Abstract

We discuss the law and economics of conflict of laws and choice of law, focusing on the law in the US. We first consider choice of law when the parties have not effectively chosen their governing law by contract. We address four questions: (1) Why do courts ever apply anything other than the law of the forum? (2) If a court sometimes applies foreign law, is a rule-based or more modern standard-based approach to its choice preferable? (3) Why have so many states abandoned rule-based approaches in favor of standard-based ones? and (4) Is there any real practical difference between the First Restatement and modern approaches? We then discuss costs and benefits of enforcing parties’ contractual choice of law provisions. We conclude that permitting parties to choose the governing law that best fits their transactions and future private disputes can enhance jurisdictional competition and help restore predictability to the conflict of laws problem.

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1. Introduction

When a legal dispute involves parties, property or events located in more than one government jurisdiction, and the substantive laws of those jurisdictions differ, whose substantive laws govern the rights and obligations of the parties? As barriers to migration and trade between jurisdictions fall, choice of law increasingly complicates transaction and litigation planning and provides new opportunities for private ordering.

Until approximately forty years ago, all courts in the United States applied the territorial rules embodied in the First Restatement of Conflicts when they resolved inter-jurisdictional disputes. The rules, which address most litigation subjects, are premised on a ‘vested rights’ theory. A party’s rights vest, if at all, at a particular place and point in time. Only that state has the power to create the rights relied on by the plaintiff (Beale, 1935; Brilmayer, 1995). Tort issues, for example, are governed by the law of the ‘place of the wrong’, which is defined for a variety of tortious activities. Contract validity, necessary forms,
and substantial performance issues are treated according to the law of the place of contracting, while details of performance are governed by the place of performance. Property issues are resolved according to the law of the situs of the property (Restatement (First) Conflict of Laws, 1934). Accordingly, although an interstate dispute is litigated in a Massachusetts court, the court might apply the substantive law of another state to resolve that dispute.

Several decades ago, however, conflicts scholars began increasingly to criticize the territorial approach to choice of law. The First Restatement Rules were condemned as arbitrary, because there is no a priori reason why states' powers should stop at their borders as prescribed by vested rights theory (Brilmayer, 1995). Indeed, conflicts scholars searched the case law for places where the choice of law under the First Restatement led to intuitively unsatisfying results (Cavers, 1933; Currie, 1958a, 1958b; Ehrenzweig, 1956). Tort immunities as applied to common domiciliaries is one such place (Ely, 1981). Under the First Restatement, a husband’s ability to recover for an injury caused by his wife’s negligence while they were on vacation in another state is governed by the law of the place of the injury, even though the marital domicile is the only state which really has an interest in compensating this husband or preserving this family’s harmony. As another example, some have advocated a place of sale rule for products liability cases to better enable manufacturers to charge customers for the varying levels of care and liability they are subject to in differing places. Because products can be moved anywhere, the First Restatement’s place of injury rule ends up causing customers in states with lesser tort protections to help pay for the increased tort protections of customers in other states (Kozyris, 1987; McConnell, 1988; O’Hara and Ribstein, 1997; Solomine, 1989).

Defenders of the First Restatement dismissed these occasional unsatisfying results and instead focused on the general benefits of rules. Rules promote predictability, uniformity, ease of application, and judicial restraint, while discouraging forum-shopping (Reese, 1972; Rosenberg, 1968). In reality, however, a number of ‘escape devices’ sometimes enabled courts to avoid First Restatement rules when they really wanted to. One method found in every rule-based system is characterization (North and Fawcett, 1992): how the forum court characterized a case, as one of tort or contract for example, determines the choice of law. Where ambiguities arose, judges were free to choose a more preferred governing law. In addition, a public policy exception in the First Restatement permitted courts to avoid applying any foreign law that violated the public policy of the forum. Critics argued that these and other escape devices deprived the First Restatement rules of the very benefits they purported to confer (Brilmayer, 1995). As discussed later in this section, however, subsequent empirical studies cast some doubt on the strength of critics’ claims.
In any event, critics argued that courts should replace the rule-based approach with a more sensible basis for choosing governing law. As detailed later in this section, some advocated maximizing the ability of states to give effect to important policies, while others promoted the use of the better or more ‘progressive’ states’ laws. Still others proffered personal rights-based approaches to choice of law. Most of the critics favored standard over rule-based approaches. As a consequence of widespread First Restatement criticism, a significant majority of US state courts have abandoned the traditional approach in favor of one of several alternative approaches to choice of law. As of 1989, only fourteen US states purported to follow the First Restatement (Solomine, 1989), and each of the others has adopted one of at least four alternative approaches. Consensus has clearly disappeared.

Part A will consider four questions regarding choice of law when the parties have not effectively chosen their governing law by contract. First, why do courts ever apply anything other than the law of the forum? Second, if a court sometimes applies foreign law, is a rule-based or standard-based approach to its choice preferable? Third, why have so many states abandoned rule-based approaches in favor of standard-based ones? Finally, is there any real practical difference between the First Restatement and modern approaches? After all, if the standard-based choices do not differ systematically in practice from the First Restatement, the academic debate seems irrelevant. Moving to contractual choice of law, Part B discusses the costs and benefits of enforcing parties’ choice of law. Permitting parties to choose the governing law that best fits their transactions and future private disputes can enhance jurisdictional competition and help restore predictability to the conflicts of law problem.

As indicated in this Introduction, we focus on choice of law by US states. The same basic economic principles apply, of course, to international choice of law. Although a detailed examination is beyond the scope of this article, we note some international comparisons and implications at relevant points of our article. We also note at the outset that choice of law within the US may have very different implications from choice of law in Europe given legal harmonization under European Community directives and regulations.

Nor do we discuss arbitration. An arbitration clause in an agreement is a type of forum selection. The choice of law governing the agreement may be as significant as choice of law in other contexts. On the other hand, the arbitrator may not be bound to apply any specific body of law, especially under the European approach of ‘de-localised’ arbitration (Dicey, 1980, pp. 583-585).
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A. The Conflict of Laws Problem

2. Forum Law: The Costs and Benefits

Forum law has at least two efficiency advantages over applying foreign law. First, it is easier to ascertain. Because the judges and lawyers who are licensed to practice in the jurisdiction have previously made significant capital investments learning the details of forum law, the costs of applying that law to any given case are generally lower than the alternatives. Second, the precedent created by applying forum law provides valuable information to primary actors as well as courts and litigators regarding future legal treatment of the issues. In contrast, an investment in foreign law is less valuable locally because foreign precedent is less binding and therefore less important in guiding local conduct or judicial decisions (Thiel, 1996).

An interesting question thus arises: why should a court ever apply the laws of another state? One reason is to enhance predictability. If actors can rely on the application of the law of a particular state, they can structure transactions and other activities and avoid inappropriate or inefficient laws. This, in turn, forces states to internalize the costs of inferior laws, thereby promoting competition among jurisdictions for more efficient substantive rules (O’Hara and Ribstein, 1997). Ex ante reliance on Delaware corporations law, for example, is only attainable if New York courts commit themselves to applying Delaware law to the internal affairs of a Delaware corporation. A lex fora approach to choice of law therefore impedes pre-litigation predictability. Conflicts scholars have, however, questioned the benefits of predictability by doubting whether people respond to differing legal standards in such contexts as accidents and child abuse (Sterk, 1994; Symposium, 1997). If governing laws do not provide marginal deterrent value in these contexts, then ex ante predictability is not sufficiently valuable to justify the increased costs of applying foreign law. On the other hand, empirical evidence indicates that governing tort standards do affect aggregate behavior (Bruce, 1984; Landes, 1982; Landes and Posner, 1987). In particular, repeat players, including manufacturers and insurance companies, pay careful attention to differing laws. Moreover, the actual uncertainty created when the plaintiff can forum-shop for the applicable law is debatable. Actors can predict that disputes will likely be governed by the most plaintiff-favoring law in the set of possible fora for disputes. And, even if parties cannot be certain which forum will ultimately be chosen, in the event of litigation they can proceed with probabilistic expectations. Although the outcome of a plaintiff’s forum-shopping law may not be very predictable ex ante in many circumstances, it is often not clearly less predictable than anticipating what law a court will apply under default choice of law standards which, as discussed below, can be vague and open-ended.
Another disadvantage to a forum law rule is that it encourages forum-shopping which can produce inefficiencies. Differing substantive laws create disparities across jurisdictions regarding plaintiffs’ expected gains from litigation. Forum shopping is generally regarded as skewing the litigation process toward plaintiffs and distributing litigation unevenly across jurisdictions (Sterk, 1994). States with more plaintiff-favoring laws end up being swamped with litigation, while lawyers in states with relatively more defendant-protecting laws face a lower demand for their services.

A third reason for applying foreign law is to take advantage of foreign jurisdictions’ comparative regulatory advantages (Posner, 1992; O’Hara and Ribstein, 1997). Suppose, for example, that a South Carolina driver collides with a Florida driver in New York City. Presumably New York adopts traffic and tort laws to encourage an optimal level of care in New York. If a defendant is sued in South Carolina and the court applies South Carolina traffic and tort laws to the suit, then the effectiveness of New York’s laws are watered down, given that drivers from all over the country traverse the streets of New York. If everyone is subject to New York standards of liability, then New York can better tinker with its own laws to encourage the standard of care it seeks.

Brilmayer (1995, p. 15) describes the tendency of courts across the world to sometimes consider foreign law as ‘virtually universal’. In the US, only two states, Kentucky and Michigan, explicitly embrace a lex fora approach (Solomine, 1989). Indeed, the United States Supreme Court has held that application of forum law is unconstitutional if the forum has no substantial interest or connection to the litigation (Home Insurance Co. v. Dick). This result is supported by our conclusion that the benefits of predictability, regulatory efforts and jurisdictional competition probably outweigh the costs of applying forum law in many interstate contexts.

3. Rule vs. Standard-based Approaches

Assuming that a court should sometimes apply foreign law, should choice of law decisions be based on rules or a standard? Rules provide predictability, enhance planning and help ensure uniform treatment of similarly situated litigants. In contrast, standards are often better at generating just results in individual cases. Because the costs of overdeterrence and underdeterrence can differ according to the context, rules may be preferable in some areas, while standards may be preferable in others.

As mentioned earlier, the First Restatement rules seemed arbitrary in some contexts. But will a standard-based approach improve choice of law overall? And if a standard-based approach is preferable, what should the governing standard be? States that have abandoned the First Restatement have usually
adopted one of three alternative standards: (1) Leflar’s ‘better law’; (2) interest analysis; or (3) the ‘most significant relationship’ test. Leflar (1966a, 1966b) says that courts should give significant weight to the ‘better law’ when faced with the choice, and the better law is generally the one that achieves the most justice, which is courts’ primary obligation.

Interest analysts advocate that choice of law should advance state policies behind their laws. Each state thinks its laws are ‘better’ in general. Consequently, courts should determine which states have an interest in applying their laws to this dispute, given the domiciles of the parties and the location of property and events leading to litigation. As originally conceived, states intend to protect or compensate only their own domiciliaries with their laws, not foreign residents. And a state has a regulatory interest in conduct occurring only within its borders. Brainard Currie, the originator of interest analysis, argued that the forum always should apply its own law when it is ‘interested’ in the outcome of the dispute. If no state has an interest in the outcome, the forum should still apply its own law because it is cheaper than applying foreign law. Foreign law should be applied only when the foreign state is interested and the forum state is disinterested (Currie, 1959). Baxter (1963), offered an alternative ‘balance of state interests’ approach. Under this approach, courts should use interest analysis to maximize the joint effectuation of state policies. If two or more states are ‘interested’ in the outcome of a dispute, a court should determine which state stands to lose most if its policies are ignored, and then apply the law of that state. In other words, in the face of a conflict, Baxter proposed that courts minimize social costs, as those costs are perceived by the individual interested states.

The drafters of the Second Restatement took a third approach. They concluded that courts should apply the law of the state with ‘the most significant relationship’ to the parties, property and events involved in the dispute. In making this determination, courts should consider a number of factors, including ‘the needs of the interstate and international systems’; ‘the relevant policies of the forum’; ‘the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue’; ‘the protection of justified expectations’; ‘the basic policies underlying the particular field of law’; ‘certainty, predictability and uniformity of result’; and ‘ease in the determination and application of the law to be applied’ (Restatement (Second) Conflict of Laws, 1971). This test approach is similar to the ‘most significant relationship’ test used in Europe, except that the latter provides somewhat more guidance in selecting the applicable jurisdiction (Scoles and Hay, pp. 45-47).

Each of the three standards used in American courts has significant problems. Leflar’s approach allows judges significant leeway for application of outcome-determinative choice of law rules. Moreover, judges’ varying
preferences undermine predictability. The same can be said of the Second Restatement test, which gives no indication of how much weight to give to each of the numerous factors (Brilmayer, 1995).

Interest analysis is more complicated. The narrow range of state interests recognized by Currie fails adequately to promote the purported goal of the standard. A state’s substantive goals reach far beyond compensating its plaintiffs or protecting its defendants. Often a state is attempting to achieve a sensitive balance between competing interests. Viewing the state’s interests behind its substantive laws ignores important choice of law concerns such as protecting party expectations and interstate harmony and preventing forum shopping (Brilmayer, 1980). On the other hand, while modern interest analysts advocate considering the state’s true interests behind its laws (Kramer, 1990, 1991a, 1991b), this reduces any predictability the approach might otherwise provide (Brilmayer, 1995) since many factors can motivate state decision making. Moreover, the idea of state interests becomes problematic from a public choice perspective (O’Hara and Ribstein, 1997). States are not monolithic entities. Individual legislators vote for very different reasons, and the state government officials, including judges, who influence the application of the laws have their own concerns. Interest groups that lobby for laws are often trying to achieve purposes very different from the ‘public policies’ stated by the legislators themselves.

Baxter’s comparative impairment approach to interest analysis further complicates the choice. Baxter advocates applying the law of the state with the most to lose if its laws are ignored. However, this calculation is often impossible. Suppose, for example, that two states have interests in applying their laws to a contract dispute. Under State A’s laws, spendthrifts can void their contracts. Under State B’s laws, spendthrifts contracts are enforceable against the spendthrifts. C, a spendthrift from state A, borrows money from D, a creditor from state B. C fails to repay the loan and D sues to enforce the loan contract. Under interest analysis, state B has an ‘interest’ in compensating its creditor, while State A has an interest in protecting its spendthrift. Which state’s policy suffers greater impairment if its laws are ignored? If such conflicts arise frequently, at least one of the states necessarily will end up having difficulty protecting its residents.

The standard-based approaches have proved unsatisfying. A better solution might be to retain the First Restatement rules with periodic modifications to avoid frequent arbitrary results. Indeed, Posner (1992) has argued that the First Restatement, for all its faults, had the virtue of enabling states to exercise their comparative regulatory advantages. For example, by defining and then applying the ‘place of the wrong’ to tort suits, states usually could apply their laws to tortious conduct within their states, and could therefore ensure that actors took optimal levels of care. The First Restatement situs rule for property enabled the
state where the land was located to regulate its use. Title questions are also resolved by the law of the place of property, a clear rule easing the tracking of titles and therefore facilitating the transfer of property to its highest valued use. Finally, contract validity issues are governed by the place of contracting, and the detailed rules tended to protect those who contract within their own borders. Those who reached across borders were on notice of being subject to the differing protections outside their states. The rule minimized the costs of gathering personal and legal information for those, such as consumers, who transacted business locally. Details of performance were governed by the state with the greatest regulatory concern, where those details were to be performed.

The choice between rules and standards also may be viewed from a contractual perspective. Part B, below, discusses the enforcement of express choice of law clauses. A related issue is the appropriate default rules to supply in the absence of express contract in order to facilitate private bargaining. Standards provide ‘tailored’ defaults that fit specific situations, while rules provide ‘untailored’ defaults that apply across a range of cases (Ayres, 1993). In general, untailored rules can reduce contracting costs by decreasing uncertainty as to the rule applied in the absence of contracting. Tailored defaults, by attempting to anticipate the parties’ actual preferences, can reduce the need for costly customized contracting (Whincop and Keyes, 1998, pp. 525-526). But untailored choice-of-law rules, because they only choose legal systems rather than specific rules, may actually do a good job of anticipating the parties’ preferences in the usual case, as distinguished from the odd cases courts actually decide (Whincop and Keyes, 1998, Ch. 3).

Any choice of law approach should take into account concerns for harmonizing state interests, protecting party expectations, minimizing costs of legal information, as well as allowing states to exercise their comparative regulatory advantages. But a rule-based system under which the drafters take these concerns into account to the extent feasible also could promote uniformity and thereby minimize forum shopping. Compared to the standard-based alternatives that have received court attention, the First Restatement likely provides much greater predictability despite its escape devices, and would be even better if these devices were narrowed.

4. Coordination Problems with Rule-Based Approaches

If the First Restatement approach to choice of law is so superior, why have most states abandoned it? In other words, why have the states been unable in recent decades to coordinate choice of law to achieve increased uniformity and predictability? Unless the states collectively adopt or retain choice of law rules, the primary benefits of those rules are lost. A few conflicts scholars have
advocated a return to a rule-based approach that would yield net benefits across states, perhaps with legislative encoding of a new Restatement to foster cooperation (Rosenberg, 1981; Scoles and Hay, 1992). But individual rules do not always benefit the state or judge that is supposed to follow them, and interstate enforcement problems may have led to the breakdown of choice of law rules. In other words, courts face an unresolved prisoner’s dilemma in the choice of law context.

In general, as the late Judge Breitel once explained in an unpublished speech (Sterk, 1994), judges first ask themselves who deserves to win. Then they assess how much cost to jurisprudence is likely imposed if they manipulate the system to get that outcome. If costs will be borne by future worthy litigants, judges will apply rules with less preferred outcomes for the present litigants. In other words, future litigants constrain judges in the present case to a general application of rules, including procedural ones. Judges who are nevertheless tempted to violate the precedents of other judges are constrained by reputational sanctions imposed by colleagues and higher courts (O’Hara, 1993).

But choice of law is different. Issues arise in many factual contexts involving people and events from different places, and sufficiently infrequently that the specific issue seldom arises again. Because the precedential value of a given choice of law decision is quite limited, costs to future litigants of reduced predictability in that factual context are slight. And colleagues and higher courts are much less likely to attempt to vigilantly protect choice of law precedents than they are to protect precedents that shape forum substantive law.

Even if rules are generally preferred to standards, formulating a comprehensive set that leaves all states better off than they are under choice of law anarchy might prove difficult to formulate (Sterk, 1994). Perhaps more importantly, judges are always tempted to defect from individual rules in favor of local litigants (Hay, 1992), or to apply more easily ascertained local laws. While other states may suffer as a consequence, they are unlikely to pressure the deciding state to prevent these defections. The classic tit-for-tat enforcement strategies (Axelrod, 1984) would be difficult to implement, especially because monitoring of other states’ choice of law decisions is costly. Even with monitoring, escape devices allow states in some contexts to defect while feigning cooperation under the rules. When defections are difficult to detect, enforcement becomes much more difficult, and bargains are likely to unravel for at least a while (Friedman, 1971; Green and Porter, 1984). Moreover, it might be years before an interstate dispute arises in the disadvantaged state enabling retaliation against the state that originally defected. Larger plaintiff-favoring states, which were the first to abandon the First Restatement, have more opportunity to defect because they handle a larger volume of interstate litigation.
In a few areas where cooperation among the states really matters, interstate compacts have been formed on a piecemeal basis. For example, state taxation of corporations and child custody disputes are now treated with relatively uniform choice of law provisions. Where cooperation is important but has proven unsuccessful, Congress can step in and federalize the substantive law, as it has done, for example, regarding both bankruptcy and products liability for vaccine manufacturers. For better or worse, choice of law problems are mooted once the federal government imposes uniform federal laws. Finally, private parties can enhance predictability and uniformity to some extent with choice of law provisions in their contracts (Kobayashi and Ribstein, 1998). What is left may not be worth coordinating, at least on the grand scale of a new Restatement.

Of course, some coordination persists in smaller rural states. The First Restatement states are clustered together in the south, including Maryland, Virginia, West Virginia, Tennessee, Alabama, North Carolina, South Carolina and Georgia (Solomine, 1989). These states share a relatively distinct economy and culture that may limit a majority of interactions to people and events in one of the other First Restatement states, perhaps enhancing cooperation. Alternatively, coordination in these states may have more to do with a shared conservative legal culture. In any event, it is not surprising that the First Restatement broke down across a majority of states as legal realism permeated the law, beginning with the larger, plaintiff-favoring states. The benefits to achieving preferred results in individual cases outweighed the costs to individual judges’ preferences of ignoring the settled choice of law rules.

5. Do the Choice of Law Approaches Matter in Practice?

The academic debate over choice of law loses relevance if court decisions do not vary significantly under the alternative regimes. Some commentators have suggested that the approaches to choice of law followed within the US make no difference in the end. (This does not, of course, apply to the different choice of law approaches in the international setting.) Sterk (1994), for example, argues that courts care about ensuring that deserving parties win their cases. In contrast, the choice-of-law theorists concern themselves with a host of issues that do not concern the courts. The courts therefore cannot be expected to take any of the approaches seriously. In fact, Leflar (1977) points out his casual impression that courts often make a choice of law determination, and then rely on the choice of law theories that support the court’s conclusion.

Even assuming that each state is committed to a single choice of law approach, systematic differences in chosen law between the modern approaches might be difficult to detect, if the modern approaches leave judges effectively unconstrained. One might predict, then, that results differ between First
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Restatement states and states adopting modern approaches, but not among states that have adopted each of the modern approaches. Alternatively, if First Restatement escape devices also leave judges unconstrained, then no differences among states would be found based on choice of law approach. It has also been suggested that the modern approaches are more pro-resident, pro-forum, and pro-recovery in principle than the relatively neutral First Restatement (Brilmayer, 1980) and that, because each of the modern approaches rests on theoretically distinct grounds, some of the modern approaches display these biases more than others (Borchers, 1992).

Three empirical papers have attempted to test for systematic differences across states according to choice of law approaches for torts. Solomine (1989) studied 227 cases retrieved from a Westlaw computer search of all published US state supreme court and federal court of appeal cases that explicitly reviewed choice of law determinations in torts. He compared those decisions made according to the First Restatement with those decided according to one of the modern theories. Solomine found that the modern theories resulted in choices of law that were more likely to favor residents, recovery and forum law than did the First Restatement.

It may seem surprising that Solomine would find differences across jurisdictions, at least with regard to recovery-favoring rules. After all, Priest and Klein (1984) demonstrated convincingly that disputes that are actually litigated are biased toward those that are on the margin. Plaintiff win rates should tend toward 50 percent. Even if they vary due to asymmetric information or stakes, win rates should not vary systematically across courts. But choice of law questions might be sufficiently inexpensive and preliminary in the litigation process that results may vary at the margin across jurisdictions.

Borchers (1992) followed with a more extensive study, and ascertained confidence intervals to test the significance of variations across choice of law methodologies. Borchers classified each state by choice of law approach, and then collected 800 published state and federal cases, including those reported at both the trial and appellate level. In the First Restatement states, he retrieved every case found on-line from 1960. In the modern approach states, he retrieved all cases found subsequent to the shift in methodology. Borchers attempted to ascertain the differences both between the First Restatement and modern states as a group and among the specific methodologies applied in the modern states. When the modern states taken together were compared with the First Restatement states, Borchers’ results confirmedSolomine’s. The modern approach states were significantly more pro-recovery, resident and forum favoring in their choice of laws. However, Borchers found essentially no statistically significant variations across the modern approaches. He found significant variation only with respect to recovery-favoring rules. The Second Restatement and Leflar states were statistically distinguishable from each other,
with the Leflar states generating more recovery-favoring outcomes. Borchers’ results were seriously qualified, however, by the fact that neither the Second Restatement nor the Leflar states produced choices statistically distinguishable from interest analysis. Borchers concludes (p. 379), ‘Courts do not take the new approaches seriously. Because all of the competitors to the First Restatement start from different analytic premises, if courts were faithful to their tenets they would inevitably generate different result patterns. Yet in practice the outcomes are largely indistinguishable.’

Thiel (1996), a trained econometrician, criticized Borchers’ methodology for lacking a regression analysis that could control for legal culture. Pro-recovery and pro-plaintiff results can come partly from the modern choice of law approach, but could also be affected by systematic differences in the general legal culture of the First Restatement and modern approach states. At the same time, the states that have adopted the same choice of law methodology might have positively correlated legal cultures. To separate out these influences on choice of law decisions, Thiel used Borchers’ state classifications, and remeasured the differences, using variables that might control the estimates for the influence of legal culture.

Thiel found that while the modern approach states clearly use forum law more often than states using the First Restatement, there was little difference at the margin between the two groups of states with respect to recovery-favoring choice of law determinations. Thiel believes that the results indicate that plaintiffs push lawsuits to where their prospects of prevailing on choice of law rulings are about equal in all states. Thiel’s most interesting results are found in comparing states according to modern methodology. Unlike Borchers, Thiel’s regressions produced statistically significant variations across the modern approaches with respect to forum and recovery-favoring choice of law. As predicted by theoretical analyses of modern methodologies (Borchers, 1992), the point estimates of the differences indicate that the Leflar states are relatively strongest in their generosity to plaintiffs and preference for forum law. The interest analysis states also show a strong bias toward choice of forum law, and are relatively strongest in favoring local parties.

More empirical studies could help clarify the choice of law debate. In the conflicts field, as least as much as any other, legal academics make bald statements claiming that various approaches or rules will work in particular ways or have specific effects on primary behavior. Those statements are supported at best with slight anecdotal evidence. The field is ripe for empiricists who can cut through the legal and academic thicket to view the landscape.
B. Contractual Choice of Law

We have so far discussed only the default choice of law rules that apply in the absence of contract. Enforcing clauses in contracts that select the applicable law has several possible benefits (Ribstein, 1993; Whincop and Keynes, 1998, Ch. 3).

6. Benefits of Enforcing Contractual Choice of Law

Eliminating Inconsistency
The parties may contract for choice of law in order to eliminate problems that arise when inconsistent mandatory rules otherwise might be applied to different aspects of or parties to the contract, such as shareholder voting rules and the rights of franchisees.

Clarifying the Applicable Law
Contracting for choice of law enables the parties easily to determine what law governs the transaction. Uncertainty about the applicable law that results from the choice of law default rules discussed above prevents the parties from easily determining the standard of conduct to which they should conform or how to price contract rights and duties. Uncertainty at the time of litigation can increase both the costs and frequency of litigation. In particular, the uncertainty may increase the parties’ gains from litigating rather than settling (Priest and Klein, 1984). This is not only privately more costly for the parties, but also imposes costs on the judicial system that are borne by taxpayers generally.

Jurisdictional Competition
Enforcing contractual choice of law is particularly useful in fostering jurisdictional competition for more efficient laws across states (Kobayashi and Ribstein, 1998; Ribstein 1993). Competition works both by encouraging states to develop new terms to attract new legal business, and by encouraging states to retain legal business by efficiently revising their laws. Jurisdictional competition was first observed with regard to corporations, where a clear choice of law rule, the internal affairs rule in the US, compels application of the law of the state of incorporation (see Section 8, below). This rule encourages corporations to select the applicable law. Commentators have debated whether this process is a ‘race to the bottom’ in which the states attract incorporation business by exploiting principal-agent problems resulting from the separation of ownership and control (Cary, 1974) or a ‘race to the top’ that is disciplined by efficient capital markets (Winter, 1977). For empirical evidence favoring the race to the top hypothesis, see Carney (1993), Romano (1985), Dodd and
Leftwich (1980). For studies of the role of jurisdictional competition in the transition from special chartering to general incorporation, see Slughart and Tollison (1985) and Butler (1985).

As Tiebout recognized, the ability of people and firms to exit jurisdictions whose policies they do not like motivates governments to reflect voters’ preferences (Tiebout, 1956; Frey and Eichenberger, 1995; Gerken, 1995; Kerber and Vanberg, 1995). Thus, the demand side of jurisdictional competition requires, among other things, that actors are mobile (Easterbrook, 1983; Tiebout, 1956; Fischel, 1987). For example, with regard to corporations, foreign incorporation imposes registration costs, exposes firms to suits in remote jurisdictions and makes unavailable intrastate financing that is exempt from the federal securities laws. Close corporations ordinarily lack incentives to incur these costs because they can get most of what they want by adapting the default provisions of their resident-state’s law (Ayres, 1992a; but see Ribstein, 1995a). Large multistate firms, on the other hand, pay these costs anyway in all but one state in which they transact business and have scale economies that can absorb the costs.

The supply side of state competition requires that states have incentives to compete for formation business (Daniels, 1991). The states provide their law free of charge at taxpayer expense. If states cannot internalize the benefits from efficient contract rules, they may have inadequate incentives to devote legislative and judicial resources to developing and maintaining efficient contract rules. The standard explanation of the state competition for corporate law is based on the states’ incentives to earn franchise and related fees from incorporating firms (Romano, 1985). They can also earn revenue if enforcing choice-of-law attracts firms’ operations to the state. Either of these mechanisms would, in effect, give the state property rights in application of its law.

In analyzing the supply side of state competition, it is necessary to disaggregate the ‘state’ and determine what motivates politicians to compete. Contracting parties’ ability to exit the state is a necessary but not sufficient basis for efficient competition. It is also necessary that this exit be translated into incentives for politicians. Whatever the benefits to states by participating in interstate competition, it is not clear that taxpayers can motivate state legislators to draft state-of-the-art legislation solely in order to maximize state revenues, particularly given legislators’ costs of producing this legislation. No individual taxpayers can capture enough benefits from legislative action to justify expending resources on legislation. Also, legislators may not be able to capture benefits from engaging in the competition because other jurisdictions easily can free-ride on their efforts by copying successful legislation (Rose-Ackerman, 1980). At the same time, legislators incur costs in competing to provide state law. In particular, because legislators can earn contributions and other support from affected parties by brokering changes in mandatory rules, they do not have strong incentives to lead the movement toward more
enabling rules. Third, legislators face an unfavorable balance of risks and rewards. They take the risk that the legislation will fail to accomplish its objectives or will alienate groups that otherwise would have supported them, while their successes can be copied easily by other states. For discussions of legislators’ weak incentives to innovate, see Rose-Ackerman (1980), Ayres (1992b), Carney (1993), MacIntosh (1993), Ribstein and Kobayashi (1996).

State competition to supply law may, however, be driven by lawyers rather than legislatures (Ribstein, 1994, 1995). Lawyers not only wield the conventional power of a cohesive interest group but, in most states, draft complex business statutes. Lawyers have an incentive to make their state a standard for commercial contracts in order to attract more litigation business to the state’s courts and increase the value of advice on and expertise in the state’s law. However, as the price for assisting in the competition of state laws, lawyers may reduce the demand for these rules by pressing for rules that favor lawyers, such as by offering open-ended default rules that discourage settlement and increase litigation (Macey and Miller, 1987; White, 1992; Priest and Klein, 1984). Accordingly, lawyers may have an interest in preventing the parties from simplifying choice of law by contracting in advance to be governed by a particular law. On the other hand, lawyers are constrained by jurisdictional competition. In general, lawyers would support rules that reduce demand for law up to the point that the reduction in demand exceeds their benefits from the rules. Demand may be reduced by inefficient legal rules that cause parties to move their legal business to other states, federal courts and arbitrators.

The extent to which states compete to supply non-corporate law depends significantly on whether interest groups in those states can protect their benefits from mandatory rules from erosion by state competition. Under standard interest group theory, state legislation is determined by the relative strength of the various groups that the legislation helps and hurts (Olson, 1965; McCormick and Tollison, 1981; Tollison, 1988). To be sure, states can successfully compete only by making their underlying legal rules generally attractive to contracting parties. Thus, a state could not win a competition to attract, say, franchise law business simply by adopting a pro-franchisee law. However, the state might be able to help franchisees by imposing retroactive burdens on existing franchise contracts. Groups helped by such laws might oppose vigorous choice-of-law competition. States’ incentives to compete therefore depend on how well organized are groups that favor mandatory rules, the costs and benefits to competing groups of applying contract-friendly enabling rules rather than protective mandatory rules, and lawyers’ benefits from competing for law business. Thus, for example, Delaware may be in a good position to compete to supply law in part because it has a highly organized commercial bar but no well-organized competing groups.
The quantity and quality of state competition ultimately depend on the legal rules regarding contractual choice of law. Politicians may protect themselves by, for example, restricting enforcement of contractual choice law. While the courts may have considerable discretion to interpret the legislature’s statutes, they can do little in the face of a statute that explicitly invalidates choice of law clauses. Even if the statute does not invalidate exit by choice of law, judges may have their own incentives to maximize the value of interest group deals by protecting them from dilution by party choice of law. After all, judges clearly have some incentive to respond to legislators’ interests to the extent that the latter control judges’ salary and tenure. If so, judges can be expected to act to increase the durability and value of legislators’ interest group deals by enforcing them within the state (Anderson et al., 1989; Crain and Tollison, 1979; Landes and Posner, 1975).

Although legislators and judges may attempt to block contractual choice of law, contracting parties to some extent have the last say. They may, among other things, choose the fora in which disputes are decided and completely exit jurisdictions that are hostile to contractual choice (Kobayashi and Ribstein, 1998).

Jurisdictional Competition and Evolutionary Theories
Contractual choice of law may lead to a process of legal evolution. As to legal evolution generally, see Benson (1995), Kerber and Vanberg (1995). Alchian (1950) observed that a study of the ‘adaptive mechanism’ of the market may be more fruitful than that of ‘individual motivation and foresight’. Under this theory, individuals and firms who have an incentive to minimize their transaction and information costs and an ability to choose legal regimes that accomplish this goal will cause the law to move toward efficiency. For example, corporate law evolved from the sale of corporate charters by state legislators to largely enabling statutes and alternative forms of limited liability business forms because of the pressure of jurisdictional competition (Butler, 1985; Shughart and Tollison, 1985). There is also evidence of such evolution with respect to the demand for statutory forms (Ribstein, 1995a) and the demand for uniform statutory provisions (Kobayashi and Ribstein, 1996). This evolutionary theory suggests that the conditions for efficiency may exist even if this outcome could not be predicted ex ante based on a study of the incentives of legislators or other key actors.

It may be indeterminate whether the mechanisms for efficient competition are in place, and therefore impossible to determine ex ante whether competition among unknown alternatives will produce more efficient results than applying a centralized rule. Nevertheless, it may be more efficient to facilitate jurisdictional competition by enforcing contractual choice of law in order to
promote a process of discovering more efficient alternatives (Hayek, 1948; Vihanto, 1992; Kobayashi, Parker and Ribstein, 1994; Gerken, 1995). Contractual choice of law is also likely to be superior to other alternatives, such as the adoption of uniform or national laws, precisely because differing state laws foster experimentation (Ribstein and Kobayashi, 1996; Kobayashi and Ribstein, 1996). Moreover, diverse environments may suggest differing optimal rules, and choice of law enables parties to choose the rule that fits best with their contracting situation (Posner and Scott, 1980; Easterbrook, 1983; Baysinger and Butler, 1985; Romano, 1985).

On the other hand, enforcing contractual choice of law might not lead to efficient competition if state legislators engage in ‘herd’ behavior by ignoring their private information generated by other states’ experiences and simply adopting prior laws. (For theoretical treatments of herd behavior, see Banerjee, 1992; Bikhchandani, Hirshleifer and Welch, 1992; Scharfstein and Stein, 1990.) However, evidence from the evolution of statutory forms for closely-held firms indicates that legislators do not simply follow-the-leader but rather apply new information in adopting legislation (Ribstein, 1995a).

7. Costs of Contractual Choice of Law

Notwithstanding the above arguments, there are also reasons why enforcing contractual law may lead to inefficient results (Ribstein, 1993).

Evasion of Mandatory Rules

Enforcing contractual choice of law arguably can lead to externalization of costs where it permits contracting parties to evade mandatory rules that are intended to address specific bargaining problems that can lead to such externalization. This may be the case, for example, where the parties are attempting to escape prohibitions on contract terms such as fiduciary duty waivers, usurious interest rates, termination-at-will or noncompetition provisions.

The argument against enforcing the contractual choice-of-law in these situations may seem to be precisely the same as that supporting the mandatory rule itself. However, there are several reasons for permitting the parties to opt out of locally mandatory rules by contractually choosing the applicable law or forum. First, where several jurisdictions’ laws may apply, the parties’ choice of law is not obviously less appropriate than any other basis of selecting the applicable law.

Second, evasion of mandatory rules is constrained by the fact that avoidance requires applying a state law rather than solely the voluntary act of contracting parties. That the chosen state’s law applies to its own residents reduces state legislators’ incentives to engage in this sort of conduct. Accordingly, this
danger of enforcing contractual choice of law exists mainly where most victims live outside the state.

Third, the enacting legislature may not have intended to preclude contracting for the applicable law or forum. In particular, a mandatory rule may not make sense to the extent that it precludes efficient bargains. The parties arguably indicate that the mandatory rule is costly when applied to them by their willingness to incur the costs of contracting for choice of law. Thus, courts generally should enforce contractual choice of law or forum even to the extent that it overrides a locally mandatory rule (Buckley and Ribstein, 1998; Whincop and Keyes, 1998a, Ch. 4, 1998b).

Information Assymetry and Protecting Contracting Parties

Enforcing contractual choice of law arguably may lead to externalization of costs because the party responsible for the term is probably more well-informed concerning the chosen law. Indeed, such information asymmetries may skew interstate competition because states may tailor their rules to suit the more informed party. However, information asymmetry is arguably not a problem where the effect of the law selection clause is to choose a legal regime that literally enforces the contract; in long-term contracts negotiated by sophisticated and knowledgeable parties who have the ability and incentive to read the contract carefully or hire an attorney to do so; or where firms are subject to market incentives to disclose and to constraints on cheating (Schwartz and Wilde, 1979). In any event, regulators could minimize information costs by mandating disclosure of unusual and significant law-selection terms in some circumstances.

Similarly, enforcing contractual choice of law is arguably inefficient where the choice-of-law clause can be characterized as an ‘adhesion’ contract imposed by one party on another. This argument also has been used to justify broad regulation of corporate governance. However, this is not the case merely because of the parties’ acceptance of a standard term, particularly where the contract chooses the entire local law of a particular jurisdiction. A state’s entire law as to a complex contract probably will not operate unfairly against one of the parties on all or most of the many issues that could arise in the future.

8. Enforcement of Contractual Choice of Law

This section considers the extent to which choice of law provisions are enforced in United States courts.
Common Law

The common law, as summarized in Restatement (1971), § 187(1) provides for enforcement of the parties’ contractual choice of law as to interpretation issues the parties could have resolved by contract. Under Restatement § 187(2), the contract is not enforced as to issues such as validity, where choice of law matters most, 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.

Courts and commentators have not clearly articulated a rationale for these limitations on enforcement of contractual choice of law (Ribstein, 1993). The ‘substantial relationship’ test in subsection (a) seems to have no function other than to increase the parties’ cost of exit from mandatory rules and, therefore, to reduce the likelihood of efficient interstate competition. For example, it is not clear why any mutually agreed choice would not be prima facie ‘reasonable’. The test conceivably could be defended on the ground that it addresses externalization of costs by states whose law is applied. But even if the particular contract at issue does not relate to the contractually selected state, the state might still be subject to market discipline where the applied law has substantial application within the applying state. In other situations, such as corporate law, the state is otherwise subject to market discipline in formulating its law. With respect to the vague ‘fundamental policy’ exception in subsection (b), the Restatement gives as examples ‘illegal’ contracts or rules ‘designed to protect a person against the oppressive use of superior bargaining power’ (Restatement, 1971, p. 568). This appears to track potential concerns about bargaining power and information asymmetries (see Section 7, above). Alternatively, this ground for non-enforcement may just invite courts to determine and effectuate the underlying goal of the interest groups that promoted the law.

In general, courts applying the US Restatement (Second) rule have quite generally enforced contractual choice of law (Ribstein, 1993). Thus, in practice, the US rule is close to the rule favoring enforcement articulated in the leading UK case of *Vita Food Products Inc. v. Unus Shipping Co.* That case enforced a provision applying English law though there was nothing to connect the contract with England except the choice of law clause.
Statutory Law

Several states, including California, Illinois, Delaware, New York and Texas, have promulgated statutes that, to varying degrees, clarify the enforcement of contractual choice of law clauses (Ribstein, 1994). These choice-of-law statutes provide some evidence both of jurisdictional competition to supply law and of the determinants of such competition. The laws do not generate obvious gains for legislators. They do not generate franchise fee or other obvious income for the state. Nor do they even appear to benefit firms and individuals residing or doing business in the enacting states since such parties do not need the statute to secure jurisdiction in or to justify contractual enforcement of the law of the enacting states. However, the laws are understandable in light of the role of lawyers in promoting jurisdictional competition (see Section 6). Lawyers’ role also helps explain differences among the four statutes. The broadest statute is in Delaware, where lawyers clearly dominate. In the larger commercial states such as Texas, other powerful interest groups clearly would want to protect local mandatory laws from erosion by interstate competition.

Corporate Internal Affairs Rule

In contrast to the rule applied to other contractual relationships, the parties’ rights regarding the internal governance of a corporation usually are determined by the law selected by the parties - that is, the law of the state of incorporation (Restatement, 1971, § 302(2). The conflicts rules that apply to corporations therefore differ substantially from those which apply to non-corporate contracts. This ignores the fact that corporations and other types of firms are fundamentally similar in the sense of being alternative devices for minimizing transaction costs (Williamson, 1985; Coase, 1937). Nor do the costs and benefits of applying contractual choice of law discussed above differ significantly according to whether corporate or non-corporate contracts are involved (Ribstein, 1993). For example, parties to non-corporate contracts, like those to corporations, would benefit from being permitted to shop for the applicable law, from the certainty of applying a contractually selected law, and from applying the same law to all parties to interstate contracts. On the other side of the ledger, corporations present the same potential problems as other contracts regarding potential evasion of mandatory rules, as indicated by commentators such as Cary (1974) who have condemned interstate competition for corporate law as a ‘race to the bottom’. Although corporations do clearly identify the applicable law through their centrally filed certificates or articles of incorporation, this does no more than justify analogous requirements for non-corporate contracts. The fact that corporate shares are traded on efficient securities markets that discount significant contract terms plainly does not justify a distinction between closely held corporations and other types of contracts.
The different treatment of corporations and other types of contracts with regard to enforcement of contractual choice of law may be due at least partly 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 (Ribstein, 1995b). This characterization is conducive to application of contractual choice of law because it seems to give greater weight to the parties’ jurisdictional choice than would characterizing the corporation as a mere contract. The entity theory helped create a legal momentum toward enforcement of contractual choice of law in corporations that has never been opposed by coordinated interest groups. In other words, the special choice-of-law rule for corporations, which has been instrumental in ensuring efficient state default rules and enforcement of contracts in firms, ironically may be attributable to the fact that the corporation traditionally has been viewed as a legal person rather than an ordinary contract.

There is a potential tension between the corporate internal affairs rule and the choice of law statutes discussed above. Those statutes arguably permit the parties to a corporation to select the law other than of the state of incorporation. This raises the question of whether states should be able to, in effect, bundle their lawmaking and adjudication services by insisting that their corporate law applies only to parties who have formally incorporated in the state and, therefore, paid the franchise tax (Ribstein, 1994). Fees and taxes arguably play a role in giving states an incentive to compete to provide law, depending on the role of lawyers in promoting in this competition (see Section 6, above).

Constitutional law
The federal government in a federal system has an important role with respect to contractual choice of law. For broad-based discussions of the economics of federalism, see Hayek (1948), Riker (1964), Shapiro (1972), Rose Ackerman (1980, 1981), Cover (1981), Kitch (1981), Macey (1990) and Carney (1993). This section discusses Constitutional provisions that mandate enforcement of choice of law contracts. Other potential effects of federal law are discussed below.

The commerce clause of the US Constitution, §8, cl.3, provides in part that Congress has the power ‘[t]o regulate Commerce ... among the several states’. The ‘negative implication’ of this clause is that only Congress, and not the individual states, can regulate such commerce (see Cooley v. Board of Wardens). The Supreme Court has endorsed an exportation-of-costs theory of the commerce clause which holds that if the costs of state regulation fall mostly on interest groups outside the state while the benefits accrue to those within it, the legislature lacks incentives to consider both costs and benefits in enacting laws (Posner, 1992, pp. 638-644; Fischel, 1987; Levmore, 1983). From an efficiency standpoint, cost exportation subverts interest group interaction within
the enacting jurisdiction that otherwise would cause laws to tend toward Kaldor-Hicks efficiency.

The cost-exportation theory arguably justifies invalidation under the commerce clause of state statutes to the extent that they prevent enforcement of choice-of-law clauses. This targets a particular application of state law that generally tends to benefit concentrated in-state groups while imposing costs on out-of-state firms or interest groups (Ribstein, 1993). It is significant in that regard that such clauses tend not to be enforced when they are in form contracts that are used on a national scale rather than within a single state (Ribstein, 1993).

This theory is arguably supported by two Supreme Court cases on state anti-takeover laws, *Edgar v. Mite Corp.* and *CTS Corp. v. Dynamics Corp. of America*. *Edgar* struck down on Commerce Clause grounds a state law which imposed conditions, including approval by a state agency, on interstate tender offers, while *CTS* held under the commerce clause that an interstate tender offer could be regulated by the law of the state of incorporation. These cases are best rationalized on the basis that regulation of a corporate contract which is inconsistent with the law of the contractually selected state - that is, the law of the state of incorporation - is invalid under the commerce clause.

Even if the commerce clause technically applies in this situation, its application may be unnecessary in the long run. Costs ultimately may be borne inside the state even if they initially fall on nonresidents (Kitch, 1981), and laws hurt out-of-state groups invite retaliation by other states (Levmore, 1983).

The full faith and credit clause, US Constitution art. IV, §1, provides in part that ‘Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State’. This requires states to respect the laws of other states at least to the extent of having a principled basis for refusing to follow the law in a particular case (see *Allstate Insurance Co v. Hague*). However, this principle does not directly protect individuals’ rights to freedom of contract.

Some early ‘full faith and credit’ cases involving fraternal benefit associations held that the association’s formation state law or charter must apply in order to ensure that a single legal regime applies to all association members (see, for example, *Supreme Council of the Royal Arcanum v. Green*, enforcing increase in assessment rate pursuant to association’s constitution). However, given the limited objectives of the full faith and credit clause discussed above, it is unlikely that this authority would be broadly applied today to compel enforcement of choice of law clauses. At most, these cases might justify applying a single rule, such as the law of the one state that has overwhelming contacts with the transaction even if this is not the law the parties selected.
Federal Law

Congress is explicitly empowered under the full faith and credit and commerce clauses to regulate choice of law. A federal choice of law rule could preserve state power and reinforce private contracts similar to commerce clause protection of contractual choice of law. However, any Congressional action would have to emerge from a competition among interest groups. There is probably no group that would gain enough from a general rule validating choice-of-law clauses to organize support for such a law. Congress may fail to act only to avoid negative interest group pressure (Macey, 1990) rather than because action would be inefficient. This suggests that it may be better to rely on the Supreme Court’s power under the Constitution to lift state burdens on interstate commerce.

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