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1998 Ladd Lecture: Empire or Residue: Competing Visions of the Contractual Canon

Ian Ayres
Yale Law School

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EMPIRE OR RESIDUE: COMPETING VISIONS OF THE CONTRACTUAL CANON

IAN AYRES*

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I. INTRODUCTION

Is the domain of contract waxing or waning? Lawrence Friedman's pathbreaking 1965 book, *Contract Law in America*, characterized contract law as covering a residual category of relatively unimportant transactions. He argued that whenever particular types of transaction became sufficiently salient—such as those concerning employment or insurance—specialized regulation was promulgated that “robbed contract [law] of its subject-matter.”¹ Nine years later, Grant Gilmore expressed this idea similarly in *The Death of Contract*, where he regarded “the general law of contract as a residual category—what is left over after all the ‘specialized’ bodies of law have been added up.”²

In stark contrast to this residual conception, many scholars have trumpeted a much more imperialist conception of contract's domain. John Langbein, for example, recently opined:

Contract has become the dominant doctrinal current in modern American law. In fields ranging from corporations and partnership, to landlord and tenant, to servitudes, to the law of marriage, scholars have come to understand our legal rules as resting mainly on imputed bargains that are susceptible to alteration by actual bargains.³

Under this view, the bedrock principles of contract inform (or should inform) an ever increasing range of legal relationships.⁴

* William K. Townsend Professor of Law, Yale Law School. Jennifer Brown provided helpful comments. This Article is the published version of the 1998 Mason Ladd Lecture delivered at the Florida State University College of Law.

1. LAWRENCE FRIEDMAN, *CONTRACT LAW IN AMERICA: A SOCIAL AND ECONOMIC CASE STUDY* 24 (1965).

2. GRANT GILMORE, *THE DEATH OF CONTRACT* 7 (1974).

3. John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 *YALE L.J.* 625, 630 (1995).

4. See, e.g., Richard Painter, *Game Theoretic and Contractarian Paradigms in the Uneasy Relationship Between Regulators and Regulatory Lawyers*, 65 *FORDHAM L. REV.*

What gives? The easiest way to reconcile these radically different claims about the domain of contract is to recognize that authors employ varying definitions about what makes a particular area of law “contractual.” A residualist might only consider an area contractual if disputes are decided by common law courts using common law principles such as the consideration requirement.⁵ Imperialists on the other hand might consider any field to be contractual if the parties have substantial freedom to reorder their legal relationship privately.

Arthur Corbin long ago cautioned against scholars being diverted by such definitional misunderstandings:

Definitions [of contract] have been constructed by almost all writers on law and in many thousands of judicial opinions It is a very common error to suppose that legal terms, such as contract, have one absolute and eternally correct definition. The fact is that all such terms have many usages, among which every one is free to select. One usage is to be preferred over another only in so far as it serves our necessity and convenience.⁶

Corbin wisely warned that we should not particularly care whether a field is characterized as contractual—unless something turns on the characterization. Our first response to someone’s impassioned suggestion that a particular area is or is not contractual should be “Who cares?” or perhaps more precisely “*Why* should we care?”

We should be quite skeptical of any canon definitions that are divorced from consequentialist considerations. Essentialist debates about what is contract are not only semantic in the most pejorative sense of the word, but may divert attention from what is really at stake. Common law decision making is prone to error when judges divorce the meaning of words from their legal consequences.⁸ Take, for example, a rent-to-own transaction whereby a consumer rents a

149, 152-53 (1996) (suggesting regulatory agencies use a contract-like approach to regulating lawyers).

5. See, for example, Austin Scott’s arguments that trust law is not contractual because of its roots in the law of equity. See Austin W. Scott, *The Nature of the Rights of the Cestui Que Trust*, 17 COLUM. L. REV. 269, 270 (1917). Langbein uses a more modern definition of contract in criticizing Scott. See Langbein, *supra* note 3, at 645-50.

6. ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS § 3 (1952) (footnote omitted); see also Robert Clark, *Agency Costs Versus Fiduciary Duties in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 55, 60 (John Pratt & Richard Zeckhauser eds., 1985) (“The term *contract* is more frequently used, even by lawyers, in varying senses than is the term *agency*, so it would be neither right nor prudent for me to claim that one particular specification of the term is the definitive legal notion of contract.”).

7. I admit, however, to having an irrational commitment to some arbitrary word meanings where little turns on the meaning. For example, like Jack Balkin, I was born and raised in Kansas City and have found myself in heated debates on whether or not I am a “Midwesterner.” I am.

8. See RICHARD POSNER, OVERCOMING LAW 178 (1996) (arguing that analogic reasoning is “not reasoning but is at best preparatory to reasoning”).

television with an option to buy. In struggling to determine whether such a transaction is appropriately characterized a "credit sale," courts often lose sight of the fact that what turns on this designation is whether the seller needs to disclose an implicit interest rate.⁹ Even nonactivist judges who want only to be faithful to the legislature's intent should ask whether the legislature in using this term intended to force rent-to-own businesses to disclose this type of information. But in the most egregious examples of this type of reifying interpretation, the standards for characterizing behavior are wholly divorced from the legal consequences of the characterization.¹⁰

Given my extreme skepticism about the utility of defining a contractual canon, I now will argue cautiously for the following definition: an area of law should be considered contractual if parties can privately reorder a substantial portion of their legal relations.¹¹ While I have no stake in maintaining that this is the only valid definition, I hope to show that the definition, in Corbin's terms, might prove to be convenient because it might lead policymakers and scholars, when speaking of contract, to focus on a central aspect of contract—whether and how parties contract around default rules.

This definition puts me squarely within the imperialist camp, but in three senses, I claim only to be a "wimpy imperialist." First, the focus on rules that are susceptible to private reordering does not necessarily include areas of law in which the rules conform to the "hypothetical contract" that parties would enter into if they could costlessly contract.¹² Thomas Jackson, for example, has claimed that bankruptcy rules conform to the hypothetical bargain that creditors

9. See, e.g., *Palacios v. ABC TV & Stereo Rental*, 365 N.W.2d 882, 885-87 (Wis. App. 1985).

10. See, e.g., *Delta Life & Annuity Co. v. Freeman Fin. Servs. Corp.*, 1995 U.S. App. LEXIS 14897, at *7-11 (9th Cir. 1995). This case (which I unsuccessfully argued in the appellate court) forced the court to decide whether the remarketing of annuities constituted the "business of insurance" under the three-part standard announced in *Hartford Fire Insurance Co. v. California*, 509 U.S. 764 (1993). See *Delta Life & Annuity*, 1995 U.S. App. LEXIS 14897, at *7-11. However, neither the Supreme Court's standard nor the Ninth Circuit's application was tied to the legal consequence—exemption from antitrust liability under section 2(b) of the McCarran-Ferguson Act, 15 U.S.C. § 1012(b) (1988).

11. This definition is close to many others in the field. See, e.g., Langbein, *supra* note 3, at 629 ("The bedrock elements of contract are consensual formation and consensual terms.")

12. See Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Contractarians*, 65 WASH. L. REV. 1, 17 (1990). Butler and Ribstein posit:

It is . . . a mistake to identify the hypothetical bargain approach with the contract theory of the corporation. Yet several commentators have done just that, and have then proceeded to criticize the contract theory because the hypothetical bargain approach is inconsistent with it, or otherwise defective. If anything, the defects of the hypothetical bargain approach provide another argument in favor of the contract theory: To the extent that courts and legislators follow this approach in adopting default provisions, it is important to permit the parties to opt out of it in order to escape its defects.

Id.

would strike amongst themselves.¹³ But as Jules Coleman has acutely observed, these theories are really arguments that particular rules are efficient.¹⁴ The hypothetical bargain approach is used routinely to describe areas of law that are not contractual because the rules are largely mandatory or not susceptible to private reordering, such as bankruptcy or professional ethics. Describing such areas as being contractual is not useful. Because hypothetical bargaining theories routinely assume monolithic preferences (i.e., every contracting pair is assumed to want the same contract), these theories divert policymakers from making the difficult but important assessments about whether particular rules should be susceptible to private reordering or not.

Second, my definition of contract is wimpy because it does not incorporate a presumption that contractual rules should be defaults (susceptible to private reordering) or a presumption that majoritarian defaults should be chosen. In contrast, Fred McChesney represents what I would call a strong-form imperialist. To his credit, he clearly states what hinges on calling corporate law contractual: "Since the firm is best explained in the contractarian paradigm as a set of contractual rules that reduce transaction costs, mandatory law overriding contracts is the exception. Those advocating legal coercion thus must bear the burden of showing why coercion should trump contracts."¹⁵ But the fact that a substantial number or even a majority of rules *are* susceptible to private reordering does not create a presumption that other rules in the area *should* be. Here, McChesney is leaping from "is" to "ought" without sufficient justification. My wimpy brand of contractarianism more modestly hopes to focus policymakers and scholars on the consequences of making particular rules mandatory. In addition, a conclusion that particular rules should be susceptible to private reordering does not lead me to presume that these defaults should be set at what the majority of contractual parties favor. Indeed, Rob Gertner and I have shown that "penalty" or "information-forcing" defaults might produce more effi-

13. See THOMAS H. JACKSON, *THE LOGIC AND LIMITS OF BANKRUPTCY LAW* 228-48 (1986); Thomas H. Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditor's Bargain*, 91 YALE L.J. 857, 860 (1982); Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditor's Bargain*, 75 VA. L. REV. 155, 156 (1989). Ron Gilson has similarly argued that many mandatory rules of professional responsibility are consistent with the hypothetical bargain that clients would collectively strike. See Ronald J. Gilson, *The Devolution of the Legal Profession: A Demand Side Perspective*, 49 MD. L. REV. 869, 875-77 (1990).

14. See Jules L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639, 644 (1989).

15. Fred S. McChesney, *Contractarianism Without Contracts? Yet Another Critique of Eisenberg*, 90 COLUM. L. REV. 1332, 1335 (1990).

cient contractual equilibria than so-called majoritarian defaults.¹⁶ My wimpier conception of contract intends to induce a more explicit consideration of how parties would bargain in the shadow of a variety of possible defaults.

Finally, by demanding that a substantial number of rules be susceptible to private reordering, the definition does not include areas where parties make all-or-nothing decisions to consent to a whole set of legal rules. The definition thereby excludes vast areas of tort and regulatory law that individuals opt into by consenting to undertake particular activities, such as driving cars. While there are interesting positive and normative issues about how particular sets of mandatory rules affect individuals' decisions to participate in particular activities, characterizing such areas as contractual might divert the policymakers' focus away from the core issues that should be in the foreground of policymakers' and scholars' minds.

In particular, my thesis is that defining the contractual canon as I have will help illuminate three normative issues: (1) Should particular rules be mandatory or merely defaults (which may be privately changed)? And if defaults, (2) Which default should be chosen?; and (3) What should be the necessary and sufficient conditions for contracting around the default? The impulse of too many scholars is to analyze legal rules as though, like much of tort law, they were not or could not be susceptible to private reordering. But a host of related normative questions arises in contexts where parties have or should have the freedom to reorder substantial parts of their legal relationship.

II. IMMUTABILITY CONSIDERATIONS

In deciding whether particular rules should be mandatory, policymakers should consider whether restrictions on the parties' freedom of contract are justified either by "externalities" or "paternalism" in that lawmakers might make rules mandatory to protect people not in contractual privity (e.g., as in the mandatory prohibition of criminal conspiracies) or to protect people who are parties to the contract itself (e.g., as in the mandatory prohibition against contracting with infants).¹⁷ Consequentialists will also want to consider carefully the interaction between mandatory and default terms of contracts and the effect of mandatory rules on the ability of people to contract at all. For example, the mandatory prohibition against usurious interest rates might limit the ability of high-risk consumers to borrow

16. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 95 (1989).

17. See *id.* at 88; Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 *YALE L.J.* 763, 786 (1983).

money or might induce sellers with bargaining power to extract their profits in a less efficient manner.

In reality, many prophylactic rules that are initially characterized as mandatory often can be modified to give even more protection to one of the contracting parties. For example, the mandatory duty of good faith can be contracted around to enhance a promisor's fiduciary duties. Policymakers should consider whether a mandatory restriction should prohibit all private reorderings or whether it should merely establish mandatory ceilings or floors to contractual duties.

Finally, when establishing mandatory restrictions on freedom of contract, the law perforce needs to establish how it will react to parties' attempts to contract around these restrictions. The law of contracts has displayed two generic responses to such attempts at violating immutability. One response, which is captured by the equitable doctrine of *cy pres*, reforms the offending provision to the "closest" nonoffending term. For example, if an employer contracts for an unreasonably long covenant not to compete, the law might respond by enforcing only a reasonable covenant not to compete.

The second broad legal response is structured to deter such attempts by punishing the responsible party. The law can deter immutability violations not only by criminally sanctioning the attempts (as with conspiracies to violate mandatory criminal rules), but also by reducing the contractual rights of one contracting party. The "blue pencil" interpretative method of striking out offensive contractual provisions may have such a penalizing effect. For example, if an employer extracts a covenant not to compete for an unreasonable time, the blue pencil method may result in the employer having no protection against competition, instead of reducing the duration of the covenant to what would have been a reasonable period.¹⁸

A subtler way the law might deter attempts to contract around mandatory restrictions is to promote contractual opportunism by the parties within such invalid contracts. While controlling contractual opportunism is usually one of the primary purposes of contract law, courts might want to *foster* contractual opportunism when parties contract for prohibited provisions in order to deter parties from entering into such contracts in the first place. For example, by voiding all contractual and restitutionary duties with regard to such "illegal" contracts, courts can undermine parties' incentives to rely in advance on the other side's performance for fear that the other side will walk away from its unenforceable duty to perform.¹⁹

18. See G. Richard Shell, *Contracts in the Modern Supreme Court*, 81 CAL. L. REV. 431, 442 (1993).

19. Countenancing *ex post* opportunism by one side of the contract will only deter *ex ante* contracting if the potential future victim has sufficient knowledge to know that it should not enter into this type of contract. Buyer opportunism should increase the buyer's

A classic example of the law struggling to choose between the *cy pres* and *deterrence* responses to contracting around mandatory rules can be found in the trial court and appellate decisions in *Frostifresh Corp. v. Reynoso*.²⁰ There, the trial court responded to a seller's unconscionably high markup on a freezer by deciding that the buyer was not required to pay any profit;²¹ the appellate court agreed that the contract was unconscionable but reversed the trial court's decision, which held that the buyer was required to pay a "reasonable profit."²²

III. CHOOSING THE DEFAULT

Even if the law allows freedom of contract to reign, it still must decide how to fill obligational gaps in agreements—those places where parties fail to specify their respective contractual duties fully.²³ There are several competing theories on how to choose defaults.²⁴ The most widely accepted standard is to choose the default that most parties would choose if they could costlessly contract. This "majoritarian" standard has the intuitive appeal that choosing the default which most parties want promotes efficiency by minimizing the transaction costs expended to contract around a particular rule.

While the majoritarian standard has acquired the status of presumptive correctness, I, as a wimpy imperialist, am intrigued with both empirical and theoretical counter-examples. Empirically, it may be difficult to identify a majoritarian rule for the simple reason that there may be several rules that a majority of parties fail to contract

willingness to contract and decrease the seller's willingness to contract. The latter effect will only dominate and deter contracting if sellers know at the time of potential contracting about the legal system's likely reaction. Thus, deciding that employers do not need to pay undocumented workers will only reduce the demand for illegal immigration if the potential workers in question know that they may be subject to such ex post exploitation. See *Gates v. Rivers Constr. Co.*, 515 P.2d 1020, 1021 (Alaska 1973).

20. 274 N.Y.S.2d 757 (Dist. Ct. 1966), *rev'd*, 281 N.Y.S.2d 964 (App. Term. 1967).

21. See *id.* at 759-60.

22. See *Frostifresh Corp. v. Reynoso*, 281 N.Y.S.2d 964, 965 (App. Term. 1967).

23. Lawyers refer to obligational gaps as rendering contracts "incomplete," while economists use the same term to refer to contracts that are not sufficiently state contingent. See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 730 (1992); Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159, 170 (1994).

24. See, e.g., Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1, 18 (1993) (discussing whether defaults should be rule-like or standard-like); Ayres & Gertner, *supra* note 16, at 127 (suggesting the economic theory of default rules); Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 906 (1992) (forwarding a "consent theory" for default rules); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1877 (1991) (critiquing the hypothetical bargaining theory); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615, 64 (1990) (suggesting a strategic bargaining theory of default rules).

around. In other contexts, there may be three or more popular provisions so that policymakers could do no better than identify a "plurality" rule.

Theoretically, it has been shown that nonmajoritarian default rules can be more efficient for a variety of reasons. First, it might be more efficient to select a default that only a minority of contractors prefer if this minority would otherwise bear particularly high costs of contracting around or failing to contract around the default rules.²⁵ Second, inducing parties to contract around a non-preferred default might induce contractors to disclose private information to each other or to third parties (including courts).²⁶

Regardless of whether policymakers embrace majoritarianism, they often must also decide two other dimensions: whether the default should be "tailored" or "one-size-fits-all," and whether the default should be a "rule" or a "standard."²⁷ The majoritarian default approach commands lawmakers to provide the gap-fillers that most people want but does not define the population over which to calculate the majority. As the population size is reduced, the default choice becomes more "tailored" to more particularized characteristics of the contracting party. At the extreme, a tailored default seeks to provide the hypothetical contractual provision that each particular contracting pair would have contracted for *ex ante*. A related but separate issue concerns whether the chosen default should be rule-like or standard-like. Legal standards are muddier provisions with contours that often are determinable only after the fact, unlike the more crystalline provisions of legal rules that are more readily knowable *ex ante*.²⁸

Lawmakers choose the degree of tailoring and muddiness in non-contractual areas as well. For example, in deciding the due care standard for torts, the law inevitably must establish whether this generally mandatory duty is tailored to particular characteristics of the tortfeasor or victim, as well as the degree of muddiness.²⁹ However, it is extremely dangerous to import tort (read: mandatory) theories about tailoring or muddiness to contract. The consequences

25. See Ayres & Gertner, *supra* note 16, at 108-18 (providing an algebraic model of the costs of contracting around default rules).

26. See *id.*

27. See Ian Ayres, Review, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1411-13 (1992) (discussing whether fiduciary duty defaults should be rules or standards); Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1, 4-5 (1993) (discussing whether default rules should be "tailored" or "off-the-rack").

28. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 559-60 (1992); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 577 (1988).

29. Consider, for example, the malleable "reasonable man" standard versus the rule of *res ipsa loquitur*.

of choosing an untailed standard are likely to be very different when parties can obliterate the law literally with a few strokes of a pen.

IV. PREREQUISITES FOR PRIVATE REORDERING

Even after deciding that a particular legal relationship will be subject to private reordering and after choosing what default provision will govern when the parties have been silent, the law must still establish what constitutes nonsilence; that is, the law must identify the necessary and sufficient conditions for supplanting or contracting around defaults. A number of cases turn on the question of sufficiency. When parties attempt to contract around a default, the court must decide whether the attempt was sufficient to create an alternative contractual obligation. For example, in *Jacob and Youngs, Inc. v. Kent*³⁰ and in *Peevyhouse v. Garland Coal & Mining Co.*,³¹ the courts, while upholding the private parties' freedom to contract for contrary results, found that the contractual language was not sufficient to give rise to "cost of performance" damages. These cases establish that certain manifestations are not sufficient to contract around a "diminution in value" damage measure but do not establish what would be sufficient. Judicial holdings and statutes that establish particular language as sufficient have the effect of creating safe harbors for parties that want to establish alternatives to a particular default. At other times, contract law clearly mandates the conditions necessary for contracting around a particular default, as in the Uniform Commercial Code provision that comes close to requiring that waivers of the implied warranty of merchantability use the word "merchantability" and be conspicuous.³²

The legal choice of these necessary and sufficient conditions can provide valuable information to a variety of people. Most importantly, the language that parties use to supplant default provisions is the most direct manifestation of their consent to the changes. Rules regarding the verbal as well as the nonverbal conditions (e.g., conspicuousness, separate initialing) can insure that the non-drafting party is aware of the particular term and thus help police the quality of the parties' consent. However, manipulating the conditions for contracting around defaults can also provide information to third parties. Specifically, requiring explicit manifestations of intent can give courts valuable information about the scope of the contract. Policymakers, at times, might also want to provide information to ancillary members of society. Policymakers will want to make sure that

30. 129 N.E. 889, 891 (N.Y. 1921).

31. 382 P.2d 109, 114 (Okla. 1962).

32. See U.C.C. § 2-316(2) (1995).

the method that parties use to contract around the default reveals the intended type of information, especially when a penalty default is chosen because of its information-forcing quality. For example, the default damages for lost profit on consumer sales might usefully be set to zero dollars as a penalty default in order to encourage sellers to contract for liquidated damages and thereby to provide consumers with better information about the seller's expected profit.³³ Providing this profit information might allow consumers to take more efficient precautions against breach³⁴ and might also give consumers more bargaining power.

The first goal, facilitating efficient consumer precaution, could be accomplished by simply requiring that the liquidated damages clause make clear to consumers that the consequence of not purchasing will be a certain amount of money. But to further the second goal, increased consumer bargaining power, the law might want to enforce damages for lost profit only if the damages clause explicitly designates the liquidated amount as being compensation for lost profit. A consumer negotiating to buy a compact car, upon learning that she was about to sign a contract in which the seller claims \$4000 in lost profits, might be put on notice that she should continue negotiating or search elsewhere.

An important, unexplored puzzle concerns the seemingly intentional fuzziness of legal standards for contracting around particular default rules. Many areas of law, even after decades of decision, resist clear statements of the necessary and sufficient conditions for contracting to a particular result.³⁵ In classic "sufficiency" cases such as *Peevyhouse* and *Jacob and Youngs*, it still is unclear what ex ante contractual language would have reversed the result. Cynics might view this as the back-door creation of mandatory rules,³⁶ but an interesting issue for further research is whether there might be other reasons why the law would intentionally make difficult or unclear how to contract around default rules. A different way of characterizing these cases is to consider them as attempts to make particular provisions mandatory for some contractual parties but not for those

33. See Ayres & Gertner, *supra* note 16, at 104; Victor P. Goldberg, *An Economic Analysis of the Lost-Volume Retail Seller*, 57 S. CAL. L. REV. 283, 298 (1984).

34. For example, consumers might protect themselves by searching for financing.

35. There are also mandatory provisions within contract law where courts almost intentionally seem to resist precise characterization. For example, in most jurisdictions it would be difficult to describe the exact maximum enforceable length of covenants not to compete.

36. See Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 321 (1985); Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 391 (1993).

who are willing to undertake the difficult and uncertain process of attempting to contract around the default provisions.³⁷

My thesis is that defining the contractual canon to focus on *private reorderings* focuses attention on whether and how default rules might be reordered. In confronting each of the three default-centric issues,³⁸ the most persuasive normative analysis will explicitly compare the predicted equilibrium of alternative rules. Too many articles argue for the efficiency of a particular rule without adequately describing the contractual equilibrium under that rule and comparing it to the contractual equilibria under alternative rules. Precious few articles try to accomplish the valuable analysis of bringing real world contracting evidence to bear in developing their consequentialist claims.³⁹

V. A DWORKINIAN APPLICATION

To illustrate the normative payoff of thinking "contractually," in the sense of focusing on the three core gap-filling issues, I intentionally choose to discuss an area of law where the leading scholars are apt to ignore contract. My illustration concerns Ronald Dworkin's recent suggestion that the First Amendment should ban most actions for libel.⁴⁰ What would it mean to think about this proposal through the lens of contract? I will argue that thinking contractually raises interesting questions about each of the three core default issues and that consideration of these three issues ultimately undermines, or at least substantially modifies, the proposal itself.

First, one should consider whether the rule banning all libel actions except for those involving actual malice should be mandatory or merely a default rule. Dworkin, like most constitutional theorists, is so inured to thinking only about mandatory rules that he does not consider this most basic issue. Currently many contracting parties warrant the truthfulness of their representations, thereby contracting for themselves an acceptance of liability if one of their representations is false, even if the misrepresentation is not made maliciously. I doubt that Dworkin believes that such affirmative contracts violate his conception of the First Amendment. The Constitution

37. See Ayres & Gertner, *supra* note 16, at 125 (discussing the possible channeling function of such sticky defaults).

38. See *supra* p. 901.

39. See, e.g., J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts: Resolving the Just Cause Debate*, 4 WIS. L. REV. 837, 863-77 (1995) (surveying 221 employers regarding their contractual terms governing the discharge of employees).

40. See RONALD DWORKIN, *FREEDOM'S LAW: THE MORAL READING OF THE AMERICAN CONSTITUTION* 209 (1996) (arguing that all plaintiffs should be required to prove actual malice); see also Cass R. Sunstein, *Earl Warren Is Dead*, NEW REPUBLIC, May 13, 1996, at 35, 36 (reviewing DWORKIN, *supra*).

similarly should not prohibit laws that allow individuals to affirmatively *opt into* potential libel liability for nonmalicious misrepresentations. Just as the maker of carbolic smoke balls offered warranties to its users to make its claims of effectiveness more credible,⁴¹ I see no reason why the Constitution should prohibit newspapers from guaranteeing that all of their news is accurate and offering to pay damages to anyone who might be injured through nonmalicious libel as a way of convincing readers that their product—the news—is truthful. It would be a strange result, indeed, if the First Amendment were read to prohibit giving people the option to stand behind the truthfulness of their statements. This analysis suggests that Dworkin's proposed ban is (and should be) merely a default rule and not, as it seems, mandatory.

But the conclusion that a particular legal rule is a default inevitably leads contract thinkers to ask the second of my default-centric questions: which default is most appropriate? If the First Amendment does not prohibit firms from *opting into* such a regime, why should it prohibit a legislature from creating an *opt-out* regime? In particular, why could not a legislature require that speakers in particular public fora open themselves up to pay libel damages for falsehoods unless the speakers explicitly opted out by expressly disclaiming such potential liability? Dworkin needs to provide a reason why a "no liability" default is to be *constitutionally* preferred to a "potential liability" default. Dworkin might argue that certain opt-out regimes are unconstitutional because forcing speakers to disclaim potential liability is too burdensome so that, as a categorical matter, opt-out regimes are unconstitutional.

But this defense of Dworkin's proposal itself necessitates an investigation of the third default-centric issue: the necessary and sufficient conditions for contracting around particular defaults. As a theoretical matter, it is unclear whether an opt-in or opt-out regime would be more burdensome to freedom of speech. If the majority of speakers wants to signal the truthfulness of its statements credibly, then forcing these speakers to opt into potential liability may be more burdensome than forcing other speakers to opt out. Instead of banning all opt-out regimes, the First Amendment might only restrict the words of disclaimer required in order to opt out. For example, requiring a speaker to say that her statement may include malicious falsehoods as a precondition for avoiding libel damages may overly burden the free speech right, but putting listeners on notice that the speaker is not willing to be legally accountable for her misstatements is not, as an *a priori* matter, inimical to the underlying goals of the First Amendment.

41. See *Carlill v. Carbolic Smoke Ball Co.*, [1893] 1 Q.B. 256 (Eng. C.A. 1892).

At a minimum, this contractual reconception has refocused the terms of the debate. Instead of arguing whether libel laws are immutably unconstitutional, we ask whether the default rule should be “potential libel damages” or “no potential libel damages,” and what should be sufficient to opt in or opt out of such liability.⁴² Once one accepts that private parties should be able to opt into libel liability, it is a short step to seeing that the state might constitutionally force parties to opt out of such liability by forcing speakers to indicate, in not overly burdensome ways, that they do not wish to be legally accountable for their misrepresentations. Recast this way, Dworkin’s bold proposal loses much of its oomph. The point here is not that an opt-out regime is necessarily constitutional, but that it is a serious enough contender to deserve more thorough and explicit consideration.

This First Amendment analysis is by no means unique. The contractual impulse can be applied, like the name game, to virtually any rule of law. And while free market proposals often are thought to have a conservative political valence, thinking contractually can defang conservative as well as liberal proposals. For example, and in contrast to Dworkin’s liberalism, contractual analysis can undermine Richard Epstein’s proposal to repeal Title VII.⁴³ Recast in contractual terms, Epstein makes several questionable arguments against Title VII as a mandatory rule and suggests that these arguments are sufficient for repeal. But as long as Epstein would allow decision makers to covenant that they will not discriminate—and as a hard-core believer in freedom of contract, Epstein would—his proposal is really that Title VII become an opt-in regime with “no potential liability” being merely the default rule. But just as Dworkin needs to provide some reason why a “no potential liability” default is to be preferred to a “potential liability” default, Epstein needs to explain why repealing Title VII is preferable to merely making Title VII a default rule. While I am not in favor of either change, I think that changing Title VII to a default that an employer could disclaim only with sufficiently public disclosures would not lead to a significant change in the current equilibrium. Most employers would be ashamed to contract for the right to discriminate on the basis of race.⁴⁴ Again, the

42. For a similar analysis of liability under security law for false statements by corporate directors, see Ian Ayres, *Back to Basics: Regulating How Corporations Speak to the Market*, 77 VA. L. REV. 945 (1991).

43. See RICHARD A. EPSTEIN, *FORBIDDEN GROUND: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS* (1992). For my fuller thoughts on this book, see Ian Ayres, *Alternative Grounds: Epstein’s Discrimination Analysis in Other Market Settings*, 31 SAN DIEGO L. REV. 67 (1994); and Ian Ayres, *Price and Prejudice*, NEW REPUBLIC, July 6, 1992, at 30 (reviewing EPSTEIN, *supra*).

44. There might, however, be a significant number of employers who contract out of disparate impact and/or reasonable accommodation duties.

point here is that legal analysts can profit by thinking about the contractual dimensions of problems even in areas that seem far removed from the traditional canon of contract.

VI. CONCLUSION

In studying for the Illinois bar, I was forced to learn dozens of corporation rules that were dutifully squibbed in my review materials. But I remember being frustrated that the materials invariably failed to indicate whether particular rules could be contracted around and if so, how. This method of teaching law is an unfortunate part of many curricula. Increasingly, however, professors are emphasizing in their scholarship and in their teaching whether and how private parties can reorder particular legal rules. While I remain highly dubious about the project of canon building, I confess that I hope to instill a certain contractual impulse, or reflex, if you will, in my students. Whenever they learn a new legal rule in any field, I hope they will ask whether and how it can be contracted around.

The debate over what it means to be "contractual" probably has been most intense in the area of corporate law. Dozens of articles have been written with the contractarian/noncontractarian divide fracturing much of the literature.⁴⁵ I propose no magic resolution to this conflict. Give me your definition of contract, and I will try to tell you whether, as a descriptive matter, corporate law conforms. If, like Victor Brudney, you believe that contract requires a certain amount of bargaining or market competition to ensure that contractual provisions are properly priced,⁴⁶ then you might reasonably conclude that a corporation is not usefully described as a nexus of contracts.

45. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Robert Clark, *Agency Costs Versus Fiduciary Duties*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* (John W. Pratt & Richard J. Zeckhauser eds., 1985); Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 *AM. ECON. REV.* 777 (1972); Barry D. Baysinger & Henry N. Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 *VA. L. REV.* 1257 (1985); William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 *STAN. L. REV.* 1471 (1989); William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 *CORNELL L. REV.* 407, 416 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 *COLUM. L. REV.* 1403 (1985); Henry N. Butler, *The Contractual Theory of the Corporation*, 11 *GEO. MASON L. REV.* 99 (1989); Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Contractarians*, 65 *WASH. L. REV.* 1, 23 (1990); John Coffee, *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 *COLUM. L. REV.* 1618 (1989); John Coffee, *No Exit?: Opting Out, the Contractual Theory of the Corporation and the Special Case of Remedies*, 53 *BROOK. L. REV.* 919 (1988); Deborah Demott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 *DUKE L.J.* 879; Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305 (1976); Fred S. McChesney, *Contractarianism Without Contracts?: Yet Another Critique of Eisenberg*, 90 *COLUM. L. REV.* 1332, 1333-34 (1990).

46. See Brudney, *supra* note 45, at 1443-44.

On the other hand, corporate law seems to meet my wimpy imperialist definition because a substantial number of rules are susceptible to private reordering.

What I have characterized as the three core default questions are of great importance in determining the scope of corporate law. But as a wimpy imperialist, my contractual view of the corporation does not close my mind to using mandatory rules or information-forcing defaults, or to manipulating the requirements for contracting around defaults to improve social welfare. The quintessentially relational nature of management's contract with the firm raises distinct issues of corporate governance. The quality of consent at a corporation's inception is often high, but the inception is so temporally removed from future contingencies that complete contracting is impossible. Inducing diversified investors to consider amendments seriously—the so-called “midstream” problem—significantly reduces the quality of consent for subsequent attempts to reorder the terms of the governance contract.⁴⁷ The midstream problem and similar difficulties underscore the importance of thinking about the consequences of properly regulating the scope and method of private reordering.

Unlike other theories, my vision of the contractual canon has not made “promise,” “consent,” or “bargain” the defining theme.⁴⁸ Indeed, my definition does not even strictly require *two* contracting parties. Hence, wills and estates are “contractual” in my view because the laws of intestacy are merely defaults that individuals have the option to contract around.⁴⁹ Placing “gap-filling” at the core focuses our attention on the consequences of granting individuals (or an individual) the option to mutate their legal obligations—the consequences of contractual freedom.⁵⁰

47. See, e.g., Lucian A. Bebchuck, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1822 (1989).

48. See, e.g., CHARLES FRIED, *CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION* 1 (1981); Randy E. Barnett, *A Consent Theory of Contract*, 86 COLUM. L. REV. 269 (1986); Melvin Aron Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741 (1982).

49. Similarly, Akhil Amar's interpretation of the Fourth, Fifth, and Sixth Amendments focuses on the ability of criminal defendants to waive or contract around a variety of rights. See AKHIL AMAR, *THE CONSTITUTION AND CRIMINAL PROCEDURE: FIRST PRINCIPLES* (1997).

50. Richard Craswell has usefully distinguished between two different types of default rules:

The rules of contract law can be divided into two categories: “background rules” and “agreement rules.” As discussed earlier, background rules define the exact substance of a party's obligation, by specifying (among other things) the conditions under which her nonperformance will be excused, and the sanctions which will be applied to any unexcused nonperformance. By contrast, agreement rules specify the conditions and procedures the parties must satisfy in order to change an otherwise applicable background rule. Agreement rules thus include most of the rules governing offer and acceptance, as well as such doctrines as fraud or undue influence, which define the conditions necessary for a

party's apparent consent to be counted as truly valid. To be sure, these two categories are not mutually exclusive, for some rules serve both functions simultaneously.

Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 MICH. L. REV. 489, 503 (1989). The term "agreement rules" then captures not only the necessary and sufficient conditions for contracting around a rule—"the conditions and procedures the parties must satisfy in order to change an otherwise applicable background rule"—this term also seems to include rules about what behavior is necessary and sufficient to form a contract. *Id.* These latter formation rules are themselves often defaults that parties can contract out of, for example by specifying a particular offer can only be accepted in writing. For an excellent analysis of agreement rules, see Richard Craswell, *Offer, Acceptance, and Efficient Reliance*, 48 STAN. L. REV. 481 (1996); and Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215 (1990).