profit Seeking*, *in* TOWARD A THEORY OF

This analysis suggests that enforcing choice-of-law clauses may encourage wealth-transferring legislation in some situations. Under the above theory, in a world without contractual choice, proponents of regulation would have to carry the heavy load of lobbying both for prospective and retroactive effect. The additional costs of prospective legislation to the law's opponents might induce them to mount an effective opposition to the law or at least force proponents to spend significantly more to get the law adopted. Conversely, even if contractual choice is fully enforced for contracts adopted after the law is passed, the law still might have value for its proponents because the latter at least get a one-time wealth transfer to the extent that contract prices reflect concessions to the other party that are invalidated by the mandatory law.[220] By enabling the unbundling of prospective and retroactive effects, enforcing contractual choice promotes the passage of inefficient, wealth-transferring legislation.

This analysis does not, however, explain enforcement of contractual choice completely. First, the retroactive effects on which it depends may be elusive because a court may strike the retroactive provision as contrary to the Contract Clause of the Constitution.[221] To be sure, courts have upheld retroactive statutes despite the Clause,[222] often by reasoning that parties had notice of the risk of regulation.[223] But because this assumes that contracts have had an

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THE RENT-SEEKING SOCIETY 3.4 (James M. Buchanan et al. eds., 1980); Ronald A. Cass & Keith N. Hylton, *Antitrust Intent*, 74 S. CAL. L. REV. 657, 709 (2001); Larry E. Ribstein, *Corporate Political Speech*, 49 WASH. & LEE L. REV. 109, 153 (1992); Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 W. ECON. J. 224, 228 (1967).

[220] *See* O'Hara, *supra* note 1, at 1588-90.

[221] U.S. CONST. art. I, § 10, cl. 1; *see* Holiday Inns Franchising, Inc. v. Branstad, 29 F.3d 383, 384 (8th Cir. 1994) (finding that Iowa Franchise Act was unconstitutional as retroactively applied); Rolec, Inc. v. Finlay Hydrascreen USA, Inc., 917 F. Supp. 67, 67 (D. Me. 1996) (holding that retroactive application of franchise law unconstitutionally impaired obligation of preexisting franchise agreement). *See generally* Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767 (1989) (demonstrating how Contract Clause can be applied to several types of changes in state corporation law and can ensure stability of internal corporate arrangements).

[222] *See, e.g.*, Reinders Bros., Inc. v. Rain Bird E. Sales Corp., 627 F.2d 44, 49-50 (7th Cir. 1980).

[223] *See, e.g.*, Chrysler Corp. v. Kolosso Auto Sales, Inc., 148 F.3d 892, 897 (7th Cir. 1998) (holding that statute regulating automobile franchises was just "fine tuning" of prior regulation, so that manufacturer should have known that it was "operating in a grey area of the dealership law [and] that the law might some day be amended to regulate disputes over

opportunity to adjust for the regulation, it does not authorize retroactive regulation when it would enable the most significant wealth transfers.

A second gap in the theory is that it does not explain how permitting enforcement of contractual choice differs from permitting direct waiver of the statute from the standpoint of maximizing interest group support. As with enforcing contractual choice, permitting the parties to opt out of the new rule would enable wealth transfers through application to existing contracts, while permitting parties to avoid future regulation.[224]

In short, a public choice theory focusing on the parties directly helped and hurt by the law that contractual choice seeks to avoid cannot fully explain why lawmakers enforce these clauses. Part IV fills these gaps by providing a more complete explanation of courts' and legislatures' incentives to enforce choice-of-law clauses.[225]

IV. POLITICS, PARTY MOBILITY, AND CONTRACTUAL CHOICE

The apparent difficulty of reconciling lawmakers' incentives in preserving mandatory rules with widespread enforcement of contractual choice can be resolved by taking into account parties' ability to choose the jurisdictions with which they maintain contacts. States' decisions whether to enforce contractual choice of law, and as to the substantive laws each jurisdiction provides, can

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relocation specifically").

[224] It has been argued that enforcing contractual choice enables lawmakers to "price-discriminate" by allowing opt-out only by those who are hurt most by the statute, as indicated by the fact that they are willing to use contractual choice of law to avoid coverage. *See* O'Hara, *supra* note 1, at 1603:

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

Id. But it is not clear why a party's adding a simple choice-of-law provision indicates that the party would lobby especially hard to be exempted from coverage, or why a waiver provision differs in this respect from a choice-of-law clause. *See infra* note 343 and accompanying text.

[225] *See infra* notes 231-329 and accompanying text.

influence contracting parties' local contacts. This can have economic consequences for influential local interest groups, particularly lawyers. These interest groups, in turn, may pressure lawmakers to enforce contractual choice and to pass particular laws. This pressure acts as a counterweight to interest group support for inefficient mandatory rules.

This theory goes further than the one discussed in Part III[226] in distinguishing the effect of contractual choice of law in mitigating the effect of mandatory rules from that of direct waiver. Enacting a mandatory law but permitting enforcement of contractual choice reduces the effect of the law *only* for interstate firms, which are in the best position to manipulate their jurisdictional contacts in response to choice-of-law decisions. Even if directly affected interest groups support regulation, indirectly affected groups may support enforcement of contractual choice. Enforcing contractual choice in particular situations also affects the substantive law; given enforcement of contractual choice, interest groups may favor laws that contracting parties are likely to select.

As discussed more fully in Part V, lawmakers' incentives to enforce contractual choice may be greatest precisely when mandatory laws are most likely to involve regulatory spillovers.[227] At the same time, inefficient enforcement is disciplined by the interplay of proregulatory and antiregulatory interest groups, because the more a group is affected, the harder it will lobby for regulation and against contractual choice.

This Part is organized as follows. Part IV.A shows how parties can respond to decisions not to enforce contractual choice by contracting for the applicable forum or adjudicator, or by manipulating their choice of forum at the time of litigation or their jurisdictional contacts in advance of litigation.[228]

Part IV.B discusses the effect of mobility on lawmakers' incentives by activating interest groups within the state.[229] Specifically, choice-of-law clauses and party mobility work together to provide

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[226] *See supra* notes 210-24 and accompanying text.
[227] *See infra* notes 331-50 and accompanying text.
[228] *See infra* notes 231-70 and accompanying text.
[229] *See infra* notes 271-308 and accompanying text.

jurisdictional choice. Parties' abilities to choose the jurisdictions with which they maintain contact promotes enforcement of the contract clauses. Enforcement of the clauses, in turn, promotes jurisdictional competition to provide efficient law.

Part IV.C shows the extent to which lawmakers' incentives depend on an important *limitation* on contractual choice—that is, requiring a connection between firms and the state whose law is designated in the contract.[230]

A. PARTY MOBILITY

Lawmakers' incentives to enforce contractual choice, as well as the lawmaking incentives that follow from such enforcement, depend on contracting parties' ability to avoid a particular jurisdiction's decision not to enforce the choice-of-law contract. If the game ends when a state's courts reject the clause, then the only question is whether the interest groups favoring the mandatory law care about opt-out through contractual choice. But this Part shows that, even apart from choice-of-law clauses, parties can choose the court or other adjudicator that will hear the case by, among other things, taking the litigation initiative and manipulating jurisdictional contacts.

The power of the exit mechanisms discussed in this Part result partly from general technological and legal developments, such as electronic commerce, that make firms more mobile. First, firms' increasing interstate reach decreases the marginal costs of forum and law-choice devices because, apart from choosing favorable law, firms need to be informed about the many state laws that might apply to them.

Second, the nature of modern businesses lends itself to the devices discussed above. Firms that rely on human capital, intellectual property, services, electronic communications, and software products may be less committed to particular locations than firms that rely on factories and brick-and-mortar stores. This observation may be qualified in high technology firms that need to

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[230] *See infra* notes 311-29 and accompanying text.

be located around a concentration of skilled workers,[231] and therefore are impeded from exiting these areas. On the other hand, the payoffs to states of attracting skilled workers may induce them to offer the appropriate "legal infrastructure."[232] For example, Virginia sought to become a hub of high-tech or Internet activity by being the first state to enact the generally pro-seller Uniform Computer Information Transactions Act.[233]

1. Choice of Forum at the Time of Litigation. Enforcement of contractual choice of law depends significantly on the parties' ability to choose the court that will decide the choice-of-law issue. A court of a state other than one that seeks to regulate the transaction will have less incentive to impose the regulation than would a court of the regulating state that is subject to discipline by the enacting legislature.

A party can choose the forum by filing the suit in, or transferring or removing the suit to, a court that will enforce the clause. Parties' choices in this regard are enhanced by the availability of declaratory relief. Federal court is a particularly promising option. Since most cases involving the application of choice-of-law clauses arise from contract rather than from federal or state law, jurisdiction ordinarily depends on diversity of citizenship and the jurisdictional amount in diversity cases.[234] Although a federal court must apply the forum's choice-of-law rule in diversity cases,[235] federal courts have stronger incentives than state courts to apply open-ended state choice-of-law rules in favor of enforcement.[236] Federal judges have

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[231] *See generally* Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 N.Y.U. L. REV. 575 (1999).

[232] *Id.* at 602 (discussing effect of state's law regarding enforcement of noncompetition agreements on local diffusion of knowledge among skilled workers).

[233] *See* VA. CODE ANN. §§ 59.1-501.1 to -509.2 (Michie 2001 & Supp. 2001) (codifying Uniform Computer Information Transactions Act).

[234] 28 U.S.C. § 1332 (2000).

[235] Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487, 496 (1941). Indeed, to ensure that federal adjudication does not affect the result, if the case is transferred from state court to a federal court in a different state, the original state's conflicts rule is applied. Van Dusen v. Barrack, 376 U.S. 612, 638 (1964). It applies even if the original forum was inconvenient. Ferens v. John Deere Co., 494 U.S. 516, 529 (1990). It does not apply if the original state would have dismissed the case because of a contractual choice of a different forum. Caribbean Wholesales & Serv. Corp. v. US JVC Corp., 855 F. Supp. 627, 632 (S.D.N.Y. 1994).

[236] *See* Ribstein, *supra* note 1, at 285.

little reason to enforce a state legislature's interest group deal because the state legislature does not control their tenure and salary. Moreover, federal courts do not have a "prestige" incentive to apply their own law because in diversity cases they must borrow rules from state courts even without a choice-of-law clause. Thus, federal courts compete with state courts for lawsuits and are a potential source of precedents supporting enforcement of contractual choice.[237]

This difference between federal and state courts arguably is supported by my study of almost 700 cases involving enforcement of contractual choice of law clauses. The study shows that most of these cases are brought in federal court, and that the federal enforcement percentage is more than three times higher than the state percentage.[238] To be sure, the greater number of federal cases may reflect parties' general preference for litigating in federal rather than state court, rather than the success of proponents of contractual choice in securing a favorable forum.[239] Also, the difference in enforcement ratios may reflect the fact that, because of the jurisdictional amount, federal courts do not hear many consumer cases, in which courts may be most dubious about enforcing contractual choice. On the other hand, the leading nonenforcement categories of franchise and noncompetition cases[240] are likely to involve more than the jurisdictional amount. On balance, the enforcement ratio and the different number of cases in federal and state courts indicate federal and state courts' differing propensities to enforce choice-of-law clauses.

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[237] *Cf.* Baxter, *supra* note 24, at 22 (discussing federal courts' beneficial role in formulating choice-of-law policy).

[238] *See supra* notes 38-40 and accompanying text.

[239] As to the latter explanation, see Ribstein, *supra* note 1, at 285 n.212. *See also* Priest & Klein, *supra* note 51, at 17 (predicting that parties would settle rather than pursue litigation when their win rate is less than 50%). Priest and Klein's observation may not hold in this situation because the choice-of-law clause is not the only issue in the case, or because the proponent of the choice-of-law clause is playing for different stakes than the opponent. *See id.* at 24-25 (discussing asymmetric effects of judgments on parties). A possible analogy is the significant effect on win rates observed for parties who request a venue transfer under 28 U.S.C. § 1404(a) (2000). *See* Kevin M. Clermont & Theodore Eisenberg, *Exorcising the Evil of Forum-Shopping*, 80 CORNELL L. REV. 1507, 1512-13 (1995). I am indebted to Bruce Kobayashi for this observation.

[240] *See* O'Hara, *supra* 1, at 1565.

2. Contractual Choice of Forum. The party favoring enforcement of contractual choice of law might increase the chances of enforcement by entering into a predispute agreement providing that the dispute will be decided in a particular court. One survey notes that only three states have a clear policy against enforcement of choice-of-forum clauses,[241] while a more recent study cites enforcing cases in two of those states.[242] Enforcement of contractual choice of forum can, in turn, be enhanced by another clause providing that the parties consent to the jurisdiction of a designated court.[243]

The party opposing enforcement of contractual choice of forum may attempt to sue in a nondesignated forum, which will decide whether to hear the case or transfer it to the designated forum, perhaps applying local law rather than the law designated in the contract.[244] Thus, it is not obvious why courts might let firms choose the applicable forum in order to avoid the application of state regulation in cases where the courts otherwise would not enforce contractual choice of law.[245]

The answer is that courts may have incentives to enforce contractual choice of forum that do not apply to contractual choice-of-law clauses. To enforce a choice-of-law clause, a court must

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[241] *See* Leandra Lederman, Note, *Viva Zapata!: Toward a Rational System of Forum-Selection Clause Enforcement in Diversity Cases*, 66 N.Y.U. L. REV. 422, 449 n.172 (1991) (referring to Alabama, Georgia, and Missouri).

[242] *See* Michael E. Solimine, *The Quiet Revolution in Personal Jurisdiction*, 73 TUL. L. REV. 1, 17 & n.107 (1998) (referring to Alabama and Georgia).

[243] *See infra* note 250 and accompanying text. Note that consent to a particular forum may be held not to require litigation in this forum absent additional mandatory language. Scott v. Guardsmark Sec., 874 F. Supp. 117, 120-21 (D.S.C. 1995) (holding that provision in forum selection clause that establishes consent to venue and jurisdiction in Tennessee does not preclude parties from selecting another forum).

[244] *See* Fendi S.r.l. v. Condotti Shops, Inc., Bus. Franchise Guide (CCH) ¶ 11,755 (Fla. Dist. Ct. App. Dec. 8, 1999), *reh'g granted*, 754 So. 2d 755 (Fla. Dist. Ct. App. 2000). Some cases have determined the validity of the forum selection clause under the contractually selected law. *See, e.g.*, Indymac Mortgage Holdings, Inc. v. Reyad, 167 F. Supp. 2d 222, 243 (D. Conn. 2001); Jacobson v. Mailboxes Etc. U.S.A., Inc., 646 N.E.2d 741, 744 (Mass. 1995). A party has also received the benefit of a choice of law clause even without suing in the contractually selected forum. *See* Ackerley Media Group, Inc. v. Sharp Elecs. Corp., 170 F. Supp. 2d 445, 451 (S.D.N.Y. 2001).

[245] *See* Lee Goldman, *My Way and the Highway: The Law and Economics of Choice of Forum Clauses in Consumer Form Contracts*, 86 NW. U. L. REV. 700, 705 (1992); Linda S. Mullenix, *Another Choice of Forum, Another Choice of Law: Consensual Adjudicatory Procedure in Federal Court*, 57 FORDHAM L. REV. 291, 307 (1988).

consider the relevant states' competing policies. The court risks error in making this determination. If the court decides to enforce another state's law, it risks additional error without much chance of a prestige reward because its precedent will not be entitled to the same weight as a home-state court's decision. But the court can enforce a choice-of-forum clause without analyzing and applying another state's law or establishing a controversial precedent on enforcement of contractual choice of law. Indeed, even without the forum selection clause, a court faced with a choice-of-law clause applying another state's law might dismiss on *forum non conveniens* grounds.[246] Choice-of-forum clauses also may have benefits for the parties that are independent of avoiding regulation. A jurisdiction such as Delaware may offer quicker, cheaper, or more expert adjudication than other states.[247]

The Supreme Court has promoted enforcement of contractual choice of forum in commercial[248] and consumer[249] admiralty cases, and has recognized the enforceability on due process grounds of a consent-to-jurisdiction clause.[250] Although these precedents do not directly compel enforcement in state or all federal cases,[251] they

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[246] It also has been argued that, because choosing a foreign forum involves substantial costs, a party that does so signals the existence of substantial deadweight costs in enforcing the rule that would apply but for the choice-of-law clause. *See* WHINCOP & KEYES, *supra* note 1, at 56-57. However, the existence of this signal would seem to depend on what forum is selected. For example, the signal is less credible when a vendor chooses the state in which it has its main office.

[247] *See* Romano, *supra* note 142, at 279-81.

[248] *See* M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 15 (1972); *see also* N.W. Nat'l Ins. Co. v. Donovan, 916 F.2d 372, 375-76 (7th Cir. 1990) (applying *Bremen*).

[249] *See* Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 593-94 (1991):

> [A] clause establishing *ex ante* the forum for dispute resolution has the salutary effect of dispelling any confusion about where suits arising from the contract must be brought and defended, sparing litigants the time and expense of pretrial motions to determine the correct forum, and conserving judicial resources that otherwise would be devoted to deciding those motions.

Id. (citation omitted). *But see generally* Paul D. Carrington & Paul H. Haagen, *Contract and Jurisdiction*, 1996 SUP. CT. REV. 331 (criticizing enforcement of contractual forum selection in consumer form contracts).

[250] *See* Burger King Corp. v. Rudzewicz, 471 U.S. 462, 472 n.14 (1985).

[251] *See, e.g.*, Am. Online, Inc. v. Superior Court, 108 Cal. Rptr. 2d 699, 707 (Cal. Ct. App. 2001) (refusing to enforce forum selection clause, although noting importance of such clauses).

support decisions to enforce contractual choice of forum or law by courts that are inclined for other reasons to do so.

3. Arbitration Clauses. The parties may be able to enhance enforcement of contractual choice of law by contracting to have the case heard by an arbitrator. Arbitration clauses may have several advantages for one or both of the parties over choice-of-forum or choice-of-law clauses. First, because arbitrators normally do not write opinions,[252] they have no personal reason to add to their prestige by setting precedent[253] and are more likely to compete for adjudication business through efficient dispute resolution.[254] Thus, arbitrators may have more incentive than judges to enforce choice-of-law clauses.

Second, federal law enhances enforcement of arbitration clauses. The Federal Arbitration Act,[255] which applies in state as well as federal court,[256] mandates enforcement of arbitration provisions in agreements that involve transactions in interstate commerce and that are enforceable on general contract law grounds.[257] The Court has upheld arbitration clauses even when upholding the clause qualifies enforcement of mandatory rules intended to protect one of the contracting parties.[258] Lower federal and state courts also have upheld arbitration provisions in consumer contracts.[259]

Arbitration and choice-of-forum clauses are not mutually exclusive. The Federal Arbitration Act does not supplant general

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[252] *See* Robert D. Cooter & Daniel L. Rubinfield, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LIT. 1067, 1093 (1989); William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest Group Perspective*, 18 J.L. & ECON. 875, 887 (1975).

[253] *See* Robert D. Cooter, *The Objectives of Private and Public Judges*, 41 PUB. CHOICE 107, 129 (1983).

[254] *See* Gordon Tullock, TRIALS ON TRIAL 119-34 (1980).

[255] Federal Arbitration Act, 9 U.S.C. §§ 1-16 (2000).

[256] Southland Corp. v. Keating, 465 U.S. 1, 12 (1984).

[257] 9 U.S.C. § 2 (2000).

[258] *See generally* Circuit City Stores, Inc. v. Adams, 532 U.S. 105 (2001) (involving employment discrimination); Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20 (1991) (involving employment discrimination); Rodriguez de Quijas v. Shearson/American Express, Inc., 490 U.S. 477 (1989) (involving securities law claim); Perry v. Thomas, 482 U.S. 483 (1987) (involving employee's claim); Shearson/American Express, Inc. v. McMahon, 482 U.S. 220 (1987) (involving securities law claim).

[259] *See* Hill v. Gateway 2000, Inc., 105 F.3d 1147, 1148 (7th Cir. 1997); Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569, 572 (N.Y. App. Div. 1998).

state law contract limitations.[260] Accordingly, just as arbitration can support choice-of-law clauses,[261] so too can contractual choice of law and forum support arbitration agreements.[262]

Since arbitrators' decisions may be less predictable than those of courts because they are not bound to follow specific precedents, parties sometimes might prefer to rely on contractual choice of forum than on arbitration. Thus, one study found that the use of arbitration clauses in a set of franchise contracts correlated negatively with the use of clauses providing for litigation in the franchiser's home state.[263] Although the authors concluded that these data indicated that arbitration was being used for purposes other than to avoid restrictive state law,[264] it is at least as likely that arbitration was a last resort substitute for contractual choice of forum in some cases.

4. Selecting Private Law System. The parties may choose to have the case decided under a system of private law, such as one established by an industry group or private association, rather than under the law of a governmental unit such as a state or nation.[265]

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[260] *See generally* Volt Info. Scis., Inc. v. Bd. of Trs., 489 U.S. 468 (1989) (holding Federal Arbitration Act did not preempt California law which permits court to stay arbitration pending resolution of related litigation involving third parties not bound by arbitration agreement where parties agreed in contract to abide by state rules of arbitration); Circuit City Stores, Inc. v. Adams, 279 F.3d 889 (9th Cir. 2002) (holding arbitration clause unconscionable under California law standards); Ticknor v. Choice Hotels Int'l., 265 F.3d 931 (9th Cir. 2001) (holding arbitration clause unconscionable under Montana standards). For a discussion of state law standards and the Revised Uniform Arbitration Act, see Stephen L. Hayford & Alan R. Palmiter, *Arbitration Federalism: A State Role in Commercial Arbitration*, 54 FLA. L. REV. 175, 210-13 (2002).

[261] *See Volt*, 489 U.S. at 479 (holding that FAA allows enforcement of choice-of- law clauses).

[262] *See* Johnston County v. R.N. Rouse & Co., 414 S.E.2d 30, 35 (N.C. 1992) (holding that since court retains jurisdiction to enforce arbitration, contractual designation of state courts may be significant in addition to agreement to arbitrate; thus contractual provision consenting to jurisdiction by North Carolina courts did not conflict with parties' contractual agreement to arbitrate).

[263] *See* Keith N. Hylton & Christopher R. Drahozal, *The Economics of Litigation and Arbitration: An Application to Franchise Contracts*, Boston Univ. School of Law Working Paper No. 01-03 (Apr. 2001), *available at* http://papers.ssrn.com/paper.taf?abstract_id=266545 (last visited Feb. 5, 2003).

[264] *Id.*

[265] *See generally* Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 J. LEGAL STUD. 115 (1992) (discussing private governance in diamond industry); David R. Johnson & David Post, *Law and Borders—The Rise of Law in Cyberspace*, 48 STAN. L. REV. 1367 (1996) (discussing potential for private

Unlike arbitration, such an agreement would choose the law as well as the procedures for resolving disputes and selection of the adjudicator.

Whether these private solutions work, however, depends ultimately on decisions of government agents, including judges, who might refuse to enforce the express or implied waiver of legal remedies. Although the firm could contract with the consumer to make private remedies exclusive, the viability of this approach again depends on a court's willingness to enforce the clause. Contractual selection of the applicable law and forum increases the likelihood that the court will apply the private regime.

5. Manipulating Jurisdictional Contacts. Firms can ensure enforcement of choice-of-law contracts by avoiding contacts with states that do not enforce the contracts[266] and establishing bases in states that do. Thus, for example, insurers have pulled out of states where regulation constrains profits,[267] firms have allocated less

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regulatory structures on Internet); Gillian Hadfield, *Privatizing Commercial Law: Lessons From the Middle and the Digital Ages*, Stanford Law and Economics Olin Working Paper No. 195 (Mar. 2000), *available at* http://papers.ssrn.com/paper.taf?abstract_id=220252 (last visited Feb. 5, 2003) (discussing examples of legal regimes designed and administered by private entities).

[266] The Due Process Clause allows states to assert jurisdiction only over parties who have had "minimum contacts" with the state. *See* U.S. CONST. amend. V; World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286, 297 (1980); Int'l Shoe Co. v. Washington, 326 U.S. 310, 316 (1945). Minimum contacts involves the defendant's directing its action toward the forum rather than merely being aware that action might result there. Asahi Metal Indus. Co. v. Superior Ct., 480 U.S. 102, 111-12 (1987). Although *Asahi* may be read as supporting something like a mere awareness of sales standards, only one of the five justices favoring that standard (Stevens) remains on the Court. A court may assert general jurisdiction over a defendant that has extensive local contacts, such as maintaining a principal place of business, even if the contacts did not arise out of or relate to the particular transaction at issue. Helicopteros Nacionales de Columbia, S.A. v. Hall, 466 U.S. 408, 414-15 (1984). Once a state with jurisdiction enters judgment, the judgment may be enforced in any state where the defendant has assets. *See* Full Faith and Credit Clause, U.S. CONST. art. IV, § 1; Shaffer v. Heitner, 433 U.S. 186, 210 n.36 (1977).

[267] Ribstein & Kobayashi, *supra* note 1, at 54; *see also* Editorial, *California Smashup*, WALL ST. J., Nov. 15, 1988, at A22 (discussing exit of forty insurers from California due to Proposition 103 rate rollback); Stephen Kreider Yoder, *Political Operator: Insurance Regulator in California Woos Voters, Bashes Firms*, WALL ST. J., Aug. 10, 1992, at A1 (discussing withdrawal of Ohio Casualty Corporation from California market because of excess regulation and poor underwriting results). States might strike back by legislating to deter exit. *See* Richard A. Epstein, *Exit Rights and Insurance Regulation: From Federalism to Takings*, 7 GEO. MASON L. REV. 293, 300-04 (1999) (discussing use of exit taxes used to deter withdrawal of automobile insurance companies from New Jersey and Massachusetts);

production to states with stricter environmental regulations,[268] and franchisers have avoided locating in the states with the most stringent franchise regulations.[269] Conversely, establishing a home office in a state may significantly increase the likelihood that that state's law will apply to a firm's transactions.[270]

While establishing or avoiding physical contact with a jurisdiction may be costly, a firm's contacts with a jurisdiction help determine the applicable law for all of its transactions, so their costs can be amortized across transactions. Thus, the effectiveness of party mobility as a constraint on regulation depends on the difference between parties' costs of moving and the present value of the cost of regulation aggregated over future transactions.

B. LAWMAKERS' INCENTIVES AND FIRM MOBILITY

Party mobility influences lawmakers because it affects in-state interest groups.[271] Lawmakers' net gains or losses from supporting opting out through contractual choice therefore depend on the

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Beatrice E. Garcia, *Aetna Takes Off Gloves on Car Insurance*, WALL ST. J., June 7, 1990, at A4 (reporting Aetna's challenge of laws in Pennsylvania and Massachusetts that control its exits from these states).

[268] *See* Wayne B. Gray & Ronald J. Shadbegian, *When Do Firms Shift Production Across States to Avoid Environmental Regulation?*, NBER Working Paper No. W8705 (Jan. 2002), *available at* http://papers.ssrn.com/paper.taf?abstract_id=296549 (last visited Feb. 5, 2003). This research is somewhat inconsistent with earlier data showing that environmental laws do not determine where firms locate plants. *See generally* Adam B. Jaffe et al., *Environmental Regulation and the Competitive of U.S. Manufacturing: What Does the Evidence Tell Us?*, 33 J. ECON. LIT. 132 (1995); Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210 (1992).

[269] *See* Kobayashi & Ribstein, *supra* note 4, at 342.

[270] *See* Woodward, *supra* note 36, at 732 n.164 (noting that RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2) and U.C.C. § 1-105 effectively permit choice of law of state where vendor is based); *see also supra* 45 and accompanying text (discussing review of cases showing importance of party residence for choice of law).

[271] For another discussion of this point, also using the franchise example, see Kobayashi & Ribstein, *supra* note 4, at 339-45. Note that the text treats "lawmakers," including both judges and legislators, as if they had similar incentives. This is plausible to the extent that legislators can influence judicial decisions. However, as discussed *supra* in note 144 and accompanying text, and *infra* in note 358 and accompanying text, judges' and legislators' incentives may differ in some respects regarding enforcement of contractual choice. This requires additional discipline in the form of explicit choice-of-law statutes. *See infra* note 358 and accompanying text.

interests not only of direct beneficiaries and subjects of regulation, but also of those who may lose when regulated parties enter or leave the state. Parties' selection of the forum or domicile that is most likely to enforce contractual choice or has the best law has economic consequences for powerful in-state business groups, particularly lawyers,[272] who can gain from dealings with other local firms and therefore from their respective states becoming business centers. Pressure from such groups can cause state lawmakers to enforce contractual choice, and partly because of such enforcement, take into account the costs state laws impose on interstate firms.

Part IV.B.*1* focuses on the effect of the mobility devices discussed in Part II.A in promoting mitigation of regulation generally, and enforcement of contractual choice in particular.[273] Part II.B.*2* discusses states' incentives to offer laws that are likely to be selected in choice-of-law clauses.[274]

1. Firm Mobility and Enforcement of Contractual Choice. The first part of the story concerns the effect of firm mobility discussed in Part IV.A on whether courts will enforce contractual choice. The franchise example illustrates the role of mobility. First, consider the perspective of traditional interest group theory. Assume a typical "spillover" scenario in which a state has enacted a franchisee protection statute at the behest of franchisees in the state and to the detriment of franchisers based elsewhere.[275] Assume further that rules such as restrictions on termination cost an average of $6,000 per franchiser doing business in the state, taking into account avoidance and compliance maneuvers that the law permits.[276] The

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[272] *See infra* notes 288-94 and accompanying text.

[273] *See infra* notes 275-78 and accompanying text.

[274] *See infra* notes 279-308 and accompanying text.

[275] Note that potential franchisees may lose from regulation that discourages entry of franchisers. However, current franchisees are likely to gain more from retroactive changes in their contracts than they stand to lose from a decreased opportunity to contract in the future. *See supra* notes 221-23 and accompanying text. Moreover, future franchisees are likely to be a diffuse, and therefore weak, interest group.

[276] The statutes apply only or mainly to franchisees in the regulating state, either explicitly by statute, by case law interpretation of the statutes, or under the dormant Commerce Clause. *See* Highway Equip. Co. v. Caterpillar, Inc., 908 F.2d 60, 62 (6th Cir. 1990) (interpreting Illinois act); Hoff Supply Co. v. Allen Bradley Co., 750 F. Supp 176, 178 (M.D. Pa. 1990) (interpreting Wisconsin act); Power Draulics-Nielsen v. Libbey Owens Ford Co., No. 82 CIV. 1134 (MBM), 1988 WL 31880, at *1 (S.D.N.Y. Mar. 11, 1988) (interpreting

affected franchisees of each franchiser doing business in the state, in turn, receive benefits averaging $5,000 from the loosening of contractual constraints because of their increased ability to shirk or free-ride on the franchiser's trademark. Although losses to franchisers outweigh the gains to franchisees, franchisees can secure passage because they can coordinate locally at lower costs than franchisers that are based out-of-state and spread across several states. For example, local franchisees and their employees have scope economies in lobbying over a range of local issues, while remote franchisers are concerned mainly with franchisee protection statutes.

Now assume an exit constraint. Assume that it costs each franchiser an average of $5,000 to avoid application of the state's law by utilizing one or more of the avoidance devices discussed in Part IV.A.*5*, such as avoiding contacts with a regulating jurisdiction.[277] The exit option thus reduces the wealth that can be extracted from franchisers, and therefore also interest groups' and legislators' benefits from arranging the wealth transfer, compared to a scenario in which franchisers can reduce the law's impact only by lobbying against it.

In addition to its direct effects, exit also affects locals who do business with the franchisers, including their existing and potential franchisees. These parties may support legislation that does not discourage franchisers from maintaining contacts with the state.[278] When the political power of directly affected groups is closely balanced, as in this example, these additional exit effects may be enough to cause legislators to refrain from regulating or to change existing laws. For example, the law might regulate franchisee

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Connecticut act). *But see* Burger King Corp. v. Austin, 805 F. Supp. 1007, 1023 (S.D. Fla. 1992) (interpreting clause limiting Florida franchise statute to persons "doing business in Florida" to include out-of-state franchisee).

[277] *See supra* notes 266-70 and accompanying text.

[278] An alternative example of the constraining effect of firm mobility might be the classic state competition for incorporations. *See* Note, *supra* note 83, at 1499-1500 (observing that firms might "retaliate against a state that disregards the internal affairs doctrine, possibly by relocating their operations to another state," and that "[t]he loss of jobs and tax revenues could have a serious, detrimental impact on the forum state, especially if a number of companies were to relocate").

termination, but not to the extent of giving franchisees the right to cure before being terminated.

More importantly for present purposes, lawmakers may support rules that favor enforcement of contractual choice, or at least oppose prohibition. Enforcing contractual choice eliminates regulated parties' need to physically exit the jurisdiction. Moreover, regulated parties' ability to avoid the regulation through the above devices reduces the costs to the regulating jurisdiction of enforcing contractual choice.

To be sure, lawmakers could accomplish similar results by permitting waiver of the regulation. The particular advantage of permitting contractual choice as a mitigation device is that it is most useful for the interstate firms that suffer most from political spillovers. A firm that operates in many states must incur the costs of learning the laws in those states irrespective of whether they contract for the applicable law. By contrast, an intrastate firm that is dissatisfied with local regulation must incur the costs of learning the laws in other states before it can decide whether it would benefit from contracting for the law of another state. The difference in learning costs between the two situations may be significant given that the different types of firms may require different types of legal counsel. While a wholly intrastate business may be able to hire a less costly small or intrastate law firm, a multistate firm may need a larger, national law firm to represent it in multiple states.

2. State Competition to Attract Firms. States have incentives not only to avoid repelling firms, but also to encourage them to establish significant local contacts, such as headquarters. The relevance of this factor depends on whether the rule regarding enforcement of contractual choice requires significant contacts in a state as a prerequisite to enforcing a contract applying that state's law. This depends on states' willingness not only to apply their *own* law where it is designated in the contract, but also to apply *another* state's law where it is designated *and* the state has contacts with the contracting parties, and to *refuse to apply* their own state's law where it is designated in the contract but where the state lacks significant contacts with the parties. The role of state contacts in explaining

lawmakers' incentives to enforce contractual choice is discussed in more detail below.[279]

The problem is aligning states' incentives with those of lawmakers. Even if lawmakers have some incentive to avoid enacting inefficient laws, or to mitigate the effect of such laws through contractual choice of law and other means, they may seem to have little incentive to adopt the sorts of laws that will attract firms.[280] Although states may benefit by attracting mobile firms, it does not necessarily follow that there is a "feedback mechanism" to ensure that politicians act in the state's interest.[281] Other jurisdictions easily can copy successful legislation while legislators risk embarrassing failure, or success that imposes costs on their supporters.[282] Thus, while enforcing contractual choice of law can increase the welfare of parties that enter into these contracts, it may have little effect on the supply of efficient law.

The conventional "feedback mechanism" emphasized in the corporate competition literature includes the fees and taxes locally incorporated firms pay into the state treasury.[283] But incorporation fees alone may give states little reason to compete,[284] with the possible exception of Delaware where franchise fees dominate the revenue base.[285] Moreover, even if states can gain, lawmakers may not necessarily serve taxpayers' interests. In any event, the franchise-fee theory cannot explain competition in the absence of significant franchise fees, including closely held firms[286] and noncorporate commercial law.[287]

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[279] *See infra* notes 311-29 and accompanying text.

[280] *See generally* Douglas J. Cumming & Jeffrey G. MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 INT. REV. L. & ECON. 141 (2000); Henri I.T. Tjiong, *Breaking the Spell of Regulatory Competition: Reframing the Problem of Regulatory Exit*, Max-Planck Project Group Preprint No. 2000/13 (Aug. 2000), *available at* http://papers.ssrn.com/paper.taf?abstract_id=267744 (last visited Feb. 5, 2003).

[281] *See* Tjiong, *supra* note 280, at 9-10.

[282] *See generally* Susan Rose-Ackerman, *Risk Taking and Reelection: Does Federalism Promote Innovation?*, 9 J. LEGAL STUD. 593 (1980).

[283] *See, e.g.*, Cary, *supra* note 174, at 668.

[284] Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law* (Aug. 28, 2002) (unpublished manuscript).

[285] Romano, *supra* note 142, at 226-27.

[286] Ian Ayres, *Judging Close Corporations In the Age of Statutes*, 70 WASH. U. L.Q. 365, 377-78 (1992).

[287] Woodward, *supra* note 36, at 758 n.265, 773 n.329.

Lawyers enter the picture as the potential missing link in the state competition story. As I have explained in more detail elsewhere,[288] lawyers have inherent advantages over other interest groups promoting legal reform: they can lobby at lower costs because they can use their expertise about the law that rivals must acquire or hire[289] and coordinate political activities through bar associations as a byproduct of the other functions served by those organizations.[290] Law reform efforts help lawyers generally acquire an aura of professionalism[291] and individual lawyers enhance their personal reputations. Lawyers also can influence the law by writing about it in forms, manuals, and treatises.[292]

State licensing laws motivate lawyers to invest their law reform efforts in the law of the particular state or states in which they are licensed.[293] Bar admission gives lawyers priority access to the courts of the states in which they are licensed, and the exclusive right to practice on behalf of clients located in the state. Lawyers' exclusive access to the courts of their licensing state pertains to the law of that state because, while any lawyer can advise on the law of any state, judges tend to apply forum law under current approaches to choice of law.[294] Thus, the benefits of the state court to which a lawyer's license gives priority access depend to some extent on the attractiveness of the local law that the court applies.

Enforcement of contractual choice, of course, may reduce courts' application of forum law. But even if courts apply the laws of other states under choice-of-law clauses, they will apply forum law most often across their whole range of cases. More importantly, given

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[288] *See* Ribstein, *supra* note 4.

[289] *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 508-09 (1987).

[290] *See* Paul H. Rubin & Martin J. Bailey, *The Role of Lawyers in Changing the Law*, 23 J. LEGAL STUD. 807, 814-16 (1994).

[291] *See* RICHARD A. POSNER, OVERCOMING LAW 37-39 (1995).

[292] *See* Klausner, *supra* note 158, at 784 (describing these materials as part of "network" that increases value of state's law).

[293] *See* Ribstein, *supra* note 4.

[294] For studies showing courts' pro-forum bias, among other biases, in choosing the applicable law, see generally Patrick Borchers, *The Choice of Law Revolution: An Empirical Study*, 49 WASH. & LEE L. REV. 357 (1992); Michael E. Solimine, *An Economic and Empirical Analysis of Choice of Law*, 24 GA. L. REV. 49, 81-89 (1989); Stuart E. Thiel, *Choice of Law and the Home Court Advantage: Evidence*, 2 AM. L. & ECON. REV. 291 (2000).

lawmakers' incentives to link enforcement of contractual choice of law to parties' connections with the chosen jurisdiction,[295] in order to lure potential clients to their states, lawyers want to make the law of the state in which they are licensed attractive to those clients. Because clients tend to seek legal advice from locally licensed lawyers, the value of a lawyer's license to represent clients residing in the licensing state therefore depends on the quality of that state's law.

Whatever the mechanism, there is evidence that states *do* compete for law business by enforcing contractual choice of law. To begin with, the widespread enforcement of choice-of-law clauses discussed above[296] calls for some explanation. As discussed in Part III, a political theory that ignores party mobility is not fully satisfactory.[297] Accordingly, the mobility-based hypothesis is at least sufficiently plausible to justify exploring some of its implications.

There are more specific indications of state competition through enforcing contractual choice. First, there is evidence of the existence of a market for contractual choice. Many relatively large companies use choice-of-law clauses, thereby suggesting that there is a significant demand for enforcement. The University of Missouri's Contracting and Organizations Research Institute (CORI) has collected such contracts from publicly traded companies that disclose contracts in filings with the Securities and Exchange Commission.[298] The contracts are available on the SEC's EDGAR (Electronic Data Gathering and Retrieval) system.[299] A search of CORI's web database indicates that 4,507 of 8,583 contracts of various types had choice-of-law clauses.[300]

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[295] *See infra* notes 311-18 and accompanying text.

[296] *See supra* notes 27-51 and accompanying text.

[297] *See supra* notes 210-24 and accompanying text.

[298] These contracts are available at http://cori.missouri.edu. *See* Michael E. Sykuta, *Empirical Research on the Economics of Organization and the Role of the Contracting and Organizations Research Institute* (Dec. 19, 2001), *available at* http://cori.missouri.edu/WPS/Sykuta-CORI.pdf (last visited Feb. 5, 2003) ("Using a semi-automated screening process, we identify and extract contract documents from disclosure filings, provide some additional descriptive information, file the contracts by their respective transaction types, and then index them in the search engine.").

[299] Sykuta, *supra* note 298, at 7.

[300] The search, performed by the author on October 10, 2002, looked for contracts with the

Second, a further indication of the existence of a choice-of-law market is that parties often contract for the law of one of a relatively small group of states, indicating that they are not choosing a party's domicile or the jurisdiction where the particular transaction is based. Eighty-nine percent of the contracts with choice-of-law clauses select the law of only ten states, seventy-two percent select the law of four states, and twenty-six percent select the law of Delaware, one of the smaller states.[301]

Third, studies of the *incorporation* market suggest that there may be competition for noncorporate choice of law. Two recent studies have shown that firms tend to incorporate in their home states when they do not do so in Delaware.[302] There could be several possible explanations for this phenomenon: the drafting and widespread adoption of the Model Business Corporation Act may make the marginal benefits of Delaware incorporation less than the costs of Delaware franchise fees plus foreign incorporation fees for small and medium-sized firms; lawyers may be pushing clients toward states in which the lawyers are licensed and based in order to get their corporate business;[303] and firms may see a "home court advantage" when dealing with local legislators on issues such as takeover laws. This Article suggests the following additional explanation: home-state incorporation provides a state contact that helps persuade courts to apply that state's *noncorporate* law.

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phrase "laws of the state of." The individual state searches referenced to in this Article added the names of particular states.

[301] The specific count is New York (1187), Delaware (1183), California (489), Texas (403), Illinois (173), New Jersey (151), Minnesota (108), Florida (106), Ohio (100), and Georgia (96). This data on contractual designation of the applicable law does not seem to mesh with the data on states that are actually adjudicating choice-of-law contracts. For example, in my database of nearly 700 cases on choice-of-law clauses, Delaware was the law chosen in only 20 cases and was the forum in only 16 cases. This may be because the relative clarity of Delaware law promoted settlement in a relatively high percentage of cases in which the parties designated Delaware law. Note also that cases refusing to enforce contractual choice of law are concentrated in five of the foregoing states (California, Georgia, Illinois, New Jersey, and New York). *See supra* note 44 and accompanying text.

[302] *See* Lucian Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, Harvard John M. Olin Center for Law, Economics, and Business Discussion Paper No. 351 (2002), *available at* http://www.law.harvard.edu/faculty/bebchuk (last visited Feb. 5, 2003); *see generally* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559 (2002).

[303] *See* Daines, *supra* note 302, at 1580-82.

Although the home state is itself an important contact, and the state of incorporation may not be very significant in itself,[304] the latter contact may matter in marginal cases, where the firm needs the strongest possible argument in order to avoid the effect of regulation in another state where it has contacts. The prevalence of Delaware choice-of-law clauses in the CORI data[305] arguably supports this hypothesis by suggesting that some firms may be incorporating in Delaware in order to support application of Delaware contract law. Although Delaware courts might enforce the choice of Delaware law under Delaware's choice-of-law statute[306] even in the absence of other contacts, combining Delaware incorporation with Delaware choice of law may help persuade a non-Delaware court to apply Delaware law. This suggests that choice of noncorporate law may influence choice of corporate law.

Fourth, and most importantly for present purposes, the parties tend to choose states that have signaled their intention to compete in the choice of law market. The top five states, with a combined eighty percent market share—Delaware, New York, California, Texas, and Illinois—all have adopted statutes providing for enforcement of contractual choice of law in relatively large contracts, with the remaining statute state, Florida, in eighth place.[307] These statutes arguably reflect the legislatures' recognition that state courts may lack adequate incentives to enforce choice-of-law clauses.[308]

Fifth, the CORI data indicates that the choice of law market may be spreading and becoming less concentrated. A search of CORI's web database on March 27, 2002, about five months earlier than the most recent search,[309] found choice-of-law clauses in 3,122 of 5,619 contracts, with ninety-four percent (as compared with eighty-nine percent) of the contracts selecting the top ten states, seventy-six percent (as compared with seventy-two percent) selecting the top

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[304] *See supra* note 106 and accompanying text.
[305] *See supra* note 301 and accompanying text.
[306] DEL. CODE ANN. tit. 6, § 2708 (1974).
[307] *See supra* notes 60-82 and accompanying text.
[308] *See infra* notes 357-59 and accompanying text.
[309] *See supra* notes 298-301 and accompanying text.

four states, and Delaware leading New York twenty-eight percent to twenty-seven percent.

C. LAWMAKERS' INCENTIVES TO ENFORCE CONTRACTUAL CHOICE: THE ROLE OF STATE CONTACTS

The discussion in Part IV.B shows that party mobility gives lawmakers incentives to enforce choice-of-law clauses and to compete for choice-of-law business even if these activities might otherwise be contrary to lawmakers' interests.[310] This Part considers the role of an important limitation on enforcement. Specifically, courts and legislators generally provide for enforcement of choice-of-law clauses only if there is some connection between the parties or transaction and the contractually selected law.[311] In other words, territorial-type conflicts rules persist despite widespread enforcement of the clauses. This subpart gives a public choice explanation for the persistence of contacts requirements. The normative implications of these requirements are discussed below.[312]

As discussed in Part IV.B, lawmakers' incentives to enforce contractual choice derive significantly from the costs to local interest groups of discouraging firms' minimum contacts with nonenforcing states and the benefits of encouraging firms to reside in enforcing states.[313] This suggests that lawmakers will tend to condition enforcement on contacts with the chosen state. This is supported by the case law.[314] It is also reflected in the widely applied Restatement (Second) of Conflict of Laws section 187,[315] which provides for a threshold "substantial relationship . . . reasonable basis" test for applying the designated law.[316] This is limited by contravention of the fundamental policy of the state whose law would apply under

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[310] *See supra* notes 272-308 and accompanying text.

[311] *See supra* notes 27-62 and accompanying text.

[312] *See infra* notes 337-43 and accompanying text.

[313] The reference is to both courts and legislatures because, while courts decide litigated cases, legislators have the power to influence judicial rules. However, courts' and legislatures' incentives may differ, which may support legislative rules on enforcing contractual choice. *See infra* notes 352-63 and accompanying text.

[314] *See supra* note 35 and accompanying text.

[315] *See supra* note 27 and accompanying text.

[316] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971).

Restatement section 188, which in turn looks to factors relating to the location of the parties and of the contract.[317]

Table 2 illustrates the issues regarding state contacts and contractual choice. The lettered boxes indicate contacts in a hypothetical case. In the clearest cases, ACEGI or BDFHJ, courts presumably always would enforce the provision. The opposite case is enforcement even in the BCEGI or ADFHJ cases. A contacts requirement means that the courts do not enforce the clause in at least some—A***J or B***I—cases. The following discussion outlines some general considerations underlying connection requirements.[318]

TABLE 2: STATE CONTACTS AND CONTRACTUAL CHOICE OF LAW		
CONTACT	STATE X	STATE Y
COL Clause	A	B
P residence	C	D
D residence	E	F
Contract	G	H
Forum	I	J

Courts clearly have incentives, at least in some cases, to enforce choice-of-law clauses that designate non-forum law. Indeed, data on choice-of-law clause cases show that courts do enforce contracts choosing nonforum law in many cases.[319] This is consistent with the above analysis showing that, if a state completely closes the contractual exit, parties may respond by taking their business dealings to other states, thereby injuring interest groups within the state.[320] Lawmakers also have an incentive to strengthen the *stare decisis* effect of a rule that leads to enforcement of their own law by other states' courts. In other words, a court in State X can enhance the likelihood of enforcement of its own law in State Y by applying

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[317] *Id.* § 188.
[318] *See infra* notes 390-97 and accompanying text.
[319] *See supra* note 44 and accompanying text.
[320] *See supra* notes 275-79 and accompanying text.

State Y law under a general rule that supports converse treatment by the State Y court.[321]

Lawmakers require a party to have connections with the designated state as a prerequisite to enforcement because they care mainly about the state's ability to retain or attract residents. Applying forum law without a connection requirement may reduce firms' benefits from residing in the forum. Lawmakers would require a connection with a *foreign* designated state in order to encourage those states to require the same connection in the reverse situation, as explained above. That is particularly so if the effect of applying another state's law is foregoing enforcement of a local mandatory law. If lawmakers applied a general rule permitting enforcement irrespective of where parties resided, they might lose important benefits of enforcing mandatory laws and attracting plaintiffs without realizing any offsetting benefits from attracting residents. Moreover, this theory suggests that lawmakers will require a residence-type connection with the designated state rather than a more fleeting connection with the particular transaction. This is consistent with data showing that one or both of the parties generally resides in the designated state in cases where the choice-of-law clause is enforced.[322]

This theory seems to be inconsistent with the provisions of the statutes on contractual choice of law, since only Texas requires a significant connection with the designated state.[323] In other words, these states do not seem to be using their law to encourage contacts

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[321] This can be viewed as the reverse of the phenomenon in which courts risk encouraging avoidance of their own state's law by applying a general rule of enforcement of contractual choice that permits avoidance of another state's law. As in that situation, courts may be constrained by comity, in this case from enforcing contractual choice only to the extent that it would apply their own law. Here, however, a broader rule serves local interests. This theory meshes with reciprocity-based theories of choice of law. *See* LEA BRILMAYER, CONFLICT OF LAWS 181-218 (2d ed. 1995); Kramer, *supra* note 25, at 342-44; *see also* Michael E. Solimine, *The Law and Economics of Conflict of Laws*, 4 AM. L. & ECON. REV. 208, 222 (2002) (contrasting competition and cooperation models of choice of law). A problem with such theories is that it is not clear why states would cooperate since enforcing states would lack an effective way of disciplining nonenforcing states. *See* O'Hara & Ribstein, *supra* note 1, at 1177. The answer suggested in this Article is that the rule is self-enforcing in that states' departure from it weakens the state decisis effect of the rule and therefore their own benefit from it.

[322] *See supra* notes 44-45 and accompanying text.

[323] *See supra* notes 63-82 and accompanying text.

with the state, but rather only to encourage local litigation. This might be explained by the fact that the statutes generally exclude controversial cases and apply only to large, nonconsumer litigation. In these categories of cases, the relatively small benefits the state gets from attracting litigation may be sufficient without also requiring a connection with the state. More importantly, the statutes generally apply only to the choice of the enacting state's law, meaning that they do not invite override by the law of another state. This Article predicts that states enacting more general choice-of-law statutes would require a residence-type connection with the designated state.

Lawmakers would not necessarily have an incentive to enforce contractual choice in every case in which parties have contacts with the designated jurisdiction. The incentive to attract, or not repel, residents may be outweighed by strong interest group support for particular mandatory laws. Accordingly, lawmakers may resist enforcement of contractual choice where it would override such laws. Consistent with the above analysis, they would be concerned not only about a *local* mandatory law, but also about supporting a rule that would permit escape from the forum state's law in a case brought in another state. Such a limitation is generally consistent with Restatement section 187(2)(b).[324]

There is a significant exception to Restatement-type rules requiring contacts with the chosen jurisdiction where a corporation chooses a state law to govern relationships among the parties to the firm. In this case, courts generally enforce the contractual choice without requiring any contacts between the firm and the state of incorporation.[325] This Article's explanation of enforcement of contractual choice based on lawmakers' incentives helps explain the special treatment of corporate cases. The foreign corporation fees paid by firms that are doing business in states where they are not incorporated arguably give lawmakers an incentive to enforce contractual choice in corporate cases even without other connections between the firm and the incorporating state. The fee, in effect, substitutes for the benefits conferred by local residence in the above

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[324] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2)(b) (1971 & Supp. 1988).

[325] *See supra* notes 83-108 and accompanying text.

analysis. The foreign incorporation fee arguably encourages lawmakers to apply other states' laws in the same way that the corporate franchise fee encourages states to fashion their corporate laws so as to attract incorporation business.[326]

Assuming that foreign corporation fees motivate lawmakers to enforce foreign corporation laws, this raises the question of whether a fee-based system could substitute for a contacts-based system in giving legislators an incentive to enforce other types of choice-of-law contracts. Corporations may be an exceptional case because corporate governance rules are mainly enabling and noncontroversial.[327] Also, any costs of corporate governance rules generally are not focused on a particular interest group, while firms generally benefit from these rules.[328] In other choice-of-law cases, where contractual choice of law may avoid mandatory rules favored by influential local interest groups, groups that are helped by enforcement of contractual choice may influence lawmakers. This may explain why courts are reluctant to enforce contractual choice of law in noncorporate contracts based solely on selection of the incorporating state.[329] In other words, although the incorporation fee is enough to buy application of corporate governance rules, it may not be enough to buy application of other types of laws.

V. EFFICIENCY IMPLICATIONS OF FIRM MOBILITY

This Article has presented a political theory of enforcement of contractual choice under which contracting parties' mobilities give

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[326] *See* Romano, *supra* note 142, at 235-65 (discussing incentive effect of corporate franchise fee). A problem with this analogy between corporate fees and party contacts is that, unlike party contacts, which can affect politically powerful interest groups, fees would seem to be of interest mainly to the diffuse and uncoordinated group of taxpayers to the limited extent that the fees substitute for tax revenues. Thus, as discussed *supra* in notes 283-87 and accompanying text, it is necessary to find some other incentive for state competition in this area.

[327] *See* John C. Coffee, Jr., *The Modern Market for Corporate Charters: Competition, Collusion, and the Future*, 25 DEL. J. CORP. L. 87, 94 (2000) (observing that "[d]eference to the state of incorporation . . . does not as a practical matter mean deference to any distinctive racial, religious, ethnic, or political group").

[328] Indeed, state governments and their legislators are investors in corporations through their pension plans. *See* Note, *supra* note 83, at 1500.

[329] *See supra* notes 106-07 and accompanying text.

state lawmakers incentives to enforce contractual choice of law. This analysis raises the question of whether lawmakers have incentives to enforce in all situations in which enforcement is efficient, or in situations in which enforcement is inefficient. If lawmakers' incentives do not align with efficiency, this might support adoption of federal law or some other constraint that compels or limits enforcement of contractual choice.

This Part shows, in fact, that lawmakers' incentives to enforce contractual choice generally do align with efficiency. Part V.A shows that interest groups favoring enforcement of contractual choice compete with proponents of mandatory laws, so that lawmakers will have an incentive to enforce choice of law contracts only when interest group support for mandatory laws is relatively weak.[330] As discussed in Part V.B, the link between lawmakers' incentives to enforce contractual choice-of-law and contracting parties' contacts with the contractually selected state[331] helps ensure that lawmakers will enforce contractual choice when, and only when, it is efficient.[332] Part V.C gives reason to expect that the lawmaking competition spurred by enforcing contractual choice will lead to more efficient laws.[333]

A. THE SELF-LIMITING EFFECT OF INTEREST GROUP COMPETITION

Lawmakers' incentives lead them to block avoidance through contractual choice-of-law of at least those mandatory rules that have strong local support. To be sure, it may follow that contractual choice-of-law is not enforced in all cases in which it is efficient. But this Article's review of the case law shows that nonenforcement is the exceptional case.[334] Indeed, a high percentage of cases that refuse to enforce contractual choice deal with two specific types of contracts, franchise agreements and noncompetition agreements.[335] This indicates that contractual choice is ineffective only when an

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[330] *See infra* notes 335-36 and accompanying text.
[331] *See supra* notes 311-29 and accompanying text.
[332] *See infra* notes 337-43 and accompanying text.
[333] *See infra* notes 344-50 and accompanying text.
[334] *See supra* notes 38-51 and accompanying text.
[335] *See supra* notes 41-42 and accompanying text.

interest group's gain from the regulation is substantial. At the same time, if the law imposed very high costs on a regulated group, one would expect the group to exert significant lobbying or exit pressure on the regulating state. Put simply, lawmakers' incentives help protect against a situation in which mandatory laws with weak benefits to the beneficiary group are enacted despite high costs to the poorly-coordinated regulated group.[336]

B. THE NORMATIVE ROLE OF CONNECTION REQUIREMENTS

This Part shows how requiring some connection between the parties and the contractually designated state helps distinguish efficient from inefficient enforcement of contractual choice of law. Connection requirements accomplish this task by encouraging bundling of legal rules and by focusing the effects of contractual choice on the spillover situation, where state mandatory rules are most likely to be inefficient.

1. Bundling. Lawmakers' incentives to condition enforcement of contractual choice on the contracting parties' residence in the designated state help constrain inefficient enforcement of contractual choice by bundling choice of residence with the choice of the state's laws. For example, a seller's contractual choice of its state of residence is more likely to be enforced across all of its contracts than its choice of the laws of some other state. To be sure, the law of the seller's state of residence will not be applied for all purposes in all cases. But a contacts requirement ensures that a party's choice of residence at least affects enforcement of the party's choice-of-law contracts.

This system allows for some competition among regulatory regimes while preserving states' power to protect against inefficient contractual choice.[337] Parties seeking enforcement of contractual choice through their choice of a state of residence have an incentive

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[336] This is similar to Becker's theory of interest group competition, *see generally* Becker, *supra* note 216, with the added dimension that opposition groups can exert pressure by exit as well as by lobbying. *See infra* note 350 and accompanying text. For a further discussion of this issue and of a proposed statutory provision implementing this interest group constraint on inefficient mandatory rules, see *infra* notes 410-11 and accompanying text.

[337] *See supra* notes 174-206 and accompanying text.

to choose the regime that provides the benefits they most need even if the jurisdiction also includes some mandatory rules. Conversely, regulators must decide which issues are most appropriate for mandatory regulation, since general over-regulation may cause valuable firms to exit for more flexible regimes.

In addition to the bundling that is promoted by connection rules, states can enact bundling regimes for particular categories of law. A prominent example is corporate choice-of-law rules that require incorporating firms to choose the state's entire bundle of corporate law. This reflects the unitary nature of corporate laws, where various types of governance provisions must mesh to provide a coherent set of rules.[338]

2. Contacts and Spillovers: The Effect on Interstate Firms. Lawmakers arguably have better incentives to regulate in areas in which those with the greatest political clout incur most of the costs and benefits.[339] This will be especially true for firms located within a single state. Conversely, interstate firms may have the most need to escape mandatory rules. Requiring the parties to have some connection with chosen law tends to make choice-of-law clauses more valuable for interstate than for intrastate firms. A firm that transacts business in many states necessarily can choose among those states in locating headquarters or other important facilities while maintaining contacts with customers and suppliers. By contrast, an intrastate company incurs extra costs if it locates its main office anywhere other than its state of operations.

It follows from the above discussion of the differential effect of contractual choice on in-state and interstate firms[340] that enforcement of contractual choice of law provides the most discipline for lawmakers in situations where it is most likely to be useful in protecting against inefficient regulation because of the potential for spillovers.[341] As discussed above,[342] national firms may be subject

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[338] *See* Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 381-82 (1995).

[339] *See* Guzman, *supra* note 1, at 909-13.

[340] *See supra* notes 234-63 and accompanying text.

[341] *Cf.* Merritt B. Fox, *Regulation FD and Foreign Issuers: Globalization's Strains and Opportunities*, 41 VA. J. INT'L L. 653, 673-81 (2001) (making similar point about exemption of foreign firms from Regulation FD).

[342] *See supra* notes 118-29 and accompanying text.

to firm-wide costs because of a regulator's actions at a single state node. State laws might be passed despite their inefficiency because of the lobbying of a well-coordinated in-state group in the regulating state over the objection of a national firm whose lobbying resources are more dispersed. Enforcing contractual choice helps interstate firms mitigate the effect of regulation by exit when they are unable to do so using the political process.

This difference between intrastate and interstate firms regarding the effect of contractual choice is one important way that permitting opt-out through contractual choice differs from permitting opt-out through direct waiver. Enforcing contractual choice of law facilitates exit by the firms that are most threatened by inefficient state legislation.[343] By contrast, building a waiver provision into the substantive law would permit exit by all firms.

C. INCENTIVES TO ADOPT EFFICIENT LAWS

The discussion thus far focuses on lawmakers' incentives to enforce contractual choice in situations where it is efficient to do so, and their incentives to compete to supply law. The remaining question is whether such enforcement and competition is likely to lead to efficient laws.

As with the existence of lawmaking competition, the efficiency of the competition turns on the role of lawyers. Lawyers' use of local law to attract clients arguably encourages lawyers to advocate adoption of efficient laws. Lawyers as a group probably could not increase their business by advocating laws that transfer wealth from one set of parties to another. If contracting parties choose the law and designate a forum likely to apply that law in their contracts rather than at the time of suit, they will want to choose the law and forum that maximize their joint welfare. Also, the effects of laws on particular parties may be unclear at the time of firms' location decisions. If firms cannot determine in advance whether they will

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[343] Somewhat analogously, *O'Hara*, *supra* note 1, at 1603, views opting out through contractual choice of law as targeting different group than those who would use direct waiver, though it is not clear how this works given relatively trivial costs of adding choice-of-law clause to contract. The explanation becomes more plausible in light of the costs of manipulating state contacts and learning about alternative laws.

be winners or losers, they will tend to choose such laws based on overall efficiency rather than possible wealth-transferring effects.

The evolution of the law on closely held firms provides evidence of lawyers' role in promoting efficient law. Competition in this market cannot readily be explained by conventional theories based on franchise fees.[344] But there is evidence of active lawyer involvement in the drafting and promotion of limited liability company statutes.[345] There is also evidence that these statutes have evolved toward more efficient provisions[346] and toward an efficient level of uniformity.[347]

This theory of lawyers' role in lawmaking depends significantly on state lawmakers' incentives to condition enforcement of contractual choice on a connection between the parties or transaction and the chosen law. If contracting parties could choose any state law regardless of where they reside or litigate, lawyers would have no incentive to push for adoption of efficient laws based solely on exclusive access to clients residing in their licensing state or to the courts of that state. In other words, the contacts required for enforcement of contractual choice give lawmakers incentives not only to support the enforcement of contractual choice, but also to improve the law so it will be chosen. This is another reason for concluding that the constrained mobility under current rules is more efficient than unconstrained mobility that does not require state contacts.

There are, to be sure, alternative hypotheses concerning lawyers' influence on the law. First, Macey and Miller argue that Delaware lawyers can exploit Delaware's dominance in the market to cause the enactment of corporate rules that favor lawyers' interests without concern that firms will incorporate elsewhere.[348] However, even if Macey and Miller's argument explains Delaware corporate

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[344] *See* Ayres, *supra* note 286, at 372-78.

[345] Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?*, 45 SYRACUSE L. REV. 1193, 1222-62 (1995).

[346] Ribstein, *supra* note 157, at 373-84, 403-11.

[347] Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity*, 34 ECONOMIC INQUIRY 464, 468-77 (July 1996), *reprinted in* UNCERTAINTY AND ECONOMIC EVOLUTION: ESSAYS IN HONOR OF ARMEN A. ALCHIAN (John Lott ed., 1997).

[348] Macey & Miller, *supra* note 289, at 506-09.

law, it does not apply to legal rules where lawyers are not so dominant.

Second, it might be argued that lawyers advise clients to choose the law in which they have expertise whether or not this serves clients' interests, rather than clients making an initial jurisdictional choice that leads them to lawyers in the jurisdiction.[349] Although this argument is plausible for unsophisticated individuals or relatively small firms, it is less plausible for larger firms advised by in-house legal departments or multi-jurisdictional law firms that do not have incentives to guide clients to particular states. Multi-jurisdictional firms in particular could be expected to compete for business in part on the basis of their ability to advise clients with multi-jurisdictional legal problems. States would be likely to care most about encouraging these larger firms to establish local contacts. This suggests that the firms that are most informed about states' laws, rather than less-informed firms or self-interested lawyers, are likely to dominate the market for state law.

Lawyers' incentives to promote efficient state laws will not necessarily dominate in all situations. For example, firms have varying abilities to avoid regulation. Thus, lawmakers and interest groups arguably can benefit from wealth-transferring laws whenever the law regulates firms whose moving costs exceed regulatory costs. This might be the case, for example, where firms have significant fixed assets, such as factories, or land in the state, or where the state offers unique benefits such as natural resources or human capital. Lawmakers and interest groups may be able to gain enough from regulating those firms to make regulation worthwhile despite other firms' ability to exit. On the other hand, even if some firms are stuck in the state, enough may be mobile that lawmakers have incentives to adopt general rules favoring enforcement of contractual choice of law.

More serious problems for the theory are presented in areas of law where law practice focuses on individuals who deal only sporadically with the law, such as divorce or estate planning.

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[349] *See generally* John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CAL. L. REV. 1301 (2001) (showing that IPO companies' selection of law firms affects anti-takeover charter provisions these companies choose in going public).

Lawyers who specialize in these areas are unlikely to be concerned about the law's effect in causing clients to move away from the state. Also, tort lawyers have much more incentive to care about litigation-friendly rules than about how such laws influence firms' location decisions. Thus, although firms may be able to avoid the worst laws through exit, they may not be able to rely on lawyers to actively develop efficient tort law. This arguably suggests a broader role for law-reform organizations in some areas of the law than in others.

In general, the above theory of state competition through enforcement of contractual choice of law adds an important dimension to public choice theory. Although interest groups and rent-seeking by politicians still matter, states' interests in inducing parties to contract for application of their laws provides a counter-force in the direction of efficiency. Thus, the problems of over- and under-regulation by subordinate jurisdictions in a federal system such as the United States may be less serious than might seem to be the case based solely on traditional interest group theory. Viewed solely from the perspective of a single political jurisdiction, the ability of interest groups to engineer wealth transfers depends mostly on disparities in coordination costs. As Gary Becker has shown, at some point the wealth transfer will exceed the disparity, and the transferee group will be able to resist the transfer.[350] The present Article shows that interest group transfers are further constrained by parties' ability to contract for law, forum, and adjudicator, to avoid contacts with jurisdictions that refuse to enforce these contracts, and to choose to reside in permissive jurisdictions.

VI. A MODEL LAW FOR ENFORCING CONTRACTUAL CHOICE

Although the above analysis shows the general consistency between normative and positive theories of enforcing contractual choice, it does not necessarily warrant a Panglossian view that the rules are entirely aligned with efficiency. In particular, although this Article has thus far considered state "lawmakers" as a unit, it may in fact matter whether courts or legislatures make the rules on

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[350] Becker, *supra* note 216, at 373-96.

enforcement of contractual choice. It follows that there may be advantages to adopting explicit legislative rules on enforcement of contractual choice rather than leaving enforcement to case-by-case judicial lawmaking.

There also may be advantages in proposing a specific model statute. In general, model laws could assist states that lack expertise in developing new types of legislation.[351] More importantly for present purposes, specific proposed language would serve to highlight issues raised by this Article.

This Part proposes a model provision that states might use as the basis of a stand-alone statute on contractual choice, as in the California, Delaware, Florida, Illinois, New York, and Texas statutes, or of the contractual choice portion of a general Oregon-type statute.[352] Part VI.A discusses the advantages of legislative rules in this area,[353] Part VI.B outlines and discusses a proposed rule,[354] and Part VI.C discusses how this rule might be embodied and adopted.[355]

A. LEGISLATIVE VERSUS JUDICIAL RULES ON CONTRACTUAL CHOICE

Legislative choice-of-law rules have advantages over judicial rules. This is indicated to some extent by the fact that courts in a few states have chosen to take contractual choice of law out of the judiciary's hands.[356] The advantages of statutes in this area relate to two inherent aspects of judicial lawmaking—differing susceptibility to interest group pressure and reliance on case-by-case adjudication.

1. The Differential Effect of Interest Groups. Judges' exposure to interest group pressure depends significantly on whether they are elected or appointed. Elected judges are more subject to the

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[351] *See generally* Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and Limited Liability Companies*, 66 U. COLO. L. REV. 947 (1995). However, this observation probably applies more to a law proposed by an expert group with a broad membership and substantial reputation than to one proposed in a law review article.

[352] *See supra* notes 63-82 and accompanying text.

[353] *See infra* notes 357-63 and accompanying text.

[354] *See infra* notes 365-429 and accompanying text.

[355] *See infra* notes 430-48 and accompanying text.

[356] *See supra* notes 63-82 and accompanying text.

particular interests of those who are repeat players in litigation. These groups also may play a role in legislative elections, but there they are more subject to competition by other groups. Although elected judges may be influenced by both sides in litigation, including both plaintiff and defense lawyers and repeat defendants such as manufacturers, their incentives specifically regarding enforcement of contractual choice likely will be tilted toward nonenforcement. Because parties favoring enforcement of contractual choice usually will be based out-of-state, they likely will have less political clout in the state.[357] Appointed judges, on the other hand, are less subject to direct interest group pressure than legislators.[358] They do not need to raise funds for election, so that any electoral pressure is filtered through the politicians who appoint them.

Elected and appointed judges' different susceptibilities to interest group pressure have mixed effects on their incentives to enforce contractual choice of law because of the effects of contractual choice on interest group behavior discussed in this Article. Interest groups that favor regulation, including lawyers who gain from litigation under regulatory statutes, would tend to oppose enforcement of contractual choice. On the other hand, interest groups that lose from regulation, either directly or indirectly because of exit by regulated parties, will tend to favor enforcement. Thus, elected judges do not necessarily have less incentive than appointed judges to enforce contractual choice.

To the extent that judges are not subject to interest group pressure, their personal interests will tend in the direction of nonenforcement. Judges may be unwilling to expend resources to decide cases without an opportunity to enhance their power and prestige by providing the rule of law. And courts may gain from expanding their dockets by attracting plaintiffs who seek to avoid enforcement of contractual choice, as long as funding and staffing

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[357] *See supra* note 118 and accompanying text.

[358] *See* Stephan, *supra* note 1, at 193-202 (arguing that judges and lawyers are less susceptible than legislators to interest group pressure, and therefore choice-of-law rules rather than legislators). However, as discussed in the text, susceptibility depends on whether the judges are elected or appointed, and interest groups may have positive as well as negative effects on lawmakers' incentives from the standpoint of social welfare.

keep pace with the increase in workload.[359] In summary, both elected judges' exposure to interest group pressure, and appointed judges' absence of exposure to such pressure, give judges less incentives than legislatures to enforce choice-of-law clauses.

2. Benefits and Costs of a Clear Legislative Rule. A statute specifying the circumstances in which contractual choice is enforced substitutes a clear rule for the relative unpredictability of case-by-case adjudication under a broad Restatement-type test.[360] This has both benefits and costs apart from the differing incentives of the lawmakers discussed in Part VI.A.*1*.[361] The main benefit of relying on clear rules rather than case-by-case adjudication is notifying the parties of the effect of their contract at the time of entering into it.[362] This notice can aid pricing and design of contract terms and reduce litigation costs.[363] The main cost of specific statutory rules is that a more open-ended Restatement-type test gives courts the flexibility to determine the costs and benefits of enforcing contractual choice in particular circumstances. The benefit of flexibility, of course, depends on the courts' incentives to make efficient decisions. While legislators may be deterred from clearly inefficient limitations by party mobility and interest groups, courts may lack similar constraints, as discussed in Part VI.A.*1*.[364]

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[359] Where funding and staffing do not keep pace, judges' incentives may tend toward enforcement. *See* Note, *supra* note 83, at 1501 (noting that courts may be unwilling to discard corporate internal affairs doctrine, one form of contractual choice of law, because of financial burden on forum courts from additional litigation brought by plaintiffs seeking to avoid internal affairs rule).

[360] Note that this benefit is not a necessary attribute of legislative rules, as distinguished from the specific rule proposed in this Article. A legislature theoretically could adopt a test similar in flexibility to that in RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971). However, this attempt to accommodate various approaches in a vague standard may be characteristic of what can emerge from the Restatement process. *See generally* Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595, 618-19 n.49 (1995). Conversely, a state enacting a statute on contractual choice is likely doing so in order to effectuate a specific policy on this issue. Indeed, the choice-of-law statutes discussed all provide for broader enforcement than the Restatement. *See supra* notes 63-82 and accompanying text (discussing choice-of-law statutes in Delaware, Florida, California, Illinois, New York, and Texas).

[361] *See supra* notes 357-59 and accompanying text.

[362] *See* WHINCOP & KEYES, *supra* note 1, at 38.

[363] *See supra* notes 63-82 and accompanying text.

[364] *See supra* notes 357-59 and accompanying text.

B. A PROPOSED STATUTORY RULE ON CONTRACTUAL CHOICE

Enforcing contractual choice of law generally is consistent with assumptions that contracting parties act rationally in their own interests and that the contract does not materially affect the interests of third parties. Under these assumptions, choice-of-law clauses represent Pareto efficient trades (*i.e.*, no party is made worse off by the clause). Moreover, the political analysis in Part IV suggests that a rule favoring enforcement will tend to reflect legislative intent in most cases because of legislators' concern about exit of transferor interest groups in reaction to nonenforcement of contractual choice.[365] On the other hand, there are also normative arguments against enforcement discussed in Part II.E[366] and political incentives not to enforce discussed in Part IV.[367] This Part proposes a model legislative rule on enforcement of contractual choice of law that attempts to accommodate these various considerations. This proposal comports with this Article's emphasis on evolution over top-down rules[368] in the sense of eschewing federal or other imposed solutions. The proposed model rule will compete with other proposals in the spontaneous ordering process.

The proposed rule is as follows:

> A. Subject to Section B, a court shall enforce, without regard to rules or principles of conflict of laws contained in any statute other than this Act, a written provision of a contract expressly providing that all or specified issues relating to the contract shall be governed by or construed under the laws of a State designated in such provision (the "designated state").

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[365] This analysis assumes the efficiency of "majoritarian" defaults in the legislative setting. Nonmajoritarian defaults may be justified in some contractual settings in order to force the party with information to disclose. *See* Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 760 (1992). However, this argument does not apply in the legislative setting in which there is no occasion for forcing disclosures.

[366] *See supra* notes 174-208 and accompanying text.

[367] *See supra* notes 226-329 and accompanying text.

[368] *See supra* note 142 and accompanying text.

B. Section A shall not apply to a contract if its enforcement is prohibited by a statute that explicitly applies to the specific type of contract, or a judicial rule that explicitly applies to the specific type of contract and that would have applied to the case prior to the enactment of this statute, unless
   (1) The contract provides that the case will be adjudicated in the designated state;
   (2) The parties to the contract are subject to the jurisdiction of the courts of, or arbitration in, the designated state either as provided by law or in the manner specified in such writing;
   (3) One or more parties to the contract resides in the designated state; and
   (4) No party to the contract resides in the state that prohibits enforcement.
C. This law shall not affect the validity of any contract other than one described in Sections A or B.
D. This law states the policy of this state regarding the law to be applied to a contract that is governed by or construed under the laws of this State pursuant to this section.

This statute applies only to choice-of-law clauses in contracts. It validates a specific category of such clauses, but does not invalidate noncomplying clauses. If there is no contract, or if the contract is not enforceable either per se under this statute or otherwise, then general "default" choice-of-law rules would apply. The proposed statute is generally consistent with the case law described above[369] in that it provides for general enforcement of contractual choice, subject to exceptions based on party contacts with the designated jurisdiction and regulation by jurisdiction with which parties have contacts.

This statute is based loosely on the choice-of-law statutes discussed above.[370] Like most of these choice-of-law statutes (the

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[369] *See supra* notes 27-62 and accompanying text.
[370] *See supra* notes 63-82 and accompanying text.

exception is Oregon), the proposed statute is not subject to an open-ended, fundamental, policy-type exception. Unlike most other statutes, it is not limited to choice of the enacting state's law or to contracts involving large dollar amounts, and it supercedes the Uniform Commercial Code ("UCC") choice-of-law provision.[371] Consistent with this Article's efficiency analysis of contractual choice,[372] the proposed statute broadens the presumption favoring enforcement of contractual choice, while preserving states' power to opt-out of enforcement with specific laws. Although the states so far have not been willing to expand statutory enforcement of contractual choice to the point reflected in the proposed statute, the proposed expansion is consistent with data showing increasing use and enforcement of contractual choice.[373] A model law may encourage states to pass statutes that reflect and further promote this trend.

Other notable features of the model statute consistent with this Article's analysis and discussed below in this Part are that the statute requires the choice of a single law to govern all or part of the contract, and it qualifies application of the designated law by requiring residence in the designated state, thus permitting override by a specific statute of a state in which a party resides.

1. Nature and Scope of Clauses Enforced. The choice-of-law provision referred to here may be one entered into at the time of the contract to which it refers. This permits the parties to shape their conduct in light of the chosen law. However, the general considerations discussed in this Article also apply to an agreement entered into at any other time, including at the time of the dispute. The contractually selected law represents the parties' mutual choice, and therefore presumably serves their combined interests.[374]

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[371] *See supra* note 75 and accompanying text (discussing U.C.C. § 1-105).

[372] *See supra* notes 113-206 and accompanying text.

[373] *See supra* note 52 and accompanying text (illustrating Table 1).

[374] The parties might agree to a "floating" choice-of-law clause in which the law is to be designated at the time of litigation, perhaps by one of the parties, as a means of dealing with uncertainty. WHINCOP & KEYES, *supra* note 1, at 42. The parties may be unable to foresee what sort of dispute would arise and therefore what type of law would be appropriate to resolve it. Allowing a particular party to designate the law also helps minimize the risk of opportunism by the other party. *Cf.* Gen. Envtl. Sci. Corp. v. Horsfall, 753 F. Supp. 664, 675 (N.D. Ohio 1990) (enforcing choice-of-law provision in contract stating Ohio party would sue

The statute requires the choice-of-law clause to be express and in writing even if other provisions of the contract to which the clause applies are not. This reflects the need for certainty as well as the importance of the designated law, including as the basis for adjudicating the validity of the rest of the contract. In order to be covered by the statute, the clause must expressly state that all or particular issues are to be governed by or construed under the designated law. By contrast, the Oregon conflict-of-laws statute applies not only to an "express" choice, but also to one that is "clearly demonstrated from the terms of the contract."[375] The narrower proposed language encourages the parties to clarify their contractual choice in order to enhance the predictability effect of the statute.[376]

The statute potentially conflicts with the "internal affairs" rule relating to corporate governance when an explicit contract provides for application of nonincorporation state law.[377] This suggests that states should specify whether the internal affairs rule or the general contractual choice rule applies in the event the parties purport to contract for the application of nonincorporating state law to corporate governance.[378]

Unlike existing choice-of-law statutes, the proposed statute applies to all contracts, including small consumer-sized contracts and those that are otherwise subject to the Uniform Commercial Code. As discussed previously,[379] arguments against enforcement of contractual choice regarding consumer contracts are weaker than some commentators have supposed and do not support a categorical

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under Swiss law and Swiss party would sue under Ohio law).

[375] *See* H.B. 2414, 71st Leg. Assem. (Or. 2001) (to be codified at OR. REV. STAT. § 81.120).

[376] Note that a court may decide that the clause is not per se validated by the statute but still supports application of the designated law under common law choice-of-law rules. On the other hand, again in order to enhance predictability, the proposed language does not include the Oregon statute's conspicuousness requirement for standard form contracts. *Id.* A state may accomplish a similar objective through more precise means by imposing a specific disclosure requirement, as discussed below in Part VI.B.6. *See infra* notes 418-29 and accompanying text.

[377] *See supra* note 89 and accompanying text.

[378] It has been suggested that states might clarify the contractual nature of the internal affairs rule. *See* Note, *supra* note 83, at 1499 n.116. This would intensify the conflict with the general contractual choice statute.

[379] *See supra* notes 174-206 and accompanying text.

rule against enforcing this type of clause. To the extent that legislatures conclude that consumer transactions require protection, the proposed statute provides for a specific exception for such laws. A broad presumption of enforceability in consumer cases reduces the costs of adjudicating application on a case-by-case basis, as where the courts must determine the jurisdictional amount or resolve questions concerning whether the case is covered by the UCC or other statute. In any event, the proposed statute is similar to the current UCC in emphasizing the parties' relationship to the designated state.[380] The main difference is that the residence standard in the proposed statute makes the nature of the required relationship generally consistent with the case law under the UCC.[381] The tradeoff is that the proposed statute includes an exception to enforcement based on a specific type of mandatory rule even where a party is connected to the designated state.[382]

The proposed statute permits enforcement of contractual choice as to any issue "relating to the contract." This could include contract validity, tort, or procedural issues.[383] This scope contrasts with the Oregon statute, which applies only to the "contractual rights and duties of the parties."[384] Requiring legal characterization of particular issues would impair predictability while providing little benefit because legal distinctions between tort and contract or substance and procedure do not turn on policies that should control enforceability.[385]

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[380] *See* Woodward, *supra* note 36, at 732 n.164 (noting that Restatement § 187(2) and U.C.C. § 1-105 effectively permit choice of vendor's state law because of relationship with parties or with transaction).

[381] The few exceptions to enforcement in this situation relate to mistakes and unforeseen circumstances. *Id.* at 716-17.

[382] An analogous tradeoff between connection requirements and fundamental policy exceptions explains the proposed statute's differences from the revised UCC provisions. *See supra* notes 78-82 and accompanying text. The proposed statute differs from the revised UCC provision applying to business transactions in requiring a specified connection with the designated law and defining the exception for mandatory rules. It differs from the revised UCC provision for consumer transactions mainly in specifying the nature of the relationship required with the designated state.

[383] *See infra* notes 424-29 and accompanying text.

[384] OR. REV. STAT. § 81.120 (2001).

[385] Of course the contracting parties might agree to a narrower clause. Parties often have done so, possibly to ensure enforceability. *See supra* notes 55-62 and accompanying text. Narrow drafting accordingly may be less necessary if the statute explicitly provides for

Consistent with Restatement (Second) of Conflict of Laws section 187(1), section A of the proposed statute validates contractual choice where there is no conflict with mandatory rules.[386] Section B(4) defines the relevant mandatory laws as those of a place where a party resides. In other words, if no party resides in a jurisdiction with a mandatory rule, the choice-of-law clause is enforceable without regard to the rest of the statute.[387]

Section C clarifies that the statute does not preclude the application of rules that more broadly authorize contractual choice in other cases. Thus, the proposed statute can be regarded as a general "default" choice-of-law rule that clarifies enforceability in a particular class of cases not covered by more specific statutes.

A final issue regarding the proposed statute's scope is whether, in light of the arguments favoring enforceability of contractual choice, the statute should have a broader validating effect. One constraint on breadth is a concern that choice-of-law provisions allow parties to evade efficient mandatory rules.[388] Moreover, because choice-of-law statutes reduce legislators' rent-seeking ability, broader statutes have less chance than narrower statutes of being widely adopted. To the extent that a national standard of enforceability of contractual choice is desirable,[389] the model statute should focus on establishing a clear area of consensus.

2. Requisite Connection with Enacting and Designated State. There is an issue as to whether the proposed statute should make its validating effect contingent on whether the contract has some other connection to the state whose law is designated in the contract where the choice-of-law clause overrides regulation of a state whose law may apply.[390] Most contractual choice statutes validate contractual designation of the law of the *enacting* state even without contacts with the *designated* state.[391] However, Restatement (Second) of Conflict of Laws section 187(2)(a) requires a "reasonable

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enforcement of broader clauses.

[386] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(1) (1971 & Supp. 1988).

[387] *See infra* notes 393-97, 416 and accompanying text.

[388] *See supra* notes 204-08 and accompanying text.

[389] *See infra* note 431 and accompanying text.

[390] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(1) applies the contractual choice to interpretation issues irrespective of any contacts with the designated state.

[391] *See supra* notes 63-82 and accompanying text.

basis" for designating a particular state's law.[392] Although this does not explicitly impose a contacts requirement, in most cases in which choice-of-law clauses have been enforced a party resided in the designated state.[393] Contact requirements give the designated state incentives to enact laws that encourage contracting parties to maintain the requisite connections.[394] These connections, in turn, confer benefits on local interest groups that provide the "feedback mechanism" necessary to encourage state competition.[395]

The proposed statute requires specific types of connections—a party's residence (which could include, for a firm, the principal place of business) in the designated state and an agreement to litigate the case in the designated state. Requiring bundling choice of forum and law gives local litigators incentives to promote adoption of laws that are presumptively efficient because both contracting parties would select them. Also, requiring adjudication in the designated state means that courts apply local law, a task to which they bring more attention—because of the precedential weight of their decisions—and expertise than do foreign state courts.

Requiring the specific connection of residence in the designated state gives transactional lawyers and other in-state groups incentives to favor the adoption of efficient laws in order to attract, or not repel, economically significant businesses.[396] To be sure, requiring residence in the designated state arguably reduces the efficiency of competition by restricting the range of party choice. But there is a tradeoff between giving parties more states to choose from and ensuring competition that is more likely to produce an efficient range of choices.

Like Restatement section 187, the proposed statute does not specify which party must reside in the designated state as a threshold requirement for enforcing the contract. As long as one contracting party resides in the designated state, the state will internalize at least some benefits or costs of the regulation. The

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[392] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2)(a) (1971).
[393] *See supra* note 45 and accompanying text.
[394] *See supra* notes 311-20 and accompanying text.
[395] *See supra* notes 280-82 and accompanying text.
[396] *See supra* notes 311-29 and accompanying text.

question of whether residence in a nondesignated regulating jurisdiction should matter is discussed below.[397]

There are further questions concerning other possibly relevant connections and qualifications that the proposed rule does *not* take into account. In particular, transitory contacts with the transaction neither give lawmakers incentives to enforce contractual choice and enact efficient laws, nor ensure internalization of the costs and benefits of regulating the transaction or enforcing contractual choice. Although requiring the transaction to connect with a particular state may "bundle" all of that state's law with the transaction, this is not assured because the transaction may touch different states. Thus, as discussed in the next subsection, bundling is best required directly.

The proposed statute directly applies only in the states adjudicating the enforcement of choice-of-law clauses. This direct effect may include either applying local law where that law is designated by a contract that is subject to the statute, or *not* applying local law where some other law is designated even if local law would apply in the absence of a choice-of-law clause. In the latter situation, the court may send the case to the designated state on *forum non conveniens* grounds.

Pursuant to section D of the proposed statute, a nonenacting state also should take another state's adoption of the statute into account in deciding the intended scope of that state's law, and therefore whether to apply that law. Specifically, a nonenacting state should not apply the enacting state's regulatory statute to a contract that is covered by the statute and does not designate the enacting state's law, or it should send the case to the enacting state where the contract designates that state's law.

3. "Bundling" a Designated State's Entire Law. The proposed statute provides for the application of "the laws of a State." This requires that the parties choose a single state's law, although that law need not apply to the entire agreement or to all issues arising under the entire agreement. This is similar in effect to the choice-of-law statutes that validate only contracts designating the law of

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[397] *See infra* notes 401-16 and accompanying text.

the enacting state,[398] except that the proposed statute permits the designation of the law of any single state. By contrast, the Oregon statute provides that "the contractual rights and duties of the parties are governed by *the law or laws* that the parties have chosen."[399] The quoted language from the proposed statute in effect requires bundling of the default and mandatory rules of a single jurisdiction.[400]

A bundling requirement has potential costs. The parties might want different states' laws to govern different portions of the contract, thereby gaining not only the advantages of default rules, but also the benefit of different states' areas of expertise. Also, a bundling requirement restricts parties' choices to fifty-one bundles of rules as compared with the vast range of combinations offered by the fifty-one jurisdictions. Requiring selection of jurisdictions rather than laws gives legislators greater power to impose inefficient mandatory rules by bundling them with desirable default rules.

On the other hand, a bundling requirement helps to police the efficiency of choice-of-law clauses without relying on *ex post* judicial determinations. If bargaining or information imbalances enable a contracting party to control the law-designation decision, a legislature might cater to the preferences of the stronger party, thereby leading to a race to the bottom with respect to a particular type of contract or provision. But a legislature is unlikely to have sold out its entire agenda to attract choice-of-law business. Indeed, many legislative provisions might reflect the pro-regulatory interests of local groups. Requiring contracting parties to choose a single state's law effectively forces them to make judgments about an overall body of law rather than cherry-picking favorable provisions.

The proposed statute attempts to achieve a balance between the costs and benefits of bundling by permitting the parties to contractually designate a particular state's law for a part of the contract

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[398] *See supra* notes 63-82 and accompanying text. The Delaware statute, for example, provides that, "parties may contract so that the laws of this State shall govern in whole or in part, any or all of their rights, remedies, liabilities, powers and duties." DEL. CODE ANN. tit. 6, § 2708 (1999).

[399] H.B. 2414, 71st Leg. Assem. (Or. 2001) (to be codified at OR. REV. STAT. § 81.120).

[400] *See* O'Hara & Ribstein, *supra* note 1, at 1192-94.

while relying on default choice-of-law rules for the remainder of the contract.

4. Legislative Invalidation of Contractual Choice. Since the proposed statute mandates enforcement of contractual choice of law, it must be reconciled with rules in other states that directly or indirectly preclude enforcement of these clauses. In general, a court may or may not interpret a state statute that prohibits waiver of the regulation as applying to a choice-of-law or choice-of-forum clause that has the effect of a waiver.[401] The effect of even explicit anti-contractual choice-of-law statutory provisions is not clear under common law choice-of-law rules. Restatement section 187 provides for override of contractual choice by the "fundamental policy" of "a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties."[402] Sections 187 and 188 are subject to general factors that affect choice of law, including "the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue."[403] A statute's anti-choice-of-law language may or may not indicate the "relevant policies" and "relative interest" of the enacting state concerning the scope of application of the statute as against other potentially applicable laws, and therefore whether a court should apply that statute rather than the law of the contractually selected state. The clear statutory rule of nonenforcement also may or may not trump the contract in light of the Restatement's "interstate" policies regarding the parties' "justified expectations," "certainty,

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[401] For cases refusing to enforce the clause in the face of a general anti-waiver provision, see Solman Distributors v. Brown-Forman Corp., 888 F.2d 170, 171-72 (1st Cir. 1989); High Life Sales Co. v. Brown-Forman Corp., 823 S.W.2d 493, 499-500 (Mo. 1992); Rutter v. BX of Tri-Cities Inc., 806 P.2d 1266, 1268 (Wash. Ct. App. 1991). For cases enforcing the clause in this situation, see Banek, Inc. v. Yogurt Ventures, 6 F.3d 357, 362-63 (6th Cir. 1993); Modern Computer Sys., Inc. v. Modern Banking Sys., Inc., 871 F.2d 734, 738-40 (8th Cir. 1989); Tele-Save Merchandising v. Consumers Dist., 814 F.2d 1120, 1123-24 (6th Cir. 1987). For cases interpreting statutory anti-choice-of-forum provisions as not applying to contractual choice of law clauses, see JRT, Inc. v. TCBY Yogurt 52 F.3d 734, 739 (8th Cir. 1995); Banek v. Yogurt Ventures, 6 F.3d 357, 360 (6th Cir. 1993).

[402] RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187 (1971).

[403] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6 (1971).

predictability and uniformity of result," and "ease in the determination and application of the law to be applied."[404]

Section B of the proposed statute would provide predictable results in these cases by specifying that, when a written contract provision requires both adjudication in, and application of the law of, a state where a party resides, and requires adjudication in that state, the laws of that state shall apply notwithstanding another state's regulatory law unless, pursuant to subsection B(4), enforcement of the contract is prohibited by an applicable statute or a pre-existing applicable judicial rule[405] of a state where a party resides. Consider the following examples of how this limitation on enforcement would apply:

1. If the contract designates the law and forum of a state that has adopted the proposed statute and another state has a regulatory statute that may apply under general choice of law rules but that does not expressly prohibit contractual choice of law, the court must enforce the choice of law provision regardless of contacts with the regulatory state.[406] It would not, as under current law, weigh the policies of and contacts with the two jurisdictions.
2. If a regulatory state where a party resides has an explicit statute that applies to the contract at issue[407] prohibiting enforcement of the choice-of-law clause, the anti-choice statute should be applied even in the state that enacted the pro-choice statute.[408]

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[404] *Id.*

[405] Where the legislature has not reversed a clear common law rule, this rule arguably reflects current legislative policy. Moreover, the parties may have contracted in reliance on the existing legal rule.

[406] *See supra* notes 357-63 and accompanying text.

[407] A problem may arise if the suit is brought in a state that has *both* a regulatory statute with an anti-contractual choice provision *and* the proposed pro-contractual choice statute. Applying general principles of statutory construction, the court might apply the more recently enacted statute or the more specific regulatory statute. Obviously legislators need to watch for such potential conflicts in drafting their statutes.

[408] For a similar conclusion in this situation, see WHINCOP & KEYES, *supra* note 1, at 63 (arguing that mandatory rule should not override choice-of-law clause "unless there is an express indication or necessary implication to the contrary").

3. In the same situation as (2) except that a party to the contract resides in the designated state but no party resides in the regulating state, the regulatory statute does not trump contractual choice even if it explicitly purports to do so.

The proposed statute's limits on enforcement present the greatest difficulty for this Article's analysis. On the one hand, the competition dynamic discussed in this Article arguably justifies effectuating a state's pro-contractual choice policy as long as the state has the requisite residence connection with a contracting party irrespective of another state's regulatory statute. If firms can avoid state regulation by residing in pro-contractual choice states, state lawmakers will have to consider both costs and benefits of state regulation because they face lobbying both by groups that are subject to the regulation and by those that want to attract such firms to the state.

On the other hand, enforcing a pro-contractual choice statute even in the face of another state's explicit invalidation of such clauses may facilitate evasion of *efficient* mandatory rules.[409] As long as courts enforce only explicit anti-choice provisions, pro-regulatory interest groups must, in effect, pay extra to have mandatory rules extended to invalidation of contractual choice. These groups' willingness to incur the extra lobbying costs arguably indicates that their gains from the mandatory rule outweigh the costs that the rule imposes.[410] To be sure, this may not be the case if firms that directly bear the costs of regulation are based out of state. Indeed, this potential externalization of costs is an important reason for enforcing contractual choice.[411] But the parties' ability to bring these costs home to the regulating state by exiting or avoiding contacts with that state to some extent compensates for deficiencies in political voice.

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[409] *See supra* notes 174-206 and accompanying text.

[410] *See* Becker, *supra* note 216, at 394-98 (suggesting that this competition among interest groups may drive laws toward efficiency).

[411] *See supra* notes 131-39, 339-43 and accompanying text.

Although the proposed statute would permit overriding contractual choice in some circumstances, it differs in important respects from current law. To begin with, the proposed statute clarifies when a particular anti-contractual choice statute applies. The statute allows for the trumping of contractual choice only if the statute explicitly applies to the case and either one of the parties resides in the regulating state or no party resides in the designated state, irrespective of whether the regulating legislature intended to reach the transaction at issue. By contrast, under the Restatement section 187(2)(b) "fundamental policy" test,[412] it may not be clear when a state's policies are "fundamental"[413] and whom lawmakers intended to protect.[414] Also, determining the relevant state under section 188 requires weighing the roles of party residence, as well as the places of contracting, negotiation, performance, and subject matter.[415] This multifactor approach reduces certainty and predictability, and permits consideration of transitory connections with the transaction that relate neither to efficiency nor to lawmakers' incentives.

The proposed statute applies a state's regulatory statute when *either* contracting party resides in the regulating state. This may seem surprising. When the party that would be protected by the regulation does not reside in the regulating state, this is arguably an appropriate case for disregarding the regulation under standard interest analysis,[416] and therefore for enforcing the choice-of-law clause under forum state law.

Nevertheless, several considerations support the proposed rule. First, the regulation is enforced only when another state has explicitly chosen to regulate the transaction, which itself provides some indication of appropriate applicability. Second, section B of the statute is an exception only to the statute's rule of per se enforcement. A state may enforce the choice-of-law clause under

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[412] *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 187(2)(b) (1971).

[413] *See supra* note 34 and accompanying text.

[414] *See supra* note 204 and accompanying text.

[415] RESTATEMENT (SECOND) CONFLICT OF LAWS § 188 (1971).

[416] More specifically, this would be regarded as an "unprovided case" under interest analysis, so that the forum would apply its own law, at least in the absence of contractual choice. *See* BRAINERD CURRIE, *Survival of Actions: Adjudication Versus Automation in the Conflict of Laws*, *in* SELECTED ESSAYS ON THE CONFLICT OF LAWS 128, 152-56 (1963).

common-law principles, perhaps using section D of the statute to supply the relevant legislative intent of the pro-choice state. In other words, a firm might avoid regulation even if it deals with a resident of a regulatory state and is sued there but the anti-choice state applies the pro-choice state policy pursuant to section D. Third, conditioning application of the regulatory statute on residence of either party may discourage states from enacting inefficient mandatory laws because of the risk that such laws will drive away economically beneficial firms. In other words, this connection rule helps ensure that states internalize the costs as well as the benefits of regulation. Fourth, not specifying which party must reside in the regulating state avoids potential complications in multiparty cases regarding who was an intended beneficiary of the regulation.

5. Legislative Validation of Contractual Choice. Section C of the proposed law would permit but not require application of statutes that provide for enforcement of contractual choice even without any connection between the parties or transaction and the designated state. The connection requirement is a default rule that assumes that states generally lack incentives to enforce contractual choice where they do not benefit from attracting parties to the state. However, states sometimes have incentives to enforce contractual choice without regard to where the firm resides. An example is the corporate internal affairs rule, where the states can charge nonresidents for use of their law.[417]

6. Procedural Restrictions on Enforcement. An additional approach to invalidating contractual choice might be through a general rule that applies irrespective of the type of contract, but imposes a procedural prerequisite to enforcement such as a disclosure requirement. As discussed above, a particular concern with contractual choice may be that the material fact of authorization of conduct that would be illegal in other states is buried in the choice-of-law clause.[418] A state might address this problem by conditioning enforcement of contractual choice on clear disclosure of material differences between the regulation and the chosen law. This form of regulation targets a specific problem with contractual

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[417] *See supra* notes 311-18 and accompanying text.

[418] *See supra* notes 194-95 and accompanying text.

choice and therefore is arguably preferable to a blanket prohibition that sweeps in efficient contracts.[419]

Although disclosure rules theoretically may be justified, the proposed statute does not include such rules. Open-ended disclosure requirements can inefficiently limit enforcement of contractual choice. The potential application of several states' disclosure rules, and the ambiguity of these rules, may defeat certainty and predictability.[420] A possible compromise would be for the legislature to decide which regulatory provisions present special problems of evasion through contractual choice and require disclosure of the specific fact of whether the chosen law offers the critical protection.

In any event, disclosure regulation may not be necessary. First, sellers have market incentives not to trick buyers.[421] Second, although choice-of-law clauses may theoretically provide an opportunity for trickery, the opportunity is less than with regard to other facts because the salient facts are publicly available in the statute books and therefore available to experts even if they are not obvious to ordinary consumers. The market, consequently, can quickly be alerted to significant laxity in state law.[422]

States also can protect buyers against one-sided choice-of-law clauses through general rules applicable to all contracts, including unconscionability[423] and rules of construction, such as interpreting the clause against the drafter.[424] For example, the choice-of-law clause might be applied only to rules of interpretation and not to legal rules as to validity of the contract unless the clause explicitly extends to such issues.[425] Thus, a court distinguished an agreement providing that "the laws of the State of Texas shall govern [this Agreement's] *interpretation*" from the more common language that the chosen law would "govern the contract" and interpreted the clause to apply only Texas "rules of contract construction" rather

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[419] *See* Ribstein, *supra* note 1, at 257-58.
[420] *See supra* notes 164-67 and accompanying text.
[421] *See supra* notes 193-203 and accompanying text.
[422] *See supra* notes 193-203 and accompanying text.
[423] *See supra* note 193 and accompanying text.
[424] *See supra* notes 53-62 and accompanying text.
[425] *See supra* note 56 and accompanying text.

than to displace application of the Arkansas Franchise Practices Act.[426] The court reasoned that:

> The choice of law language . . . did not provide [the franchisee] with fair warning that in signing the dealer agreements it would forfeit its right to protection under the AFPA. Lennox's use of such narrow language when drafting its dealer agreements evinces an intent to limit the effect of the choice of law provision, and Lennox has proffered no extrinsic evidence demonstrating that the parties had a contrary intent. Furthermore, although we find that the plain language of the parties' choice of law provision is unambiguous, we note that to the extent that there is room for disagreement, we must construe any ambiguity in the contract against Lennox [citations omitted]. The parties' limited choice of Texas law thus has no impact on the determination of whether A/C can claim protection under the AFPA.[427]

Although unduly strict interpretation can permit back door judicial invalidation of choice-of-law clauses, a clear and reasonably applied interpretation rule has the advantage of encouraging buyers to check the applicable law without potentially open-ended disclosure requirements.

An additional interpretation issue concerns application of a choice-of-law clause so as to invalidate all or part of the contract.[428] For example, the parties to a franchise contract may have designated a state with a franchisee protection law that invalidates a termination-at-will provision in the contract. The court may enforce the contract as written, refuse to apply the statute, or apply the statute only insofar as it does not invalidate an explicit provision of

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[426] Heating & Air Specialists, Inc. v. Jones, 180 F.3d 923, 930 (8th Cir. 1999).

[427] *Id.*

[428] *Compare* Kipin Indus. v. Van Deilen Int'l, Inc., 182 F.3d 490, 494-96 (6th Cir. 1999) (declining to apply chosen law that would invalidate single provision), and Yates v. Bridge Trading Co., 844 S.W.2d 56, 60-64 (Mo. Ct. App. 1992) (declining to apply forum state law that would have voided stock issuance), *with* Milanovich v. Costa Crociere, 954 F.2d 763, 768-69 (D.C. Cir. 1992) (applying contractual choice of Italian law to invalidate cruise line's contract with passenger as one of "adhesion").

the contract. The latter construction might seem consistent with the parties' expectations that they are entering into an enforceable contract. On the other hand, literal interpretation of the choice-of-law clause even where it selects an invalidating law is consistent with the arguments favoring bundling a state's mandatory and default provisions.[429]

C. LEGISLATIVE ADOPTION OF THE PROPOSED TEST

This Part considers the dynamic process that might lead to widespread adoption of the proposed statutory provision clarifying enforcement of contractual choice.

1. State Choice-of-Law Statutes. Although legislators might seem to have little incentive to adopt statutes that promote evasion of mandatory state laws, this Article has shown how the competition for firms can affect local interest groups, who then have an incentive to push for rules that let firms avoid excessive regulation. Legislatures may seek to take this issue out of judges' hands because of the divergent incentives between courts and legislatures regarding enforcement of contractual choice.[430]

It arguably follows that the National Conference of Commissioners on Uniform State Laws should promulgate a uniform choice-of-law statute. Uniformity has several potential benefits.[431] First, it clarifies the effect of choice-of-law contracts, which are likely to be adjudicated in states other than where the contract is formed or the parties reside. Second, the statute is more likely to be widely adopted if promoted as a uniform law. Third, a widely adopted law will tend to generate a larger "network" of interpretive cases and forms than idiosyncratic state laws.

Even if the proposed statute becomes a uniform law proposal, however, it is unlikely all states will adopt it. Some commentators argue that states would seek to cooperate in adopting efficient laws

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[429] *See supra* notes 398-400 and accompanying text.

[430] *See supra* notes 357-63 and accompanying text.

[431] *See generally* Larry E. Ribstein & Bruce H. Kobayashi, *An Economic Analysis of Uniform State Laws*, 25 J. LEG. STUD. 131 (1996) (discussing costs and benefits of state law uniformity).

that are in their residents' long-run interests.[432] More realistically, state laws ultimately reflect the interests of state lawmakers, which in turn depend on the lobbying power of various interest groups.[433] This Article has attempted to reconcile these approaches by showing how competition for residents encourages states in the long run to enforce contractual choice of law. But it does not necessarily follow that all states would want to adopt such a proposal. Some states may be able to exploit their unique resources and markets by refusing to enforce contractual choice where parties' costs of avoiding contacts with the jurisdiction would exceed the benefits of transacting business under more permissive laws.

Even if it is not universally adopted, a uniform law proposal arguably has net social benefits if its widespread adoption increases legal predictability. On the other hand, the uniform lawmaking process may have perverse effects. Uniform lawmakers have incentives to seek *more* uniformity, and not necessarily simply *efficient* uniformity.[434] They may therefore cater to state legislators' interest in preserving their rent-seeking power from erosion by state competition. Thus, the uniform law process is more likely to promote a cartel of state lawmakers than increased state competition. Lawmakers might favor uniform laws that restrict enforcement, or at least the practical effect, of contractual choice.[435] A uniform choice-of-law statute therefore is less likely to reflect the jurisdictional competition this Article favors than one that is encrusted with exceptions, such as exclusions for particular types of contracts or parties. The uniform proposal may become a rule of suboptimal enforcement to which states gravitate.

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[432] *See* BRILMAYER, *supra* note 321, at 193-95; Kramer, *supra* note 25, at 340-42 (noting states' incentives to act reciprocally adopting uniform laws that restrain their own ability to export costs in order to avoid costs imposed on them by other states).

[433] *See* O'Hara & Ribstein, *supra* note 1, at 1156-59; Ribstein & Kobayashi, *supra* note 431, at 140. *See generally* Stephan, *supra* note 1 (arguing that regulatory competition requires consensus about enforceability of contractual choice, but noting that governments may have no incentive to cooperate).

[434] *See* Ribstein & Kobayashi, *supra* note 431, at 142.

[435] Pressure for uniformity also might come from the other direction, namely the threat of federal preemption at the behest of pro-regulatory interest groups. *See* Kathleen Patchel, *Interest Group Politics, Federalism, and the Uniform Laws Process: Some Lessons from the Uniform Commercial Code*, 78 MINN. L. REV. 83, 93-98 (1993) (noting that UCC resulted at least partly from Congressional efforts to federalize sales law).

Apart from the problems of state law uniformity, it is not clear whether a particular statute promoting enforcement of contractual choice is efficient. For example, although this Article advocates applying contractually designated law only when it is the law of a party's residence state,[436] a law that more broadly enforced contractual choice might be preferable. Also, it may not be efficient to permit explicit anti-contractual choice provisions to override the general pro-contractual choice statute.[437]

It follows that it is preferable to seek the benefits of uniformity through a spontaneous process in the market for state laws.[438] This process can be promoted through a "model" law like that proposed in this Article without risking the distortions of the uniform lawmaking process.[439] Among other things, such a law could provoke debate and discussion that might help guide the state lawmaking process.[440]

2. Federal Choice-of-Law and Choice-of-Forum Statutes. Congress could adopt statutes permitting or regulating contractual choice.[441] Federal law could, for example, provide efficient disclosure rules while avoiding the problem of overlapping state regulation by preempting inconsistent state law.

There would, however, be significant problems with a federal statutory approach to contractual choice.[442] To begin with, it is not clear why Congress would have an incentive to legislate in favor of contractual choice, or to limit its regulation to disclosure.[443] Enacting neutral procedural rules probably would not earn enough

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[436] *See supra* notes 390-97 and accompanying text.

[437] *See supra* notes 401-16 and accompanying text.

[438] *See generally* Kobayashi & Ribstein, *supra* note 347.

[439] *See generally* Ribstein & Kobayashi, *supra* note 351 (discussing these potential distortions).

[440] *Cf.* Stephan, *supra* note 1, at 201-02 (discussing benefits of legal scholarship in illuminating issues concerning contractual choice).

[441] *See* Solimine, *supra* note 321, at 223 (discussing proposals for federal choice-of-law statutes).

[442] *See* O'Hara & Ribstein, *supra* note 1, at 1224-25.

[443] The incentives of federal courts and Congress are inverted from those of state courts and legislatures. While, as discussed above, state courts may have less incentive than state legislatures to enforce contractual choice, federal courts may have more incentive to enforce than Congress. Federal courts lack incentives in diversity cases to insist on applying their own rules, and have led the way in enforcing contractual choice. *See supra* note 235 and accompanying text.

rents for federal legislators to justify the political risks of interfering with the traditionally state-governed area of conflict-of-laws.[444] Congress obviously lacks the incentives state legislators have to attract contracting parties to particular states. This suggests that Congress is unlikely to pass a general choice-of-law statute.

Congress likely would legislate on choice of law only to effectuate some distinctly federal policy rather than simply to promote enforcement of contracts. For example, the only modern example of Congress using its Full Faith and Credit power is the Defense of Marriage Act, in which Congress empowered states *not* to enforce a state law, including one selected in a contract, to the extent that it authorizes same sex marriage.[445]

A federal statute mandating enforcement of contractual choice of *forum* has a greater chance of enactment than one concerning choice of *law*. Since choice of law often follows choice of forum,[446] states may be no more likely to mandate enforcing contractual choice of forum than they are to mandate enforcement of contractual choice of law. But it may matter to Congress whether the contracts concern law or forum. Unlike contractual choice of law, legislators enacting a choice-of-forum statute would not have to directly make the policy judgment of which state's law should be enforced. A federal choice-of-forum statute also would comport with Supreme Court cases favoring enforcement of choice-of-forum clauses[447] and with enforcement of arbitration under the Federal Arbitration Act.[448] The political case for such legislation is that it addresses potential excesses of state adjudication without taking the more extreme step of substituting substantive federal regulation.

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[444] *See* Jonathan R. Macey, *Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward A Public-Choice Explanation of Federalism*, 76 VA. L. REV. 265, 2874-91 (1990) (describing lack of Congressional interest in enacting laws without good information regarding what constituents want).

[445] 28 U.S.C. § 1738c (2000). For a discussion of contractual choice in this context, see Buckley & Ribstein, *supra* note 1, at 578-87.

[446] *See supra* notes 233-40 and accompanying text.

[447] *See supra* notes 233-40 and accompanying text.

[448] *See supra* notes 252-63 and accompanying text.

VII. CONCLUSIONS AND IMPLICATIONS

This Article has shown how the normative case for broad enforcement of contractual choice of law can be reconciled with state lawmakers' incentives. State lawmakers might be expected to resist such enforcement because it erodes their lawmaking power. But parties' mobility in a federal system drives a competitive process that gives lawmakers incentives to enforce the clauses. This theory is consistent with data showing widespread use and judicial enforcement of the clauses. Moreover, state legislators have an incentive to take the ultimate decision out of courts' hands and compel enforcement through state legislation. This Article seeks to promote legislative adoption by proposing a specific model statute on contractual choice of law.

Although this Article focuses on commercial contracts, its analysis potentially applies to many types of contractual or consensual arrangements. It certainly applies generally to the competition for corporate law, since this Article adopts a basically corporate model of enforcement of contractual choice. Many have argued that the market for state corporate law leads to efficient outcomes.[449] Some have expressed concerns about managers' incentives[450] and "network externalities" that supposedly entrench Delaware law irrespective of its efficiency.[451] These commentators, however, do

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[449] *See, e.g.*, Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 968-81 (2001).

[450] *See* Bebchuk & Cohen, *supra* note 302, at 16-19; Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1174-77 (1999); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1458-61 (1992); Lucian Arye Bebchuk & Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 VA. L. REV. 993, 997-98 (2001); Cary, *supra* note 174, at 697-99.

[451] *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1923-24, 1928-32 (1998); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 815-25 (1995); Brett McDonnell, *Getting Stuck Between Bottom and Top: State Competition for Corporate Charters in the Presence of Network Effects*, Minnesota Public Law Research Paper No. 02-12 (Sept. 4, 2002), *available at* http://papers.ssrn.com/paper.taf?abstract_id=330661 (last visited Feb. 14, 2003); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, Harvard NOM Working Paper No. 01-10 (Dec. 2001), *available at* http://papers.ssrn.com/paper.taf?abstract_id=292679 (last visited Feb. 5, 2003).

not question the basic scheme of state regulation coupled with a choice-of-law rule providing for application of the law of the state of incorporation to the firm's internal affairs. Indeed, strong arguments have been made for extending the corporate model to securities regulation.[452]

There are also arguments for enforcing a form of contractual choice in marriage[453] and choice of professional ethics rules.[454] The basic jurisdictional competition model that underlies enforcement of contractual choice in these far-flung contexts can be applied even in nonconsensual settings, such as environmental law.[455]

Finally, this Article's analysis is subject to change as the basic characteristics of the market for law evolve. Jurisdictional choice is likely to become more prevalent as reductions in transportation and communication costs and trade barriers increase the party mobility that underlies this Article's model of contractual choice.

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[452] *See generally* Romano, *supra* note 202.
[453] *See* Buckley & Ribstein, *supra* note 1, at 592-600.
[454] *See generally* Ribstein, *supra* note 121.
[455] *See supra* note 268 and accompanying text.