MISTAKEN JUDICIAL ACTIVISM: PROPOSED CONSTRAINTS ON CREDITOR REMEDIES

Simon Rottenberg

Introduction

In a system of liberty, the smallest possible number of constraints is put on the rights of individuals to participate in exchange transactions and to define the terms on which exchange is consummated. In such a system, judges will be active in the review of legislative constraints on exchange in order to assure consistency with constitutional prescriptions of individual liberty. Judges will also be active in either compelling performance or requiring that compensation be given to those who suffer losses from nonperformance where exchange arrangements have been entered into without deception, fraud, or coercion.

What is *not* consistent with a system of liberty is behavior by judges in which they, themselves, become instruments of constraint upon parties engaged in consensual transactions. We depend upon judges to enforce contracts. If they refuse to enforce some contract terms, contracting parties are compelled to refrain from the use of those terms in the design of contracts and to select contract characteristics that will be enforceable at law. The altered contract terms had been available, in any case, and had been rejected in favor of the alternative that judges had refused to enforce. Thus, contracting parties are jointly made worse-off by judicial constraint on their freedom to contract. In addition, if the judges are not sensitive to the altered behavior that their decisions induce, they may generate consequences that are not consistent with, and are perhaps the opposite of, what the judges intend.

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The author is Professor of Economics at the University of Massachusetts at Amherst.

Such a case of mistaken judicial activism made its appearance in a Supreme Court decision affecting the law of creditor remedies, rendered in the early 1970s. That decision was followed by a number of conforming lower court decisions, until the Supreme Court sustantially reversed after only a few years.

It is that case of a proposed revision of creditor-remedy law, its pretended defenses, and its predicted consequences, if the revision had survived in law, that will be discussed in this paper.

Some exchanges are consummated instantaneously and others spin themselves out over time. It is sometimes efficient for payment to be made now for commodities that will be delivered later, or for commodities to be delivered now for payment to be made later, or for agreements to be made now for delivery and payment to be made simultaneously at some later moment of time.

One of the central purposes of the law of contract is to permit activities and exchanges to sort themselves efficiently into instantaneous and time-consuming or lagged boxes. If the courts, as instruments of the state, did not enforce contract commitments, private systems of enforcement might still evolve. But the cost of enforcement would be substantially higher, in both private and social senses, and resources would tend to be skewed toward activities that are instantaneously consummated; inefficiency would be systematically introduced into the system.

In the absence of constraint, the market will tend to produce contract forms that are consensually and mutually acceptable to the contracting parties. Obnoxious contract arrangements will tend not to survive because they will be shunned by the side that they offend. Contract arrangements that are found to persist over a long period exhibit, by their survival, that they are joint welfare maximizing.

The judges, sometimes operating from ideological perspectives, have put limits, or sought to put limits, upon what might be consensually arranged by uncoerced contracting parties by defining what they will and will not enforce and by defining the procedures of enforcement that must be followed.

Those judicial constraints will be examined in the context of the law of creditor remedies of installment sellers whose capital is put at peril by defaulting buyers. Both, decisions that are settled law and decisions of lower courts that were reversed on appeal will be examined since this paper proposes to expose both the rationale and the predicted consequences of alternative rules of creditor-remedy law. Members of the set of alternative rules appear in lower court decisions even if they have not made their way into settled law.

Traditional Creditor Remedy Law

The law of secured transactions derives from the practice of ancient Rome and Greece, appears in the common law, and is codified in the Uniform Commercial Code, which has been adopted by all states except Louisiana. A secured creditor may, if the buyer defaults, take possession of the collateral, if he can do so without breach of the peace. If the collateral is, for example, an automobile standing in the street, the creditor may resort to self-help repossession. He takes the car, without notice, hearing, and neutral judgment that repossession is warranted. If the collateral is furniture or appliances in the buyer's home, the creditor may not resort to self-help repossession, since crossing the threshold has been construed to breach the peace. In such cases, the standard practice for generations has been that the creditor makes an *ex parte* declaration to a clerk of court that repossession is warranted and, on the basis of that declaration, a writ of replevin is issued, also without notice, hearing, and neutral judgment, and an agent of the state, such as a sheriff, is paid by the creditor to execute the repossession.

If a buyer believes that repossession was not warranted, *he* may bring suit for recovery of the collateral and for damages he has suffered as a consequence of the repossession.

Clauses permitting repossession on these terms and in this way have commonly and conventionally appeared in contracts agreed to by buyers and sellers upon the execution of exchanges.

Recent Court Decisions

Summary prejudgment processes as a creditor remedy, when it involves state action, was struck down by the Supreme Court in *Sniadach v. Family Finance Corp. of Bay View*[1] for failure to meet the procedural due process requirements of the Fourteenth Amendment. The Fourteenth Amendment says that no *state* may "deprive any person of . . . property without due process of law." If a debtor has had property taken from him to satisfy debt to a creditor, a claim that he has been denied due process in the taking has no standing unless he can show that the property was taken under the terms of state law, or that it was taken by an agent of the state, or that the taking was otherwise "under cover of state action." When a creditor takes a debtor's property to satisfy debt and this is done under terms of a contract, without involving action by the state, constitutional due process prescriptions do not apply.

[1]395 U.S. 337 (1969).

Sniadach owed Family Finance $420 under a promissory note. Family Finance garnished his wages and Sniadach's employer, under Wisconsin state law, withheld half the wages owed him. The machinery of garnishment was set in motion when a clerk of court issued a summons at the request of the creditor's lawyer; notice of garnishment was given to the debtor at the same time as it was given to his employer.

The Supreme Court held that Sniadach had been denied the right to be heard and, therefore, that he had been denied constitutional procedural due process. Justice Douglas, in the Court's opinion, said:

> A prejudgment garnishment of the Wisconsin type may as a practical matter drive a wage-earning family to the wall. Where the taking of one's property is so obvious, it needs no extended argument to conclude that absent notice and a prior hearing this prejudgment garnishment procedure violates the fundamental principles of due process.[2]

Following *Sniadach*, summary prejudgment remedies came to be challenged in many parts of the country and many courts struck down remedies that did not give prior notice and provide for a hearing when debtors were deprived of property under state law. In *Fuentes v. Shevin*,[3] the Court extended the *Sniadach* principle to conditional sales contract remedies when an agent of the state was an instrument for the execution of a writ of replevin.

Margarita Fuentes, a resident of Florida, bought a gas stove from Firestone Tire and Rubber Co. and, later, a stereophonic phonograph, under conditional sales contracts that gave Firestone title to the merchandise but permitted Mrs. Fuentes to possess and use them unless and until she defaulted on payments for them. Firestone filed a claim in small claims court alleging that Mrs. Fuentes had defaulted and, simultaneously, obtained a writ of replevin ordering a sheriff to seize the goods at once. The goods were seized without prior notice to Mrs. Fuentes, without hearing, without opportunities to her to offer defenses, and without the judgment of a neutral person that repossession was warranted. The conditional sales contracts had provided that, in the event of default, the creditor may "take back" or "repossess" the merchandise.

In the court's opinion, it was held that "prejudgment replevin provisions work a deprivation of property without due process of law

[2]Id. at 341–42.
[3]407 U.S. 67 (1972).

insofar as they deny the right to a prior opportunity to be heard before chattels are taken from their possessor."[4]

Two years after *Fuentes*, in *Mitchell v. W. T. Grant Co.*,[5] the Supreme Court modified (Justice Stewart, dissenting, said it "overruled") *Fuentes*. In *Mitchell*, the Court held that it was acceptable for agents of the state to take household appliances from a debtor, on behalf of a creditor who claimed default in repayment of debt, even in the absence of notice and hearing, if the state's agent was supervised by a judge, rather than a court functionary.

Grant sold Mitchell a refrigerator and other appliances. A balance of $547 was unpaid and overdue. Grant had a vendor's lien on the goods. A city court judge in New Orleans, based on a petition and affidavit, and without prior notice or opportunity for hearing being given Mitchell, signed a writ of sequestration and the constable of the court seized the merchandise. Mitchell filed a motion to dissolve the writ, claiming that the seizure violated the due process clauses of the state and federal constitutions. The Court demurred on grounds that the Louisiana seizure "provides for judicial control of the process from beginning to end" and "Mitchell was not at the unsupervised mercy of the creditor and court functionaries."[6]

Shortly after the *Fuentes* decision, a number of cases were brought challenging self-help repossession under contracts permitting such repossession. The challenges asserted that state enactment of the Uniform Commerical Code permitting private persons to self-help repossess under contract terms constituted action under color of state law and, therefore, caused self-help repossession to be covered by the procedural due process requirements of the Fourteenth Amendment. Petitioners were successful in some of the lower federal courts but those decisions were reversed in the circuit courts of appeal and certiorari was denied by the Supreme Court. In the end, those challenges were unsuccessful; they were failed attempts to turn out a principle of law of ancient standing.

Thus, the current state of the law is that contractual self-help repossession without notice, hearing, and judgment is permitted for automobiles and for other chattels that can be repossessed without breach of peace; whether prejudgment repossession is permitted as a creditor remedy, where a house must be entered to recover the merchandise, depends upon the extent to which the repossession process is overseen by a judge, rather than a court functionary.

[4]Id. at 96.
[5]416 U.S. 600 (1974).
[6]Id. at 616.

In its current state, the law of creditor remedies seems to be nearly consistent with contractarian principles. Monies may be lent to finance the purchase of automobiles and lenders and borrowers may freely engage to permit repossession, without notice, hearing and judgment, if the buyer defaults. Lenders can be made more secure in the recovery of their loans and borrowers can have more favorable borrowing terms in other respects precisely because they have consented to an arrangement that increases the security of the creditor's assets.

There may or may not be freedom to engage in similar contracts for the financed purchase of merchandise that will be located in houses or in other enclosed spaces. This depends upon the closeness with which judges oversee the repossession of such merchandise. The closer the oversight, the less secure are the creditor's assets and the more severe are the constraints on the freedom of sellers and buyers of such merchandise to undertake contracts that jointly serve their purposes.

The Reasoning of the Courts

Where prejudgment creditor remedies have been struck down, the courts' rationale has taken a somewhat class-angled ideological perspective. In *Sniadach,* Justice Douglas wrote that a "prejudgment garnishment . . . may as a practical matter drive a wage-earning family to the wall." He also wrote:

> A procedural rule that may satisfy due process for attachments in general . . . does not necessarily satisfy procedural due process in every case. . . . *We deal here with wages*—a specialized type of property presenting distinct problems in our economic system.[7]

Douglas then quoted, with apparent approval, Congressman Sullivan (chairman of the House Subcommittee on Consumer Affairs), who said in congressional debate:

> In a vast number of cases the debt is a fraudulent one, saddled on a poor ignorant person who is trapped in an easy credit nightmare, in which he is charged double for something he could not pay for even if the proper price was called for, and then hounded into giving up his pound of flesh, and being fired besides.[8]

It is not at all clear why the rule of law should not be applied uniformly to *all* who appear before the courts. Justice Douglas thought

[7]395 U.S. at 340; italics added.

[8]Id. at 341. Quoted from 114 Cong. Rec. 1832.

uniform application of the law was inappropriate. Wages—the payment for labor services—were, he wrote, "a specialized type of property presenting distinct problems." A rule that satisfies due process for attachments "in general" (say, of physical possessions or of bank deposits) may not do so for attachments of wages. Prejudgment attachment might be acceptable for other assets, but not for wages. He does not say with clarity why they are to be distinguished, except that he says the garnishment of wages may "drive a wage-earning family to the wall" and, by inference, that wage-earners are poor and ignorant and are objects of fraud who are easily enticed to take on an excess of debt for the acquisition of possessions for which they will pay prices that are excessively high.

Families that derive their sustenance from annuities or from rent, dividend, or interest earnings and that live beyond their means may also, of course, be driven to the wall by the attachment of their assets. Wage-earners are not necessarily poorer nor more ignorant of their prospects and their options than are earners of other kinds of income streams; and, if they were, it is not clear that wage-earners are made better-off by a differentiated rule of law, applying only to them and not to others, that informs prospective creditors that their capital is put at higher risk, if they lend to wage-earners. Nor is it clear that the poor are more commonly trapped in "easy credit nightmare[s]" than those of higher incomes. Justice Douglas surely did not know how aversion to risk is distributed in society; if he did, he did not tell us. If higher prices are charged to the poor who finance the purchase of possessions, may it not be because creditors are covering themselves against the risk of default? If creditors could not acquire this cover, perhaps they would not deal. Is the condition of the poor improved, if they cannot acquire assets to which they aspire because the law does not permit them to compensate creditors for the risk of nonpayment of debt?

In *Fuentes,* Justice Stewart sought to distinguish the Court's decision from that in *D. H. Overmyer Co. v. Frick Co.*[9] In *Overmyer,* the Court declared that a contractual waiver of due process rights was "voluntarily, intelligently, and knowingly" made.[10] Justice Stewart, in *Fuentes,* reasoned that this was because

> the contract . . . was negotiated between *two corporations*; the waiver provision was specifically bargained for and drafted by their lawyers in the process of these negotiations. . . . It was not a case of unequal

[9]405 U.S. 174 (1972).
[10]Id. at 187.

> bargaining power. . . . The . . . agreement . . . was not a contract of adhesion.
>
> The facts [in *Fuentes*] are a far cry from those of *Overmyer*. There was no bargaining over contractual terms between the parties who, in any event, *were far from equal in bargaining power*. The purported waiver provision was a printed part of a form sales contract and a necessary condition of the sale.[11]

The point was pursued by Justice Stewart in his dissent in *Mitchell*, where he wrote that, absent procedural arrangements prescribed by *Fuentes*, consumers were "defenseless."[12] Justice Stewart was apparently unable to understand the power of the market to compel contracts of adhesion to take forms that would be found by both buyers and sellers to be not obnoxious nor did he understand that buyers have the power to refuse to consummate transactions that do not improve their circumstances.

In *Watson v. Branch County Bank*,[13] the Federal District Court for the Western District of Michigan wrote, in a class action suit in which the district court held that self-help repossession of automobiles was unconstitutional:

> The automobile financier is typically either a large financial institution or is backed by such an institution. Financiers have overwhelming bargaining power and expertise and automobile financing contracts are typically contracts of adhesion. Consumers have no power to insist that printed contracts be changed. . . . Debtors as a practical matter have no legal remedy for abuses. The brutal consequences of the exercise of this uncontrolled self-interested private power are illustrated by. . . . The cognizable interests of the corporate creditors in repossessing automobiles without resort to legal process are *de minimis*. . . . The corporate defendants have no human rights or values at stake here, merely profits. . . .
>
> It is also important that the contracts in this case are contracts of adhesion. There is a great disparity of bargaining power, and the debtors apparently received nothing additional for the contractual self-help repossession clauses. . . . This the constitution does not permit. Liberty of waiver, like liberty of contract begins with equality of position between the parties. . . .
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> The coercive nature of the unilateral conditions and requirements imposed upon purchasers of ordinary necessities of life in modern circumstances cannot be considered voluntary, understanding waivers of constitutional rights.[14]

[11]407 U.S. at 95; italics added.

[12]416 U.S. at 635 (Stewart, J., dissenting).

[13]380 F. Supp. 945 (1974). Reversed without published opinion by the Sixth Circuit Court of Appeals, 21 May 1975.

[14]380 F. Supp. at 945.

A similar rationale appears in the opinion of the Federal District Court for the Southern District of California in *Adams v. Egley.*[15] Adams borrowed $1000 from a bank, executing a promissory note, and signed a security agreement giving the bank a security interest in three vehicles. The security agreement said in part: "Upon the occurrence of . . . default, the Secured Party is entitled to take possession of the vehicle. . . ."[16] Adams defaulted in his payments and the bank employed a licensed repossessor to take the vehicles. Adams challenged the self-help repossession on grounds that the repossession involved sufficient state action, under the California Commercial Code, to establish a federal cause of action and that, since summary prejudgment had occurred, his procedural due process rights had been violated.

The district court held for Adams and wrote, in part:

> While a signed contract may represent an effective waiver where the contracting parties are of equal bargaining power, it is clearly not so in all cases, particularly those involving so-called "adhesion contracts," in which the terms are specified by the seller or lender. As noted by the Supreme Court of California in *Blair v. Pitchess* [5 Cal. 3d 258 (1971)]: "The weaker party, in need of goods or services, is frequently not in a position to shop around for better terms, either because the author of the standard contract has a monopoly . . . or because all competitors use the same clauses. His contractual intention is but a subjection more or less voluntarily to terms dictated by the stronger party. . . ."
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> . . . If the policy underlying the decision in *Sniadach* is to provide some extra modicum of legal protection to those who live on the lower economic margins of our society, it would be illogical for the courts to be dissuaded from applying that policy by the presence of standard-form contracts which often operate most harshly on the poor. . . .
>
> Where . . . the parties are both commercial entities, the bargaining power is to some extent equalized, and the purported waiver of the constitutional right to prior notice and hearing may indeed be effective. However, the California repossession statute presently under consideration is not limited to secured transactions between parties of equal bargaining power. . . .
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> . . . In light of *Sniadach*, then, the statutes providing for summary repossession and sale must be held unconstitutional.[17]

[15]338 F. Supp. 614 (1972). Reversed by the Ninth Circuit Court of Appeals in *Adams v. Southern California National Bank* (492 F.2d 324 (1974); certiorari denied 419 U.S. 1006 (1974).

[16]338 F. Supp. at 616.

[17]338 F. Supp. at 620–22.

Standard Form Credit Contracts

Contracts of adhesion—that is to say, standard form contracts—also have been subject to review and have been attacked in the administrative agencies, as well as by some judges. In 1975, the Federal Trade Commission (FTC) initiated a proceeding on credit practices that examined contracts of adhesion as a prelude to the possible adoption of a trade regulation rule. Hearings were held in four cities during 1977–78. In 1980, the FTC issued a staff report, concluding that there is market imperfection in the consumer credit market and that this imperfection derives, in part, from "the use, by creditors, of standard form instruments which contain complex conditions which are not the subject of arms-length bargaining at the point of sale."[18]

According to the FTC report, "The adhesive nature of consumer credit contracts has long been recognized." Following Ehrenzweig, the report defined adhesion contracts as "Agreements in which one party's participation consists in his mere 'adherence,' unwilling and often unknowing, to a document drafted unilaterally and insisted upon by what is usually a powerful enterprise."[19] The report then noted that "The essence of an adhesive transaction is the weaker party's lack of alternatives to accepting the contract exactly in the form in which it is presented."[20]

The FTC's staff recommended that the FTC adopt a rule that would prohibit borrowers and lenders from agreeing to credit contracts that included a number of different kinds of creditor remedies that appear often in standard form contracts. In March 1984, the FTC adopted a rule forbidding some creditor remedies; the rule was to be made effective in March 1985.[21]

The Court decisions and the FTC's record in the credit practices rule case are of a piece when they deal with standard form contracts and they both come to incorrect judgments because they examine market phenomena only superficially.

Justice Stewart wrote in *Fuentes* that the parties to the contract were not equal in bargaining power because prejudgment repossession was permitted by a provision of a (standard) form contract. In his dissent in *Mitchell*, he wrote that consumers were defenseless

[18]Federal Trade Commission, Bureau of Consumer Protection, *Credit Practices*, Staff Report and Recommendation on Proposed Trade Regulation Rule, Washington, D.C., August 1980, p. 33.

[19]Ibid. For original source, see Albert A. Ehrenzweig, "Adhesion Contracts in the Conflict of Law," *Columbia Law Review* (1953): 1072.

[20]*Credit Practices*, p. 34.

[21]49 Fed. Reg. 7740 (1984).

without procedural due process and neutral judgment. In *Watson,* the Michigan district court said that financiers have overwhelming bargaining power, that consumers may not have printed contracts changed, and that debtors had no legal remedy for abuses. Private power (of the creditors), the Michigan court said, was self-interested and uncontrolled and the exercise of this power had brutal consequences. In cases of contracts of adhesion, it went on to say, there is great disparity in bargaining power and consumers "received nothing additional for the contractual self-help repossession clauses." The conditions imposed upon buyers who sign adhesive contracts are, the court wrote, coercive and not voluntary and the conditions are unilaterally imposed by lenders upon borrowers.

The California District Court wrote in *Adams* that the terms of standard form contracts were dictated by the stronger party—the creditor; the borrower is not able to "shop around" because all use the same clauses; standard form contracts operate harshly upon the poor; and, where standard form contracts are used, there is not equal bargaining power.

The record of the FTC case on credit practices is replete with similar testimony and findings. Standard form contracts in the credit market are said to be "prepared for creditors" and "drawn almost entirely from the creditor's standpoint"; the clauses dealing with creditor remedies must be accepted "as is" and may not be altered; the contracts are uniform among competitive creditors; there is an absence of "arms-length bargaining" over creditor remedy terms of the contracts; and borrowers do not understand the standard form contracts they sign.

It is therefore not surprising to find the 1980 FTC staff report concluding: There is market failure in the credit market; a "free market cannot establish equity in consumer transactions" (quoting William Ballenger, Michigan Department of Licensing and Regulation); and current creditor remedies are "a product of market imperfection or imbalance of market power."[22]

The notion that standard form contracts are instruments of exploitation of debtors is based on a fundamental misunderstanding of the processes of competitive markets. There are many sellers in the credit market. There are many sellers of commodities on installment payment terms and many lenders who make loan funds available on the condition that security be provided to diminish the risk of creditor loss when default occurs. Entry into the market and exit from it is not difficult. The credit market is clearly competitive and a price

[22]Federal Trade Commission, *Credit Practices*, p. 68.

theoretic expectation is that the rate of return on investment in the market is normal and that exploitation—for which the existence of monopoly is a necessary condition—does not exist in it.

It is widely recognized that standard form credit contracts are used because the law of contracts is complex and only specialized legal practitioners have sufficient knowledge to draft the contracts in forms that the courts will enforce. If each contract were separately drawn, transaction costs would be immense; the use of the standard form, *once it is drafted, reduces those costs virtually to zero.* The diminution of transaction costs explains not only the existence and ubiquitous use of the standard form but also the great reluctance to alter its phrasing in separate individual transactions. *Far from exhibiting market* imperfection, therefore, the use of contracts of adhesion and the refusal to make changes in those contracts shows the market to be working well. The absence of negotiation for each credit transaction forestalls, for the community, the employment of large quantities of real resources that have alternative valuable social uses.

What of the terms of those contracts? Can they be expected to be drawn to favor the interests of creditors over debtors? Is there an absence of bargaining over contract terms? Is there "inequality of bargaining power" between participants in credit transactions? Do debtors get nothing in return for putting their assets at risk of prejudgment seizure by their creditors, if they should fail to make timely repayment of their debt?

The creditor remedy clauses of contracts of adhesion in credit markets are not randomly drawn. They are limited by two sets of constraints. First, they must be consistent with the rule of law. That is to say, they may require no more than the courts find acceptable in the enforcement of contracts. If they go further than this, they are superfluous. Second, they may not extend beyond limits that are defined by competition in the credit market; creditor remedies, when *taken in conjunction* with other credit contract clauses, may permit no more than a normal rate of return on investment. If creditor remedies go beyond those limits, the competition of new entrants can be *expected, in time, to press them back to the parametric constraints* that are appropriate to a normal return on investment.

Thus, though bargaining may not occur in the "negotiation" of individual credit contracts, where a standard form is used, a more cosmic form of bargaining does, in fact, occur. In this cosmic market negotiating process, creditors are not more powerful than debtors. Each of the sides of the market has its influence upon the negotiated outcome. Contract terms are the product of *both* "blades of the scissors," with demand-side and supply-side phenomena both playing out their market roles. Borrowers on the demand side of the credit market cannot extract terms that will yield less than normal rates of return; if they insist, creditors are unwilling to lend. Creditors on the supply side of the market cannot extract terms that will yield more than normal rates of return; if they do, new entrants, in competition, will offer loans on terms that are less burdensome upon borrowers. Even if entry into the credit market were so costly that incumbents on the selling side of the market were able to include remedial clauses in their standard contracts that produced for them a monopoly rent, monopoly lenders would still need to be concerned that the terms were not so onerous that they greatly reduced the willingness of borrowers to borrow. In addition, borrowers have the ultimate power of refusing to participate in ventures offered to them. They cannot be compelled to borrow on terms they find obnoxious. The power of decision lies with them.

Thus, when one thinks about the elementary characteristics of the competitive market process, it can be seen that there *is* bargaining in credit contracting and that the parties are not unequal in bargaining power.

Nor is it correct, as the Michigan court said in *Watson*, that debtors who agree to self-help repossession clauses in the contracts they sign "receive nothing additional for it." Contracts consist of baskets of properties. The aggregates of baskets produce normal investment yields. Let one component be enlarged and the forces of competition will compel another to shrink. If a lender's risk of the loss of his assets is diminished because a borrower has consented that, if he is delinquent in repayment, the collateral may be repossessed without notice, hearing, and neutral judgment, then competition will compel that the commodity be sold at a lower price or that financing terms be more attractive than would be true if the lender's risk were larger. Or, in some other components of the contract than these, the terms will be made more attractive for the borrower; in competitive markets, in the long run, the lender cannot have a higher rate of investment return than is earned in alternative investment lines.

It is clear, in the end, that the circumstances surrounding the use of contracts of adhesion in the market for credit do not make an acceptable case for the intervention of either the courts or the administrative agencies of government in the foreclosure of options for creditor remedies to which lenders and borrowers may voluntarily agree.

Courts have sought to impose constraints upon creditor remedies on grounds that exhibit preferential regard for those of lower-class origin and status, a lack of trust in the capacity of wage-earners and the poor to know and to serve their own self-interest, an unwillingness to permit individuals to make uncoerced exchange arrangements, and a failure to understand the behavioral adjustments that occur in markets that are free of constraints and in those where constraints are imposed.

Expected Market Effects of Proposed Changes

The creditor-remedy rules the courts have sought to define could be expected to have perverse effects. Rules thought to enlarge the opportunities of consumers and the poor, in fact, would impose additional costs on them. The courts have not seen this because they do not understand how markets work.

Let us suppose that in every case of alleged default—those now covered by methods of self-help repossession and those covered by writs of replevin and sequestration—the law required for repossession (1) notice to defaulters that repossession is intended, and (2) opportunity and time for the preparation of defenses, a hearing, and judgment by a neutral person showing why repossession is warranted. Let us also suppose that such a procedural rule cannot be contractually waived. What does price theory tell us would be the consequences that can be predicted, if this were the rule of law?

Under such a set of assumptions, it is likely that the consequences would be as follows:

- Real social costs would be incurred in executing judgment. Resources employed in the giving of notice, the conduct of hearings, the preparation of claims and defenses and in their delivery, and in the consideration of judgment would be lost by society to the alternative uses to which they could be put.
- The rate of physical depreciation of the social stock of capital would be increased. Automobiles, appliances, and other equipment that are collateral for loans or that otherwise secure transactions would be treated with more abuse and more imprudence in the period between notice of intended repossession and actual repossession than they would be if notice were not given and if there were no lag between the creditors' decisions to repossess and the time they take actual possession.
- More real resources would be devoted by creditors to the screening of applicants for credit to more certainly distinguish between those who will be and those who will not be probabilistic defaulters. Incremental resources consumed in the measurement of creditworthiness would constitute a social opportunity cost in that they would not be available for alternative socially valuable uses.

- Some who would have passed muster for the extension of credit under less intensive credit evaluational procedures would be excluded for they would be found to offer excessive risk of default. Those excluded would include those with volatile earnings: such as the young, the elderly, the handicapped, and the infirm. Some of them would now be deprived of borrowing opportunities they would otherwise have.
- There would be an increase in the cost of doing lending business. There would be some combination of more intensive screening of applicants for credit, increased costs of recovery of collateral, and increased risk that loans cannot be covered by repossessed merchandise. There would be, therefore, an increase in financing charges. If financing charges are uniformly applied to all borrowers, this would imply a wealth transfer from probabilistic non-defaulters to probabilistic defaulters.
- There would be a revision of lending practices to diminish the incidence of default. These revisions would include enlarging the magnitude of "down payments" and reducing the fraction of the price of merchandise that can be paid for over time; reducing the period of time in which loans must be completely paid off; and increasing the quantity of life insurance and health insurance that borrowers are required to purchase as a condition for securing loans. These changes would tend to exclude from the borrowing queue those for whom the probability of default is relatively high.
- The prices of commodities purchased for payment over time would rise relative to the prices of commodities paid for "in cash." The new price ratio, however, may not be consistent with the community's time-preference function.

It can be seen, therefore, that the application of a procedural due process rule requiring notice, hearing, defenses, and neutral judgment for the recovery of merchandise from defaulters in secured transactions would impose costs upon society and have distributional effects that are adverse for the most disadvantaged and vulnerable segments of the community's population.

Conclusion

From the foregoing analysis, it is evident that what was intended by some judges to serve consumers and the poor actually would tend to do them harm—that is to say, judges intent on doing good would be seen as doing harm. A clearly superior alternative to judicial intervention would be a rule permitting free and unconstrained contracts by contractors who are not subject to coercive, deceptive, or fraudulent practices, with courts enforcing contracts by procedures that are contractually defined.

One could expect different procedural forms to evolve with different commodity prices that would express different degrees of risk and security of lenders. Commodity prices would then be lower for those who accept prejudgment repossession procedures—and higher for those who prefer procedures that require notice, hearing, and neutral judgment before repossession. Buyers would then choose the alternative that maximizes utility for them.

Contractarian arrangements would produce allocational and distributional effects that are preferable to the effects generated by judges seeking to do justice.

CONTRACTUAL REMEDIES AND THE NORMATIVE ACCEPTABILITY OF STATE-IMPOSED COERCION

Charles J. Goetz

A commentator on Professor Rottenberg's views about judicial treatment of creditor remedies has difficulty in knowing whether (1) to express fundamental agreement, objecting only that its new insights[1] are "less than meets the eye"; or (2) to complain that Rottenberg ignores a tough and provocative underlying issue while (3) straining to picture the courts as even sillier than they sometimes really are. Since there arguably is truth in each of these positions (which, after all, are not actually inconsistent), this comment will attempt to expand on all three of those themes.

The instrumentalist view of contract law, to which I am personally sympathetic, sees contracts as mechanisms for achieving mutually advantageous shifts in the allocation of rights and resources. "Executory" contracts involve only a promise of some future performance and these agreements—as Rottenberg emphasizes—critically depend on the state's coercive power to ensure that the promisee will honor his obligation. In this context, an individual's ability to subject

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The author is Joseph M. Hartfield Professor of Law at the University of Virginia.

[1]As one might imagine, the cases and underlying issues discussed by Simon Rottenberg ["Mistaken Judicial Activism: Proposed Constraints on Creditor Remedies," *Cato Journal* 4 (Winter 1985): 959–74] have not gone unnoticed by other commentators, some of whom have explicitly considered essentially the same economic efficiency implications. Early examples of this literature include Robert E. Scott, "Constitutional Regulation of Provisional Creditor Remedies: The Cost of Procedural Due Process," *Virginia Law Review* 61 (1973): 807–67; Robert W. Johnson, "Denial of Self-Help Repossession: An Economic Analysis," *Southern California Law Review* 47 (1973): 82–115; Edward A. Dauer and Thomas K. Gilhool, "The Economics of Constitutionalized Repossession," *Southern California Law Review* 47 (1973): 116–50; Robert W. Johnson, "A Response to Dauer and Gilhool: A Defense of Self-Help Repossession," *Southern California Law Review* 47 (1973): 151–64.

himself to potential coercion by the state actually enlarges freedom in a highly relevant sense. Exchanges that would not otherwise be "reliable" enough to occur now become practical and trading opportunities expand. When a contractual party voluntarily embraces these new opportunities, fully aware that the state will hold both parties to the performance of their freely exchanged obligations, a strong *prima facie* argument supports the inference of welfare-enhancement.[2]

From this perspective, remedies represent state-supplied means to ends that are generally desirable from the standpoint both of the parties themselves and usually also of the rest of society. But it seems to be well settled that society will not lend its enforcement power to certain classes of individual agreements that it finds obnoxious. Indeed, in the subset of cases where society does object to the ends served by certain agreements, it commonly withholds its facilitating power, designating such contracts unenforceable as "contrary to public policy."[3] The creditor rights decisions do not seem to fit this category where the state refuses enforcement because it might object to the substantive aims of the contracts—in these cases, the transfer of mundane products such as automobiles, consumer appliances, etc. Nor do the courts treat the cases in question within the framework of the more orthodox, albeit debatable, doctrine of "unconscionability" infecting the bargaining process that led to the formation of the contract.

Rottenberg quite properly asks why a court should withhold a fairly bargained-for remedy constructed by the marketplace to facilitate a special contractual goal that is not itself the subject of any objection. What is going on here? Rottenberg's own answer seems to be that there is a muddle-headed judicial activist attempt to benefit certain parties through a result-oriented concoction of special rules. As he points out, among the many objections is the classical one of throwing out the baby with the bathwater. The prospective effect of non-enforcement will not even aid the intended beneficiaries and, indeed, will deprive them of what were, on balance, beneficial trading opportunities.

There is little to quibble about in this basic message, one generally congenial to me. I am, indeed, elsewhere on record as attacking judicial limitations of remedies in contexts where trading gains to

[2]The text is careful to couch this as a presumption only, since there are many qualifications to this result. Centering on systematic gaps in information, defects in the bargaining process, etc., these exceptions to the general thesis are well-known and need not be dealt with explicitly here.

[3]See *Restatement, Contracts*, 2d, §8.

the parties are sacrificed without any identifiable counterbalancing gain.[4] Nonetheless, an alternative reading of this same line of cases surfaces both a lurking problem and a defense that the courts have not been as muddle-headed as it first seems.

The *reductio ad absurdum* is a time-honored method of argumentation whose application here may be provocative even if, by definition, exaggerated in tone. Accordingly, a strong, blunt statement of the Rottenberg thesis might be that the state has an obligation to enforce *any* fairly bargained-for remedy necessary to facilitate any legitimate contractual goal. The consequences of *not* doing so, the argument runs, would be both the opportunity costs of foregone contractual gains and the excess resource costs of less efficient alternative remedies.

The thriving industry of illegal "loan sharking" provides empirical evidence that the state in fact fails to facilitate many contracts regarded as mutually beneficial by the parties involved. One aspect of illegal loan sharking depends on the refusal of the state to enforce interest rates arbitrarily adjudged to be "usurious." Even more important for our present discussion, however, is the availability to the creditor of potent extra-legal enforcement mechanisms that may extend to physical violence to the debtor's person and his possessions. From the strict economic perspective, each of these black-market transactions can claim the same presumption of mutual advantage as loans negotiated in the legal marketplace. In fact, the evidence of revealed choice shows that the "advantages" of the illegal market predominate over the legal market for hordes of people, notwithstanding the efforts of the state to stamp out such transactions through criminal and civil sanctions.

A rigidly single-minded economic analysis might urge the state to draw several inferences from the continuing robustness of the loan shark market. One is that, for many parties, the existing system of legal remedies is not as economically efficient as the extra-legal ones. A second, corollary inference is that the unavailability of the equivalents of the black market remedies in legal credit markets obstructs many mutually beneficial trades. The third possible inference, arguably following from the first two, is that legitimate market remedies ought to be expanded to include more and closer equivalents of some of the stronger illegal remedies. One suspects that many people will regard the first two inferences as entirely plausible and nevertheless

[4]See especially, Charles J. Goetz and Robert E. Scott, "Liquidated Damages, Penalties and the Just Compensation Principle," *Columbia Law Review* 77 (1977): 554–94 (arguing against judicial invalidation of bargained-for liquidated damages clauses).

balk at accepting the final policy conclusion, perhaps without being able to articulate exactly why.

It is unnecessary to overplay the role of the pixy by inviting the reader to dwell on the notion of a judicially enforced contractual "late payment penalty" calling for a broken finger per week or a Shylockian pound of flesh. Such blatantly outrageous examples are designed only to establish the existence of a polar extreme of repugnant or "unpalatable" penalties and enforcement processes that society is unlikely to impose through *official participation, no matter* what the prospective efficiency advantages to the affected parties. Various explanations for this exist. One is that my sense of squeamishness may make me reluctant to be co-opted, through the state as my representative, into sanctioning *judicially administered*[5] enforcement devices that, after all, benefit classes of transactions in which I am unlikely to engage. Another possibility is that, although I might myself derive transactional advantage from such rules, I accord even greater benefit to the maintenance of certain principles, values, or mere "appearances" regarding official process. In this vein, there is a traditional saying about not wishing to "soil the judicial ermine" through involvement in certain matters.

By conceding the notion of a polar extreme of state-action remedies that are beyond the pale, one necessarily confronts the spectrum between these and "ordinary" acceptable remedies and procedures. At some point along the continuum, a genuine balancing of desiderata is required: Tradeoffs between the character of the enforcement process itself and the results from the process become relevant. Traditionally, lawyers have perhaps overemphasized the former, sometimes speaking of process values as though they need not be weighed against variations in results, whether economic or otherwise. But perhaps economists too quickly assume that process values, as encapsulated in some state institution, such as the adjudication of contracts, are not also economic values that must be weighed against values produced in the market. Lawyers and economists may systematically err in different directions because each tends to be ignorant of, even scornful of, those implications of the problems traditionally addressed through the expertise of the other.

In sum, Rottenberg begs potentially important questions: Can there be a legitimate tension between process values and transaction values, even in commercial law? Is that what was troubling some courts?

[5]Significantly, the courts took a much more *laissez-faire* attitude toward so-called self-help repossession without the assistance of state action. See Adams v. Southern California First National Bank, 492 F. 2d 324 (9th Cir. 1973), cert. denied 419 U.S. 1006 (1974); Flagg Bros., Inc. v. Brooks, 436 U.S. 149 (1978).

The history of the creditor rights cases is, in any event, susceptible of a more optimistic reading than Rottenberg's, which tends to focus on a few early and arguably extreme cases in the relevant series. Those of us who place at least some stock in the quasi-Darwinian production of common sense by common law courts are cheered by the thought that the courts, after considering a series of these cases, may ultimately have gotten it "about right" and improved on the original no-right-to-hearing situation.

It is tempting in reading these cases to jump to the conclusion that the debtor is always unjustified in resisting repossession and that, therefore, any delay in repossession is an unwarranted failure to enforce the creditor's legitimate property rights. In fact, however, some fraction of the cases (including the leading *Fuentes* case[6] discussed by Rottenberg) involve debtors whose failure to pay money due is predicated on an alleged prior failure by the creditor to perform some duty owed under the contract. In sum, since it may be debatable as to which party breached the contract and whether the nonpayment is justified, an optimal contract requires *both* parties to protect themselves against unjust assertion of possession by the other.

Consider the possibility of three kinds of contracts, varying in their modes of protection. Under Type A, creditor repossession is permitted without a hearing and an unjustified repossession can be contested by the debtor only at the final adjudication. Under Type B contracts, repossession still does not require a prior hearing, but a prompt post-repossession hearing may be demanded by the debtor. With Type C contracts, a pre-repossession hearing is required. Type C is the focus of Rottenberg's criticism, Type A was the original law, and Type B is approximately the present law.[7]

Which of these three forms is the most economically "efficient" type of contract? Obviously, they represent a spectrum of shifting degrees of relative debtor/creditor advantage. But economic theory suggests that, if the terms are known in advance, the debtor would have to "pay" for the more advantageous B and C forms with counterbalancing concessions, such as higher price, in order to secure the acquiescence of the seller. Conversely, the seller can presumably achieve his maximally protective Type A contract only by foregoing the inducements that buyers might offer to secure a B or C agreement. While space does not permit a detailed analysis here, I suggest that

[6]Fuentes v. Shevin, 407 U.S. 67 (1972) at 70–71.

[7]See, for example, Mitchell v. W. T. Grant, 416 U.S. 600 (1974). The Court upheld a Louisiana statute authorizing seizure without a hearing, but required that the debtor have an opportunity promptly after the attachment to contest its validity. Id. at 609–10.

Type B is optimal. Briefly, Type B improves on A by protecting legitimate debtor counterclaims in the small fraction of cases where they can plausibly be asserted, while also avoiding Type C's high repossession costs and incentives for debtors unjustly to retain property through procedural delay.

If Type B were optimal, would the market produce this as the dominant form? Probably not. A little bit of reflection reveals that the state is a necessary "silent signatory" to agreements that attempt to rearrange adjudicatory procedures. It is much easier for a debtor to contract away his pre-repossession hearing than for the creditor to contract into an obligation for the state to provide a prompt post-repossession hearing on the debtor's request. Thus, one interpretation of the history that alarms Rottenberg is that courts viscerally sensed the suboptimality of the extreme Type A, overreacted with Type C mandates, then readjusted to the perfectly defensible and arguably welfare-enhancing environment of the "compromise" Type B. And, as a bonus, Type B satisfies the traditional view of procedural protections when the power of the state is invoked.

My comments then can be summed up as follows. First, I wholeheartedly agree that courts should, as a general rule, enforce fairly bargained for remedies. There is little new in this proposition, however, and Rottenberg does not come to grips with the more original and intriguing question whether process values may qualify the general rule of enforcement-provision in some limiting cases. Finally, the account of judicial activity given strikes me as unnecessarily alarmist, failing to acknowledge that the system did, after all, produce a reasonably happy ending.

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