Lessons from Behavioural Economics for the Design of Commercial Law Legislation

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Author's note:

James Davey is unable to attend the 2015 Garret FitzGerald Autumn School as he will be addressing the UK Insurance Fraud Taskforce to urge the use of behavioural economics in the design of insurance policies and claim forms to deter opportunistic fraud. This, it is hoped, will provide further real world evidence of the power of empirically driven law-making and policy-making.

Abstract:

Law and policy makers routinely face the task of designing rules and principles to be enshrined in legislation or regulatory codes. Within Ireland and the United Kingdom, Law Commissions play a significant role in revising and developing the law, especially commercial law. These bodies often draw on expert legal advice, from both academics and practitioners. However, this tends to overlook a further source of useful expertise: the growing body of literature that explains how people react to choices and mandatory rules. Whilst the understanding of behavioural economics is fast-developing in public health and governance circles, it is underused in the design of commercial law legislation, where more simplistic goals of 'legal certainty' and 'freedom of choice' are sought.

This project seeks to provide Law Commissions[1] with 'behaviourally informed' guidance on the drafting of commercial law, by examining the forms of commercial law. This issue of legislation as choice architecture is much overlooked in private law.[2] In particular, attention will be given to the role (and design) of default and mandatory rules, as forms of hard and

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[1] We use this as a collective noun for bodies that draft non-political legislation to assist legislators. This will encompass a wide range of 'law reform' groups outside of the official Law Commissions, including for example groups such as the Irish Sales Law Review Group. Nothing in this paper turns on this distinction.

[2] See however J Davey, 'The reform of insurance warranties: a behavioural economics perspective' [2013] *Journal of Business Law* 118-137; J Davey & C Kelly 'Romalpa and Contractual Innovation' (2015) *Journal of Law & Society* 358-386; C Kelly, 'The proposal for a common European sales law: looking beyond the merits of optional instruments' [2013] *Journal of Business Law* 703-722.

soft paternalism ('shoves and nudges'). This form of social science inquiry is vital for ensuring that the State actually preserves freedom of choice (where desirable) or effectively disincentives socially harmful behaviour. Our aim would be to later extend the project to include the design of commercial legislation by government departments and other draftsmen.

A. Introduction

Roy Goode, in delivering the Hamlyn Lectures in 1997, sought to imagine the commercial law of the twenty-first century.[3] His prognosis was relatively pessimistic, identifying a lack of engagement with theory, except for 'old school' law & economics, over which he had considerable doubts.

Nearly twenty years later, we examine his predictions, and offer a contrasting model of the shape of things to come. In doing so, we suggest that attention should be paid not only to the content of legal rules, but to their format and architecture. In essence, we suggest that the form of rules, whether mandatory or default in nature, is key to the actual effect they have on markets and wider society. Moreover, for commercial law to be optimised we suggest that it needs to be become part of an iterative model by which law-makers formulate, test and adapt legislation.

We hope that our work in this field will add to a broader literature on the nature and shape of legislation generally. However, for now, we limit ourselves to (i) commercial contract law; and (ii) legislation drafted by Law Commissions. These self-imposed limits reflect not only the authors' shared expertise and experience,[4] but also our growing awareness of the relatively limited nature of commercial law theory, at least in the United Kingdom and Ireland. Moreover, the work of Law Commissions (rather than government departments) in developing commercial law is assumed to be apolitical and technical in nature. This is an ideal arena in which to seek to develop an improved technical model for drafting contractual rules, free from the need to satisfy government ministers. This is then an area that is in need of upgrading to twenty-first century thinking, and which is close to both our hearts.

[3] Published as R Goode, *Commercial Law In The Next Millennium* (Sweet & Maxwell, 1998).

[4] Both authors have been closely involved in consultations on the drafting of draft commercial law Bills. Davey with the (UK) Insurance Act 2015 and Kelly with the Irish Law Reform Commission *Report on Privity of Contract and Third Party Rights* (LRC 88 – 2008) and the Consumer Rights Bill 2015.

This essay adopts a relatively simple structure. We begin (in part B) with a review of commercial law as it is, through the eyes of the leading commercial lawyer of the past generation, Roy Goode. His legacy as academic, as practising lawyer and as law reformer is considerable. We then outline (parts C, D, E) our three point plan for improving the design and implementation of commercial law legislation. This utilises three distinct branches of legal theory: 'default rules analysis'; 'empiricism through randomised controlled testing'; and 'regulatory lookback'. In each case we seek to show how theory could be applied to improve practice. We then offer some tentative conclusions in part F.

B. The Shape of Twentieth-Century Commercial Law Making: 'Not How', but 'How Many'[5]

The tradition in commercial law making is to adopt a 'problem solving' mentality, with little interest in underlying theory or method.[6] Within the United States, there is considerable high level discussion of the commercial code from neo-formalists and neo-realists, with both economic and socio-legal analysis offered. This is not kept within the legal journals—although it is plentiful there—with judicial discussion of concepts such as efficient breach not unknown.[7] Within the United Kingdom and Ireland, this is a less obvious trend. A notable exception to this lack of reflection is found in Roy Goode's Hamlyn lectures and we use this source to establish the *status quo* position for commercial law design.[8]

In Goode's treatment of commercial law, he remarks on the largely passive nature of lawmakers, both judicial and legislative. He typifies judicial interventions in the commercial law sphere as demonstrating 'a relaxed approach to commercial contracts and a recognition of the importance of upholding reasonable market practice'.[9] This sense of following, rather than leading, market behaviour provides a loose delineation between commercial law and the

[5] A golfing phrase that captures the idea that ends are examined rather than means. Despite this, golfing commentators then eulogise about the form of the swing and its resilience under pressure. We suspect that commercial law is also concerned with understanding why things work, rather than just 'what works', but has not persuaded itself that a concentrated discussion of these matters is a valuable activity.

[6] Goode, above n 3, at 4: 'Commercial law is about problem-solving, about fashioning the contract structures and other legal tools by which the legitimate needs of the market can be met'

[7] This is not to suggest that American judges are persuaded by the academic literature, see eg C Warkol 'Resolving the Paradox between Legal Theory and Legal Fact: The Judicial Rejection of the Theory of Efficient Breach' (1998-99) 20 Cardozo Law Review 321.

[8] Our generalisation regarding the absence of commercial law reflection is of course subject to exceptions, such as S Worthington (ed) *Commercial law and commercial practice* (Hart, 2003) and J Lowry & L Mistelis (eds) *Commercial law: perspectives and practice* (Butterworth, 2006).

[9] Above, n 3, at 3.

regulation of commercial markets, these being seen as two distinct branches of activity.[10] However this line in the sand should not be overstated as even in commercial regulation there has been considerable evidence of a 'light touch' approach.

The limited role he attributes to the legislature is certainly true across the longer term, but may be contested on the basis of the recent growth of European Union harmonisation and regulation, albeit largely restricted to certain consumer markets.[11] In respect of statutory intervention in markets across the Twentieth Century as a whole, his characterisation is accurate:

> "It is a fact that in the development of our legal techniques for the accommodation of business transactions the legislature has, rather remarkably, played almost no part at all. A striking illustration of the non-interventionist policies of the State is that, except from some rather desultory provisions in the Bank Charter Act 1844, banking in the United Kingdom was not regulated by any legislation whatsoever until 1979. The whole system of control worked on the basis of the moral suasion exercised by the Governor of the Bank of England."[12]

This evidences a pattern of law-making that was either content to leave matters outside formal law—as in banking regulation above—or to provide for a series of contractual rules that were generally subject to the contrary intentions of the parties, those intentions being discovered either by express contractual terms or the more nebulous implied term. The underlying assumption—and this links directly into one of our key proposals for Law Commissions—was that parties needed clear, simple default rules around which they would then contract where required. This was part of the 'minimal interference' model so well described by Goode, but is, we assert, based on the false premise that default rules are not 'sticky'. Building on prior research, we build an alternative model of 'default rule' design that is designed to meet the stated objective of lawmakers of minimal interference.

Goode completes his essay with a reflection on the relatively poor quality of commercial law-making. In essence he describes two problems that are key to this paper's focus:

(1) We do not know how to achieve our desired goals; and

(2) We do not learn from the past.

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[10] For an excellent monograph operating on the borderline, see H Collins *Regulating Contracts* (OUP, 2002).

[11] There is clear growth in the control of many compulsory insurance products and within the consumer sale of goods and supply of services. Moreover, there are substantial 'soft law' trends towards harmonised prudential and regulatory standards in financial services.

[12] Above, n 3, at 6-7.

This lack of a reflective approach to commercial law is beautifully captured by Goode:

> "It is a characteristic of human behaviour—some would say, of human folly—that we learn primarily from our own experiences, not from those of our predecessors. The history of commercial law is one of constant reinvention of the wheel."[13]

Commercial law has traditionally been about results—about ends and not means. But our society's ongoing inability to predict and correct market failures means that this is not enough. Lawyers need to recognise that human decision making is messy and complex, and that commercial law needs to be change the way it seeks to assist and/or intervene in markets. In order to fix the two problems above, this means:

(1) Improving, even if only incrementally, our understanding (as lawyers) of commercial markets, and being suspicious of simple ideological positions (such as the efficient market); and
(2) Developing legal interventions by learning from the past. Law-making must become an iterative process of designing, testing, implementing and retesting.

This paper is the start of an explicit attempt to build such a model for Law Commissions. It builds upon our prior work across commercial and consumer law, but is also likely to develop in an iterative fashion. On that basis, comments and questions are welcome to J.A.Davey@Soton.ac.uk and Cliona.Kelly@ucd.ie.

C. STAGE 1: 'Default Rules Analysis'- Building Bridges

1. Millennium Bridge, London and its 'fluid dampers'[14]

[13] Above, n 3, at 3.

Much of commercial contract law scholarship exists on two sides of a chasm. On one bank is the discussion of express contractual and implied statutory terms. This is often technical and doctrinal in nature. It assumes that the fundamental principles of contract law are largely immutable, such as the remedies for breach, and the rules of contract formation. It tends to rely on relatively simple (and often unexamined) principles for the design of rules such as 'legal certainty' and 'freedom of contract'. The focus of this branch of law is solving specific problems that arise in the market: the micro-questions. On the other side is a highly developed conceptual analysis of the fundamental principles of contract law. This is often abstract in nature and interested in the macro-questions such as the nature of promising and/or the place of economic efficiency as an overarching goal for damages. What is normally lacking is a bridge between the two: a detailed but practical analysis of the rules that underpin commercial trading but are often invisible. In essence, we lack a coherent body of 'applied theory' that seeks to identify and resolve real world problems but not by *ad hoc* solutions.

The chasm we imagine is not empty. There have been a number of attempts to span the gap, but many of them are abandoned or only partly constructed. Others (and perhaps the Chicago law & economics movement is the best example) built elegant structures of staggering complexity that collapsed any time they were tested in the real world. This is not a fanciful analogy: London's Millennium Bridge (above) was closed for considerable re-engineering because the models for pedestrian transit across it failed to account for how real people walk when in large groups.[15] I can imagine the equivalent Chicago Law Review paper starting with: 'assume all pedestrians walk in uncorrelated patterns'.[16] As so often, unexamined assumptions about the real world create significant errors when modelling outcomes.

In this section we consider one of the more promising attempts in recent years to build a usable normative structure for contract rules: 'default rules analysis'. It should be noted at this early stage that the version we propose to use is much modified from the 'vanilla' version of the model and now incorporates cognitive and market biases identified by behavioural economics. Moreover, we do not claim that it is a perfect model. One of the fundamental

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[14] "Bridge vert mode shock" by Dave Farrance - Own work. Licensed under CC BY-SA 3.0 via Commons - https://commons.wikimedia.org/wiki/File:Bridge_vert_mode_shock.jpg#/media/File:Bridge_vert_mode_shock.jpg

[15] David E Newland 'Vibration of the London Millennium Footbridge: Part 1– Cause' http://www2.eng.cam.ac.uk/~den/ICSV9_06.htm.

[16] Whilst we are poking fun, I'm sure some *arriviste* behavioural economist will announce the discovery of the 'people-excited lateral bridge vibration' heuristic.

points of this paper is that we ought to be suspicious of claims of accurate models. It deserves consideration because it is a (reasonably) neutral lens through which to assess proposed rules, and is capable of assessing a wide range of interventions.

The 'Default Rule' and the 'Mandatory Rule'

In seeking to provide an intuitive taxonomy for commercial law rules, we build upon the default rules theory literature developed in the United States, as adapted to account for behavioural economics. We are concerned with the rules of contractual formation, performance and remedies that provide the framework in which the parties then agree a specific contract. We do not expect parties to stipulate in their agreements the standard remedies for breach, or the basis for determining when risk or property has passed in the contract. These 'default rules' are capable of being displaced by the parties but in many cases they are not, they are only agreed tacitly.[17]

A prime example of the use of 'default rules analysis' is found in a recent essay by Tom Baker and Kyle Logue in the *Research Handbook on the Economics of Insurance Law*.[18] As they note, this is an underused approach in commercial law. It must be said that their survey of the application of default rules to commercial theory was, regrettably, limited to North American journals and overlooks the prior application of these principles in Europe and elsewhere.[19]

In the Baker / Logue continuum, they identify three distinct types of clause:

1. The mandatory rule;
2. The 'sticky' default; and
3. The majoritarian default.[20]

Each of these can arise via the standard law-making mechanisms (judicial, legislative or administrative decision).[21]

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[17] R Barnett, 'The Sound Of Silence: Default Rules and Contractual Consent' (1992) 78 Va L Rev 821

[18] T Baker & K Logue, 'Mandatory rules and default rules in insurance contracts' in D Schwarcz & P Siegelman *Research Handbook on Economics of Insurance Law* (Edward Elgar, 2015). We are grateful to the publishers for sight of an advance copy of this paper.

[19] The failure of North American scholars to recognise the excellent technical work in the Geneva Papers on Risk and Insurance (and similar) in European insurance law & economics scholarship is a blind spot. It perhaps reflects ease of access to materials: European scholars have no difficulty accessing North American journals post-Hein Online, see eg J Davey, 'Claims notification clauses and the design of default rules in insurance contract law' (2012) 23 Ins LJ 245.

[20] Above, n 18, at 379-383.

We think that this approach, whilst useful, is incomplete. The 'sticky' (or 'strong') default rule also has an analogue- the 'weak mandatory rule'- which in theory is mandated and immutable but which is rarely (if ever) enforced by the parties or the courts.

This gives us the following range of clauses:

'Strong' mandatory clause: Unchanged by contrary party intention, and routinely enforced: [forfeiture rule].	**'Weak' mandatory clause:** Unchanged by party intention but rarely enforced: [insurable interest].
'Strong' default rule: Requires active contrary intention by parties. Normally incentivises drafting of replacement rule by imposing cost on party assumed to have private information. Also known as 'information forcing' or 'penalty' default. [New requirements for contracting out in IA 2015].	**'Weak' default rule:** Seeks to mirror what the majority of market participants would seek. Readily displaced by party intention, even where only implicit. Also known as 'majoritarian' default. [rules regarding place of delivery].

Before we continue with an exploration of this taxonomy, it should be made clear that these represent points on a scale. None of these classifications represent a homogenised genus of clauses with identical effects. These are, in truth, tendencies such that there could be overlap in practice—not shown above within the theoretical construct—between the normative effect on the market of a very strong default and a very weak mandatory rule. This represents a contribution to the understanding often shown by lawmakers who commonly assume that defaults preserve freedom of choice whilst mandatory rules impose unalterable sanctions on those who fail to comply. Our point in this section is to show that the range of possible outcomes from rules that are often thought—if thought about at all—to be mutually exclusive in effect. We will demonstrate this further below by considering some examples from English and Irish commercial law.

The purpose of developing a better description of the types and uses of clauses is perhaps obvious, but nonetheless important to state. To pick the right tool for the job, you need to

[21] In the case of US insurance contracts considered by Baker & Logue, a mandatory administrative clause might arise by State insurance regulators refusing to accept a policy without the inclusion of clause [X].

know what a tool does, and, more importantly, what it cannot do. At present, many Law Commission proposals do not seem to be able to reflect on the nature of the rule intended, because the focus lies almost entirely on the content of the rule, and not its shape or intended function.

Where function is discussed—as Goode above noted—it is often only raised in the most simplistic of forms. According to many lawmakers, most rules are meant to 'provide legal certainty' or 'protect freedom of contract' (often used to justify default rules). When imposed, mandatory rules are often assumed to correct a market failure without considering how the intervention corrects the problem. Much of commercial contract law's intervention in the market is the equivalent of shouting at children to 'play nicely or else' (mandatory rules) or to 'sort it out amongst yourselves, or I will' (the default rule).[22]

The Function of Default Rules in Commercial Law

A classic example of the 'invisible' default rules that underpin commercial law arise in the standard remedies for breach. The standard remedies would not normally be mentioned in the express terms of the contract, unless they were being varied or excluded entirely (where possible). One much studied example is the extent to which consequential losses are sufficiently predictable (or foreseeable, in the vernacular) at the time of contracting, and therefore fall within the breaching party's obligation to compensate.[23] The classic English law case discussed on this point is *Hadley* v *Baxendale*,[24] which concerned the recoverability of loss of profits of a claimant mill owner against the carrier of his drive shaft when there was a delay in delivery of the shaft. On the facts as found, the carrier of the goods was certainly in breach of contract for its dilatory performance, but was not responsible for the loss of business caused when it was not specifically told that this mill shaft was the only one in

[22] In the interests of fairness, James Davey would like to make clear that these are examples of his bad parenting skills, and not that of Cliona Kelly.

[23] A Hein Online search for papers discussing *Hadley* v *Baxendale* (an English case, it should be remembered) provides a staggering list of more than 3,000 sources. Most key modern contract theorists in the United States have discussed the default rule in *Baxendale*, for example: B Adler 'The Questionable Ascent of *Hadley* v. *Baxendale*' (1998-1999) 51 Stan. L Rev 1547; M Eisenberg, 'The Principle of *Hadley* v. *Baxendale*' (1992) 80 Cal L Rev 563; L Bebchuk & S Shavell, 'Information and the Scope of Liability for Breach of Contract: The Rule of *Hadley* v. *Baxendale*' 7 J L Econ & Org 284; R Danzig, '*Hadley* v. *Baxendale*: A Study in the Industrialization of the Law' (1975) 4 J Legal Stud 249; E Posner, 'There Are No Penalty Default Rules in Contract Law' (2005-06) 33 Fla St U L Rev 563; I Ayres, 'Ya-Huh: There Are and Should Be Penalty Defaults' (2005-06) 33 Fla St U L Rev 589; O Bar-Gill, 'Quantifying Foreseeability' (2005-06) 33 Fla St U L Rev 619 and A Schwartz, 'The Default Rule Paradigm and the Limits of Contract Law' (1993-94) 3 S Cal Interdisc L J 389.

[24] *Hadley v Baxendale* (1854) 9 Ex 341

operation, and that the business could not operate until it was repaired and returned. This is a good example of a default rule which incentivises the provision of information by reducing the damages available for a breach of contract unless such information is provided. The strong default rule in *Hadley v Baxendale* thus serves a similar function to a mandatory rule requiring the provision of information, but does so in a manner which, at least superficially, involves minimal interference with the contractual relationship.

We would suggest that there are other hidden default rules within the law of damages, and some irreducible minimum standards that operate as mandatory rules. The normal level of damages awarded within a market (the market price rule, that compares the contract price with the cost of alternative performance) is capable of being substituted for eg a fixed estimate of loss, but the law is sensitive to this contractual freedom being abused and will declare unrealistic estimates as 'penalty clauses' and unenforceable. Moreover, in theory, parties could substitute a formula that provides for wasted expenditure to be restored (rather than loss of profits) or some share of the breaching party's gain on breach (rather than the innocent's party's loss). In each case the initial damages rule is likely to be somewhat 'sticky' in that the courts will require some overt effort to replace the orthodox model, and may in some cases find that the variation agreed by the parties is unenforceable for infringing some immutable mandatory principle, often some unspoken sense of offending against justice. What is notable about this judicial conservatism is that it is often enforced despite an absence of evidence of illicit use of bargaining pressure such that the 'agreed' outcome was really a 'take it or leave it' imposition by a stronger party.[25]

In other situations, the opportunity to contract out of a default rule is explicitly governed by statute. In the UK, the Sale of Goods Act 1979 implies various rights and obligations into a contract of sale. Section 55(1) then expressly provides that these can be "negatived or varied by express agreement, or by the course of dealing between the parties, or by such usage as binds both parties to the contract." Thus the Sale of Goods Act is often put forward as a clear example of a commercial statute based primarily (although not entirely) on default rules which parties are free to vary. However, the ability of parties to opt out of these rules is controlled by the Unfair Contract Terms Act 1977, which provides that any attempt to exclude the implied terms in the Sale of Goods Act in a commercial contract must be fair and reasonable.[26] Moreover, the "stickiness" of this default rule is reinforced by the judicial

[25] The classic 'contract of adhesion'.
[26] Sections 3, 6 and 11, Unfair Contract Terms Act 1977.

approach to this requirement, in particular the stringent requirements regarding the drafting of contractual clauses which seek to exclude, for example, the requirement that goods be of satisfactory quality, with such clauses being construed strictly *contra proferentem.*[27] The assessment of whether a term is "fair and reasonable" is notoriously difficult, but at this point judicial analysis turns on an assessment of the equal bargaining power of the parties.[28] Thus, although the Sale of Goods Act is often described as the perfect example of default-based statute, in reality the ability of parties to contract out of its provisions is often strictly controlled.[29]

A similar situation can be seen in relation to the new regime for insurance contract law in the United Kingdom. Entering into force in August 2016, the Insurance Act 2015 creates a new default rule for contractual warranties in insurance. Under the prior regime (established almost 250 years ago) any failure by the insured to comply with an insurance warranty discharged the insurer from liability for claims arising automatically from the moment of the breach. The approach, adopted by Lord Mansfield in the late Eighteenth century[30] and confirmed by the House of Lords in 1991,[31] was much criticised within other common law jurisdictions for its strictness.

The new default rule, in s. 10(2) Insurance Act 2015, provides:

> '(2) An insurer has no liability under a contract of insurance in respect of any loss occurring, or attributable to something happening, after a warranty (express or implied) in the contract has been breached but before the breach has been remedied'

However, the 'stickiness' of the default is shown in sections 15 - 18, which govern attempts to contract out of the rule in commercial contracts. For consumers, the new default rule

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[27] See *Wallis v Pratt* [1911] AC 394; *The Mercini Lady* [2011] 1 Lloyd's Rep 442. See however *Air Transworld Ltd v Bombardier Inc* [2012] EWHC 243 (Comm).

[28] See *Watford Electronics Ltd v Sanderson CFL Ltd* [2001] 1 All E.R. (Comm) 696, at para.55: "Where experienced businessmen representing substantial companies of equal bargaining power negotiate an agreement, they may be taken to have had regard to the matters known to them. They should, in my view be taken to be the best judge of the commercial fairness of the agreement which they have made; including the fairness of each of the terms in that agreement. They should be taken to be the best judge on the question whether the terms of the agreement are reasonable. The court should not assume that either is likely to commit his company to an agreement which he thinks is unfair, or which he thinks includes unreasonable terms. Unless satisfied that one party has, in effect, taken unfair advantage of the other - or that a term is so unreasonable that it cannot properly have been understood or considered - the court should not interfere."

[29] Similar restrictions exist in Ireland: see s.55, in particular s.55 (4) of the Sale of Goods Act 1893, as amended by the Sale of Goods and Supply of Services Act 1980. The doctrine of fundamental breach also continues to play a role in Irish law, in the absence of legislation as wide reaching as the Unfair Contract Terms Act 1977.

[30] *De Hahn* v *Hartley* (1786) 1 TR 343.

[31] *Bank of Nova Scotia* v *Hellenic War Risks Association (Bermuda) Ltd, The Good Luck* [1990] 1 QB 818 (CA) per May LJ; [1991] 2 WLR 1279 (HL) per Lord Goff.

provides a mandatory ceiling on insurer rights, and cannot be amended except in favour of the insured.[32] For commercial contracts, the default can be amended, but only if the underwriter provides sufficient notice of the alteration, and the new clause is clear and unambiguous in its effect.[33] This goes beyond the common law rules on incorporation, particularly if the document is signed. This establishes a higher than standard threshold for amending a default, and is a clear example of deliberate measures to increase the 'stickiness' of defaults. Whilst we are in favour of this form of explicit positioning of default rules as majoritarian or sticky in nature, it must be said that one author had argued strongly for non-sticky defaults in commercial policies of this type.[34]

It is clear, however, that not all default rules are "sticky". Some "weak" default rules are readily displaced by party intention, even if such intention is only implied. These rules tend not to pursue a policy objective—such as the protection of weaker contracting parties—or to incentivise certain behaviour—the provision of information for example—but arise in a more neutral context and seek to make contracting easier by mirroring what the majority of market participants would seek. A good example of such a rule is the default rule regarding the place of delivery under the Sale of Goods Act 1979. Section 29(2) provides that "apart from any such contract, express or implied, the place of delivery is the seller's place of business if he has one, and if not, his residence". However, a contrary intention will often be inferred from the circumstances of the case[35] and certain standard form contracts (such as an f.o.b. contract) routinely provide for an alternative rule.

This analysis perhaps shows that the use of default rules analysis does not prejudge the non-interventionist (or otherwise) nature of the legislative provision, but is a relatively neutral tool for converting policy into law. Its ultimate effect is often determined by the surrounding matrix of legislative and common law rules: how easy is it within the overall regulatory framework, including the day to day realities of the "law in action", to avoid or replace the default rule? And, crucially, to what extent does the actual ability of contracting parties to

[32] S. 15 IA 2015.
[33] S. 17(2)-(5) IA 2015:
(2) The insurer must take sufficient steps to draw the disadvantageous term to the insured's attention before the contract is entered into or the variation agreed.
(3) The disadvantageous term must be clear and unambiguous as to its effect.
(4) In determining whether the requirements of subsections (2) and (3) have been met, the characteristics of insured persons of the kind in question, and the circumstances of the transaction, are to be taken into account.
(5) The insured may not rely on any failure on the part of the insurer to meet the requirements of subsection (2) if the insured (or its agent) had actual knowledge of the disadvantageous term when the contract was entered into or the variation agreed
[34] J Davey 'The reform of insurance warranties: a behavioural economics perspective' [2013] JBL 118.
[35] See *Wiskin v. Terdich Bros* [1928] ALR 242.

contract out of a default rule correspond with the policy objective of that rule? Is commercial law design prohibiting parties from circumventing default rules which they should be able to avoid, or is it steering them in a particular direction, and if so is this the intended result? And what assistance can behavioural economics offer us in determining the effect, intended or not, of default rules? Our recent work has begun to elaborate further on this latter point, examining the impact of behavioural influences on contracting, in particular, the pull of the status quo bias by which contracting parties tend to seek to maintain or amend existing contractual defaults even where this is inefficient. We have shown in this recent work how these influences can have an effect in relation to individual default rules—such as the default rule which applies when there is non-compliance with a promissory warranty in a marine insurance contract[36]—and in relation to "opt in" legal regimes—such as the proposal for a Common European Sales Law.[37]

Our suggestion is then that the relationship between default and mandatory rules is a complex one. Some default rules are stated as subject to contrary party intention but require such a perfect storm of equality of bargaining power and precise contractual draftsmanship to overcome that they approach mandatory status. By contrast, as discussed below, some mandatory rules are so weakly enforced that they are reduced to a shadow of the 'law on the page'.

The Function of Mandatory Rules in Commercial Law Statutes

The imposition of mandatory rules is normally justified on the basis of a type of market failure that cannot be corrected by simply forcing the parties to contract around an established default. A classic example is where the contract is likely to generate significant externalities: costs on non-contracting parties. However, interventions may also steam from some sense of irreducible norms of behaviour within commercial markets, such as law's disapproval of fraud as socially wasteful activity.[38] The two examples we take below demonstrate these differing approaches, but they are indicative and other bases for intervention are possible.

When considering the imposition of mandatory rules, policymakers should be highly sensitive to the need to ensure adequate enforcement mechanisms, particularly where the rule

[36] J Davey 'The reform of insurance warranties: a behavioural economics perspective' [2013] JBL 118

[37] C Kelly, 'The proposal for a common European sales law: looking beyond the merits of optional instruments' [2013] *Journal of Business Law* 703-722.

[38] Where one party is dishonest, it knows it is not entitled to the benefit sought, and the other party must waste resources to deny the unjustified claim.

is designed to protect third parties. The simple assertion that 'contracting parties should not do [X]' will not remove all instances of [X] from the market without more. Speed limits on roads are mandatory rules, but are understood by road users and those who enforce them to be of varying levels of strictness and significance in practice.

The Forfeiture Rule in Insurance Contract Law

Insurance contract law is home to a number of strong mandatory rules, and the forfeiture rule is a classic example. Its effect is to deny the insured any right to sue on an insurance policy for a claim tainted by fraud. Although its genesis is in express terms of insurance policies from the mid- Nineteenth century,[39] it is now considered to have force as a rule of law, independent of party intention:

> 'The older common law cases (particularly, *Levy* v *Baillie* (1831) 7 Bing. 349, *Goulstone* v *Royal Insurance Co* (1858) 1 F & F 276 and *Britton* v *Royal Insurance Co* (1866) 4 F & F 905) stand for a rule of law, applicable even where there is no express clause in the policy, to the effect that an insured who has made a fraudulent claim forfeits any lesser claim which he could properly have made'.[40]

The strict application of the rule to cases where the level (and consequences) of the fraudulent conduct was minor is the subject of an appeal to the UK Supreme Court, to be heard in early 2016.[41]

As a rule that reflects public policy, it is not reliant on party intention, at least not below the minimum standards required by the court's disapproval of fraudulent conduct. This reflects the instrumental purpose of the law: to deter insurance fraud, as stated by Lord Hobhouse of Woodborough in *The Star Sea*:

> "[The law] will not allow an insured who has made a fraudulent claim to recover. The logic is simple. The fraudulent insured must not be allowed to think: if the fraud is successful, then I will gain; if it is unsuccessful, I will lose nothing."[42]

It may be possible, even with some strong mandatory rules, for the contract to stipulate even stronger disapproval by granting extended remedies to the contracting parties. Thus, in

[39] Eg *Levy* v *Baillie* (1831) 7 Bing 349, *Britton* v *Royal Insurance* (1866) 4 F & F 905.
[40] *Agapitos* v *Agnew (The Aegeon)* [2002] EWCA Civ 247, [2002] 2 Lloyd's Rep 42; [2002] Lloyd's Rep IR 573; [2003] QB 556, [21].
[41] *Versloot Dredging BV* v *HDI-Gerling Industrie Versicherung AG (The DC Merwestone)* [2014] EWCA Civ 1349; [2015] 1 Lloyd's Rep 32, on which see J Davey & K Richards, 'Deterrence, human rights and illegality: the forfeiture rule in insurance contract law' [2015] LMCLQ 314.
[42] [2001] UKHL 1; [2001] 1 Lloyd's Rep 389; [2001] Lloyd's Rep IR 247; [2003] 1 AC 469, [62].

addition to the forfeiture of the fraudulent claim it may be possible to declare that submitting a fraudulent claim constitutes breach of the contract such that it is immediately terminated, and/or that previous untainted claims would need to be repaid. This practice is not routine in insurance contracts, but is not unknown.

This then is best viewed as a strong mandatory rule, vigorously enforced by the courts as part of a broader conception of the administration of justice, and not reliant on the consent of the parties. In this respect, it shares many similarities with other rules on illegality in contract formation and performance, most notably the *ex turpi causa* doctrine.

However, the recent codification of this rule has—perhaps without conscious decision—shifted the nature of the rule as a minimum floor standard of public policy to a maximal standard for consumers and a strong default for business. This complex point deserves some unpicking. In the statutory reformulation of the forfeiture rule in the Insurance Act 2015, the rules laid down are subject to the same controls on variation as noted above for insurance warranties. In the warranties example, the court was imposing further obligations on underwriters on what was already a default rule. But in the forfeiture model, the nature of the rule is being changed from a mandatory rule operating outside of the contract to a regulated implied term. Both type of clause ('fraud' and 'warranty') is now treated identically: for consumers, any attempt to impose an obligation on the insured above the obligation imposed by the statute is of no effect. For business insureds, variations of this type are only binding if notice is drawn to them and if they are clear and unambiguous.[43] Prior to legislative interference, each had a very different purpose and legal base.

This is, we suggest, an accidental change in the nature of the law. Moreover, given that the statutory rule does not repeal the prior 'public policy' rule that exists independently of the contract, there are presumably both common law and statutory duties imposed on the insured which will normally, but not always, coincide. We make this point not as a criticism of hard-pressed Law Commission staff but as a guide to how easy it is to accidentally re-categorise a rule from mandatory minimum protection for underwriters to a maximal right in the consumer sphere and a 'sticky' default for businesses. In practice, this may have little impact in this example, as underwriters have not normally claimed contractual rights over fraud cases beyond the common law rule. Nonetheless, a better understanding of the nature and shape of legal rules could prevent accidental reclassification.

[43] See above, and ss. 15-18 IA 2015.

The Doctrine of Insurable Interest

We now turn to the doctrine of insurable interest in insurance contract law as an example of a 'soft' mandatory rule. In doing so, we develop the Baker & Logue approach to mandatory rules, as they treat 'insurable interest' as a paradigmatic mandatory rule, an approach we question, at least in English law. The crucial question, so often overlooked with the analysis of legal rules 'on the page' is what resources will be committed to ensuring the 'mandatory' rule is enforced. In the doctrine of insurable interest, it is clear that the rule is enforced at the behest of the underwriter, and the State has shown little interest in ensuring enforcement. First, the statutory provisions that impose the insurable interest rule in marine insurance[44] and life assurance[45] provide for an entirely one-sided remedy: the non-enforcement of the contract. In many cases this is combined with a finding that the policy was an illegal contract, which means that the premium is not returnable even where the contract is not enforceable in court. This imposes no sanction on an underwriter that sells a policy without interest, but denies legally enforceable cover to the insured. The insurer will often make payment, as it is in its commercial interest not to rely on a technical defence, but the rule imposes no real discipline on the market participants. Where insurers do seek to raise the technical defence, courts are resistant to finding that there was no interest, as Brett MR made clear in *Stock* v *Inglis*:

> 'In my opinion it is the duty of a Court always to lean in favour of an insurable interest, if possible, for it seems to me that after underwriters have received the premium, the objection that there was no insurable interest is often, as nearly as possible, a technical objection, and one which has no real merit, certainly not as between the assured and the insurer.'[46]

This lack of rigour in enforcement is well demonstrated by judicial acquiescence in avoiding the rule by tolerating attempts to 'contract out' what is purportedly a mandatory rule. Under the Marine Insurance Act 1906, there is a specific prohibition of attempts to include in the contract a 'p.p.i.' clause (or similar) stating that the insured need not prove an interest to recover. Judges turned a blind eye to parties editing the contract before putting it before the

[44] The Marine Insurance Act 1906 and the Marine Insurance (Gambling Policies) Act 1909.
[45] Notably, the Life Assurance Act 1774.
[46] *Stock* v *Inglis* (1884) 12 Q.B.D. 564, 571 per Brett MR.

court (by physically removing the p.p.i. clause) so as to avoid the statutory prohibition, as described by Scrutton LJ in the *Vaughan Bros* case.

> 'For many years there has been an unfortunate conflict between the statute law and the practice of business men. It has been extremely common to place in policies a p.p.i. clause providing that there shall be no necessity to prove the amount of loss, although all the time there was a statute which said that such a clause was either illegal or null and void… It is the duty of judges, if they know that a policy has that clause on it, to treat it as null and void under the Act, and a practice has grown up of deceiving the Court by parties tearing off the clause which they have put on the policy in the hope that the Court will not know that there is such a clause and will give effect to the policy. The Court does not generally know, but having had some commercial experience suspects what those two pinholes in the margin of the policy mean, and still more when it sees that a piece of paper has been torn off. Judges are therefore placed in a difficult position - at least, I personally feel the difficulty - when they strongly suspect that they are being asked to enforce a null and void contract, but have no evidence beyond the kind of indications that are on the policy. However, that is the practice, and the only thing to be said to business men who carry on business in that way is, that if they persistently enter into contracts which are null and void under a statute, they must not complain if the Courts obey the statute rather than their commercial practice'.[47]

It should be recalled that what Scrutton LJ describes would be a criminal act of the contracting parties and broker under ss. 1(1)(b), (2) Marine Insurance (Gambling Policies) Act 1909:

> (1) 'If—
>
> (a) …
>
> (b) any person in the employment of the owner of a ship, not being a part owner of the ship, effects a contract of marine insurance in relation to the ship, and the contract is made "interest or no interest," or "without further proof of interest than the policy itself," or "without benefit of salvage to the insurer," or subject to any other like term,

[47] *Thomas Cheshire* v *Vaughan Brothers* [1920] 3 K.B. 240, 252-53 per Scrutton LJ.

the contract shall be deemed to be a contract by way of gambling on loss by maritime perils, and the person effecting it shall be guilty of an offence, and shall be liable, on summary conviction, to imprisonment, . . . for a term not exceeding six months or to a fine not exceeding [level 3 on the standard scale], and in either case to forfeit to the Crown any money he may receive under the contract.

(2) Any broker or other person through whom, and any insurer with whom, any such contract is effected shall be guilty of an offence and liable on summary conviction to the like penalties if he acted knowing that the contract was by way of gambling on loss by maritime perils within the meaning of this Act'.

It should be noted that prosecutions for these offences require the permission of the Attorney General to be brought, and research has failed to discover any attempts to prosecute.

What might- *prima facie*- be viewed as a strict mandatory rule, with the contract declared:

- unenforceable; and
- (often) an illegal contract; and
- in marine cases, a criminal act

is in practice:

- rarely enforced by the contracting parties;
- even when raised, avoided wherever possible by the courts.

The insurable interest rule is therefore a soft default. The influences of 'prosecutorial' and 'judicial' discretions have reduced it to a shadow of its apparent significance. This is not to say that that may not be an efficient outcome, but if so then the rule ought to be removed from the class of mandatory rules, and simply made subject to contrary intention.

D. STAGE 2: 'Experimental' Commercial Law Reform

Our model for developing a more reflective cohort of Law Commissions is based, in part, on the approach taken at the (UK) Financial Conduct Authority. Born out of the financial crisis, at perhaps the lowest point of faith in efficient markets, the FCA is committed to applying behavioural economics to inform its policy and administrative decisions.[48] This is

[48] K Erta et al, *Applying behavioural economics at the Financial Conduct Authority* (April 2013, Occasional Paper No.1, FCA).

increasingly reflected in state organisations worldwide, with President Obama recently issuing a Presidential Order to follow suit across the US federal system.[49]

Within this change of strategy lies the use of experimental economics, often (but not limited to) the use of Randomised Controlled Tests (RCTs). We take as our core example the sale of 'add on' insurance products that commonly accompany consumer purchase of white-goods and technology products. The market for 'extended warranties' is enormous. Moreover, the product is considerably more profitable than would be expected. This has led over the years to a series of investigations by the competition authorities, and by financial services regulators.[50]

In order to diagnose the problem more accurately, the FCA commissioned research on behavioural errors that might explain purchasers' irrational fondness for extended warranties. This work and expert academic analysis (based largely on behavioural economics) have assisted in the diagnosing the form of market failure at play and in designing remedial legislation.

Before examining the literature, we should explain how extended warranties are sold. Normally, at the point of sale, the purchaser of a consumer good is offered the opportunity to extend the period of guarantee against various losses (such as the product failing) beyond the period covered by the manufacturer's guarantee. These products often represent poor value for a number of reasons:

1. The replacement value of consumer goods diminishes sharply as the extended warranty replaces the item with a similar item rather than a good of the same quality. So, a television that was 'top of the range' in 2012 will lack many key features of the most expensive set in 2015. The warranty only provides the 2012 equivalent.
2. Many potential causes of loss to the purchased item are likely to be already covered by household insurance (theft, accidental damage, etc).
3. From an economics perspective, it represents poor value. Insurance works best when it allows 'spare' capital to be invested to prevent a large loss that would deplete substantially the resources of the insured. Fire insurance on our home is good value because the small amount of premium paid protects us from a catastrophic loss: the

[49] 'Using Behavioral Science Insights to Better Serve the American People' at https://www.whitehouse.gov/the-press-office/2015/09/15/executive-order-using-behavioral-science-insights-better-serve-american.

[50] Eg Competition Commission, *A Report On The Supply Of Extended Warranties On Domestic Electrical Goods Within The UK*, (2003) and Office Of Fair Trading, *Extended Warranties On Domestic Electrical Goods*, (2012).

value of our home. But the kinds of consumer goods protected by extended warranties do not represent catastrophic risks. Recall, this is in addition to the existing manufacturers' guarantee. For many households, the risk of having to replace a laptop in 4 years' time is not worth the premium required, given that it would often be updated at that point anyway. For households for which the cost of replacing a laptop every few years is prohibitive, the cost of insurance premium is also likely to be a poor use of scarce resources. They would do better to replace with eg a second-hand good.

According to Baker & Siegelman, people make these poor investments for two reasons:

1. They overvalue 'peace of mind' beyond that which is rational. They are attached to a new purchase by more than its economic value: the 'consumer surplus'. This is the 'new car' feeling writ large, even (apparently) with toasters and TVs.
2. Sales techniques (at the point of sale) are able to separate in the minds of purchasers the cost of the item bought from the price of future protection so as to play on the 'new car' weakness in (1). So the cost of the television [£500] is not added to the cost of protection in the mind of the consumer, but used as the basis for generating a further investment in protection. This they term a 'situational monopoly'. If all the insurers in the world were effectively able to compete for your business at the point of sale, premiums would be competitive. But, the salesmen selling the television is offering only a single supplier of extended warranties and by raising the fear of losing the asset so recently purchased, sell cover at well above competitive market rates.

This explanation was not developed on the basis of standard law & economics because there was no market failure by that account. There was no barrier to entry of new firms and purchasers were assumed to act rationally. It was only by the use of experimental economics that researches and regulators were able to test for the effect on consumers of making the decision to buy 'add on' insurance at the point of sale. Published in 2014, the project tested consumers' attitudes to insurance products in a variety of simulated environments.[51] In essence, it used a representative sample of individuals presented with:

(a) Standalone insurance products;

[51] Z Iscenko et al *How does selling insurance as an add-on affect consumer decisions? A practical application of behavioural experiments in financial regulation* (2014).

(b) Price of consumer good and insurance product displayed together;

(c) Price of add-on insurance only revealed after purchase [‘the situational monopoly’].

The findings were remarkable.[52] The ability of purchasers to accurately ‘comparison shop’ and find best value was significantly worse in situation (c). Moreover, more than 60% on those consumers purchased the first insurance product they were shown, and so did not engage in comparing value at all. This is the reason for the supra-competitive profits: in the white-heat of buying a new gadget, we are temporarily irrational when presented with the cost of protecting that asset. The extent of these findings was such that Baker & Siegelman proposed prohibiting the sale of ‘add on’ insurance at the point of sale.

We suggest that measuring consumer (and commercial) behaviour in this fashion is highly advantageous for those designing legal interventions. It helps identify market failures and provides a virtual space in which policymakers can experiment with a variety of solutions. This is no magic bullet: there will be situations where the behaviour of the ‘lab rat’ consumers will not mirror real world reactions. Of course, as our expertise on designing and delivering experimental economics improves, so should our ability to account for experimental difficulties. This is fundamentally, the nature of scientific method.

In our final section, we examine the role of the Law Commission after legislation, in search of a role for ‘regulatory lookback’.

E. Stage 3: Regulatory lookback

The final phase of our model for the design and implementation of commercial law incorporates a role for “regulatory lookback”. This stage would involve a post facto review of the effect of commercial law rules, with a scientific approach of experimentation and evaluation being taken to legislative design. This is in contrast to the current situation, where commercial law is rarely empirically tested or evaluated once placed on the statute books (or indeed, at any stage). Our approach would recognise that we do not yet fully understand the impact of commercial design on the practices of contracting parties, and would ask whether “particular rules should be revised, simplified, strengthened, or eliminated in light of what we learn about what those rules are actually doing”.[53]

[52] See above, n 51, Figure 1, p. 7.
[53] C. Sunstein, *Simpler, The Future of Government* (2013) p.177.

The case for post facto review of regulation has been persuasively put forward by Michael Greenstone:

> "The current system for making [regulatory] choices is broken. It is largely based on faith, rather than evidence. The efficacy of many regulations is never assessed. Many others are only evaluated before they are implemented—the point when we know the least about them. The result is that our regulatory system all too frequently takes shots in the dark and we all too infrequently fail to find out if we have hit anything—or even worse, we only find out when things have gone horribly wrong."[54]

Cass Sunstein, who was strongly influenced by Greenstone in his role as administrator of the White House Office of Information and Regulatory Affairs, has illustrated how retrospective review of regulation has had a real impact in the United States, resulting in the streamlining and/or elimination of regulatory requirements which were shown to be overly burdensome in practice[55] and contributing to our understanding of the real costs associated with regulation.[56] Our proposal is that a similar assessment should apply to commercial law rules, asking not only whether the original objective of the rule is still relevant (a question with which law reform bodies are familiar, albeit often several decades or centuries after the promulgation of the rule) but also whether the way in which the rule is designed (for example as a strong / weak default / mandatory rule) affects its ability to achieve this objective, and the way in which it is applied in the real world. This involves a more scientific, experimental approach to commercial law than has hitherto been taken, with an emphasis on real time empirical data and the findings of behavioural economics and how contracting parties *really* behave, rather than a purely doctrinal legal analysis.[57] It is important to try to avoid a review which is merely "impressionistic, rather than systematic or rigorously empirical",[58] and to that end the authors plan to investigate and set out a systematic way in which this could be achieved. We envisage that any such review will involve cooperation between law review bodies, government agencies, and university researchers in law and the social sciences, and we

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[54] M. Greenstone, "Towards a culture of persistent regulatory experimentation and evaluation" in D. Moss & J. Cisterno (Eds.) *New Perspectives on Regulation* (Cambridge, 2009) 111, 111 – 112.

[55] C. Sunstein, *Simpler, The Future of Government* (2013) p.180 – 184. See also C. Sunstein, "The Regulatory Lookback" (2014) 94 *Boston University Law Review* 579. For criticisms that regulatory lookback is still ad hoc and poorly managed see: C. Coglianese, "Moving forward with Regulatory lookback" (2013) *Faculty Scholarship* Paper 1190, http://scholarship.law.upenn.edu/faculty_scholarship/1190.

[56] See also W. Harrington, R. Morgenstern & P.Nelson, "On the Accuracy of Regulatory cost estimates" (2000) 19(2) *Journal of Policy Analysis and Management* 297.

[57] Although such doctrinal analysis of course remains important as regards the substantive content and objective of those rules, it tells us little about whether the design of those rules has the desired effect in practice.

[58] C. Coglianese, "Moving forward with Regulatory lookback" (2013) *Faculty Scholarship* Paper 1190, p.64 http://scholarship.law.upenn.edu/faculty_scholarship/1190

welcome the opportunities that such cooperation could bring. The design of commercial law is long overdue rigorous testing and analysis, and a systematic post facto review of how commercial law design affects commercial law practice would go a considerable way towards meeting Goode's concern that commercial law does not learn from the past.

F. Conclusions

There is something wonderful at being at the start of research project with the open road stretching ahead. This paper represents the first steps in a project designed to join the burgeoning literature on the effect of rules in the real world with law- and policy-makers seeking to bring about change. This returns law to its first principles as 'applied politics' and is meant to better match intended outcomes to real world change. In doing so, the crucial point is not to overestimate our ability to predict. A quote so famous no-one knows who said it, captures this well: 'Prediction is hard, especially about the future'.[59]

Law-makers must then learn to design more intelligently, but to include within their wisdom the acknowledgement that it is likely to be imperfect; to permit themselves time to test and then reflect, and if necessary redesign. Once law is released into the real world, it should be tracked and where needed, designed again. In case this be confused for some 'Whiggish' conceit of permanent improvement, we should be explicit in saying that some changes are likely to make things worse, not better. But that ought to trigger reflective redesign also.

None of this should be taken as a criticism of the current Law Commissions: they do what they are designed to do. Moreover, we would hope that the proposals put forward in this paper are not dismissed as a burden[60] but are rather viewed as an opportunity for increased collaboration between law reform bodies and university researchers in law and social sciences. We have much to learn from interdisciplinary research which examines not just doctrinal aspects of commercial law but also the design and real-world impact and effect of commercial law rules, and this type of research will benefit from the respective expertise of both law reform bodies and universities.

[59] Attributed variously to Niels Bohr and Yogi Berra amongst others.

[60] Even if there are costs associated with such research, we would argue that the increased cost would be reflected in improved outcomes in commercial law.