Default Rules for Incomplete Contracts

by

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A central distinction between contractual and non-contractual areas of law is whether private parties can contract around legal rules (Ayres, 1997). Rules that govern in the absence of contrary agreement are now commonly referred to as "defaults" but have alternatively been termed background, backstop, enabling, fallback, gap-filling, off-the-rack, opt-in, opt-out, preformulated, preset, presumptive, standby, standard-form, suppletory and yielding rules (Ayres & Gertner, 1989). In contrast, the much smaller class of contract rules that parties cannot change by private agreement are referred to as "immutable" or "mandatory." Llewellyn called them "rules of iron" (Schwartz, 1997; Llewellyn, 1938). Awarding expectation damages is thus a default rule (because parties can stipulate alternative damage amounts); while the duty of good faith is a mandatory part of every agreement.

The ability of private parties to change a rule should affect how an initial default is chosen. Early law-and-economics scholars, however, often modelled the choice of efficient defaults as if they were choosing among immutable rules. But the ability of private parties to opt-out can have profound effects on efficiency and equity. The Coase theorem teaches that if parties can efficiently contract to internalize externalities, the choice of legal rules will only affect distribution, not allocative efficiency. But Schwab (1988) pointed out that when the Coase theorem holds, different default rules will affect neither efficiency nor distribution. Default rule choice thus does not implicate the same type of wealth effects as immutable rules (Craswell, 1991).

On the other hand, when the Coase theorem does not hold, default choice can profoundly affect the amount of strategic inefficiency produced by private negotiation. Law-and-economics scholars have at times down played the importance of default rule choice by claiming that the amount of the inefficiency from choosing the wrong default would be no larger than the cost of contracting around the rule. But taking into account how individuals might strategically react to rules reveals that choosing the wrong rule can produce inefficiencies that are much larger than the nominal costs of contracting around (Ayres & Gertner, 1992).

This essay will suggest that lawmakers should choose among competing defaults by explicitly considering the contractual equilibria induced by the alternative rules. Before proceeding to the question of default choice, however, let me briefly touch on two ancillary issues: what is contractual incompleteness and when should contract rules be immutable?

Incomplete Contracts. The term "incomplete contract" is somewhat confusing because legal and economic scholars use it to refer to two distinct types of incompleteness. Legal scholars (including law-and-economics scholars) use the term to refer to contracts in which the obligations are not fully specified. A contract to sell a good is "obligationally" incomplete, for example, if it fails to specify the price, quantity, or date of delivery. In contrast, a contract is obligationally complete if the obligations of the parties are fully specified for all future states of the world.

Economic scholars, on the other hand use the term "incomplete" to refer to contracts that are not sufficiently state-contingent. If the contract does not make obligations of the parties contingent on "all the payoff-relevant information" (Hadfield, 1994) or for some reason, the parties' obligations are "too coarsely" partitioned (Schwartz, 1992), a contract is deemed "incomplete" in this second, distinct sense. In rare instances (such as impossibility), courts will reform contracts to make unconditional duties to perform conditional on there not being egregious changes in circumstances. Such decisions are not filling obligational gaps, rather these decisions are responding to contracts that courts deem to be insufficiently state-contingent (the second meaning of "incompleteness"). This essay addresses only questions of obligational incompleteness. However, it should be noted that Schwartz (1992) has persuasively argued that courts should not attempt to make contractual duties more contingent than the parties stipulate in the initial contract, because parties have good reasons (chiefly the difficulty of proving the occurrence of conditions) for creating coarse, unconditional duties.

Immutable Rules. Before addressing how courts should fill obligational gaps in contracts, it is useful to say a few words about whether particular obligations should be merely defaults or mandatory parts of a contract. There is surprising consensus among academics at an abstract level on two normative bases for immutable rules. Put most simply, immutable rules are justifiable only to the extent the restriction on contractual freedom is needed to protect (1) parties within the contract, or (2) parties outside the contract. While these two categories rather tautologically encompass the universe of all people, the dichotomy is still useful because parties to the contract have different mechanisms for protecting themselves (e.g., refusing to contract) and the law of contracts can offer a host of procedural protections to enhance our confidence that the agreement advances each contractor's welfare. People who are not parties to the initial contract are not necessarily benefitted by these procedural protections and would need to pay Coasean bribes to induce the original contractors to internalize the external effects of their contract.

As a descriptive matter, the immutable rules of contract on closer inspection are often one-sided, in that they mandate immutable ceilings or floors. For example, the immutable duty of good faith defines a minimum duty but does not prohibit parties from contracting for heightened duties of performance. Or the immutable rules limiting the length of covenants not to compete or limiting the size of liquidated damages are immutable ceilings that allow the parties flexibility to contract for smaller quanta.

Immutable rules of law also force lawmakers to decide what obligations should govern when parties' attempt to contract around an immutable restriction. 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" non-offending 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 immutable 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). A subtler way that the law might deter attempts to contract around immutable restrictions is to promote contractual opportunism by the parties within such invalid contracts. If courts countenance contractual opportunism by one or more of the parties, they might no longer find it in their interest to contract initially. While controlling contractual opportunism is

usually one of the 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, the courts can undermine the parties' incentive 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 (Ayres, 1997). A classic example of the law struggling to choose between the *cy pres* and *deterrence* responses to contracting around immutable rules can be found in the trial and appellate decisions in *Frostifresh v. Reynoso*. 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; the appellate court affirmed the unconscionability decision but instead reformulated the contract to require the buyer to pay a "reasonable profit."

Choosing the Default. Even if the law allows freedom of contract to reign, it still must decide how to fill obligational gaps. There are several competing theories on how to choose defaults (Symposium, 1993). The most widely accepted standard is to choose the default that most parties would choose if they could costlessly contract (Goetz & Scott, 1985). This "majoritarian" standard has the intuitive appeal that majoritarian defaults minimize the number of times parties will need to contract around a particular rule to achieve an idiosyncratic obligation.

While the "majoritarian" standard has acquired the status of presumptive correctness, there are several reasons why this standard might be difficult to implement. First, 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 around. In other contexts, there may be three or more popular provisions -- so that policy makers could do no better than identify a "plurality" rule.

Moreover, the majoritarian principle does not by itself adequately guide two dimensions of default choice: whether the default should be "tailored" or "one-size-fits-all" (Ayres, 1993), and whether the default should be a "rule" or a "standard" (Ayres, 1992; Kaplow, 1992; Rose, 1988). 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 the particular characteristics of the contractors. 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 whose contours are often only determinable after the fact -- unlike the more crystalline provisions of legal rules which are more readily knowable *ex ante*. 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 immutable duty is tailored to particular characteristics of the tort feasor or victim, as well as the degree of muddiness ("reasonable man" v. *res ipsa loquitur*). However, it is extremely dangerous to import tort (read: immutable) theories about tailoring or muddiness to the contractual domain. The consequences of choosing an untailored standard are likely to be very different when parties can obliterate the law literally with a few strokes of a pen.

Finally, there are important theoretical reasons to think that majoritarian defaults (even when identifiable) may not be efficient. Rob Gertner and I showed that "penalty" (a.k.a. "information-forcing") defaults could at times be more efficient than majoritarian rules. (Ayres & Gertner, 1989 and 1992). As a descriptive matter, many default rules seem to have an information-forcing quality. Many courts will supply the price term that the parties would have contracted for (following the majoritarian standard), but penalize the parties if they fail to specify the quantity to be traded -- by effectively reading into the contract a zero quantity default (Ayres & Gertner, 1989). Similarly, the famous rule of *Hadley v. Baxendale*, that only foreseeable damages will be awarded, gives the non-breaching party an incentive to disclose the potential for unusually large damages. Finally, the *contra proferentem* canon which interprets all ambiguities against the offeror induces the drafter to educate the offeree *ex ante* about the contract terms or risk being penalized by an unfavourable reading ex post by the court.

Many subsequent scholars have mistakenly described our thesis as universally favouring penalty defaults or as suggesting that policy makers have an all-or-nothing choice between majoritarian and penalty defaults. This is not our position. Rather we emphasized the *possible* efficiency of information-forcing rules, as an extreme counterexample to those who unthinkingly accepted that lawmakers should choose the default rule that most parties would want.

Indeed, we believe that policy makers have a much richer choice than merely choosing between majoritarian rules and

penalty defaults. For example, sometimes a minoritarian rule will be efficient -- not because of information-forcing effects -- but because it will be cheaper for the majority of contractors to contract around (a minoritarian default) or because they will face lower costs of failing to contract around.

Instead we think that the meta-theory of default choice should turn on explicit analysis of the equilibrium induced by distinct competing defaults. At a minimum, it is incumbent on scholars to predict what proportion of contractors will contract around competing defaults. To use the current voguish economic terminology, scholars should make claims about whether particular defaults will induce pooling or separating equilibria (Hviid, 1996; Ayres & Gertner, 1992). Doing so will almost inevitably lead to an analysis of the causes and consequences of such pooling or separating. There is no *a priori* reason to think that pooling or separating equilibria will be generally superior: Separating contractual equilibria entail the costs of contracting around and possibly inefficient oversignalling (Hviid, 1996; Ayres, 1991), but they also create the possibility of information disclosure and tailoring of contractual obligations to the underlying contracting types.

Explicit equilibrium analysis of competing defaults is especially amenable to empirical testing. Every default change provides a natural experiment where one could potentially see whether and how the contractual equilibrium changes. Two examples of just this kind of work can be found in Stewart Schwab's pathbreaking classroom experiments on default choice (Schwab, 1988) and Rip Verkerke's excellent cross-sectional analysis of how employment contracts respond to different "just cause" firing rules (Verkerke, 1995).

Prerequisites for Private Reordering. Even after deciding that a particular legal relationship will be subject to private reordering and after choosing which default provision will govern when the parties are silent, the law must still establish what constitutes non-silence -- that is, the law must identify the necessary and sufficient conditions for supplanting or contracting around defaults. While default-talk often speaks in terms of "contracting around," it is not necessary that the consent of both parties be given in order to supplant the workings of a particular rule. This possibility can most easily be seen with regard to what Craswell (1989) has termed "agreement rules." The aphorism that an "offeror is master of her offer" captures the notion that an offeror unilaterally can contract around the default agreement rules establishing what constitutes an acceptance. Hence an offeror might unilaterally contract around the mailbox rules by specifying that her offer will not be accepted until received by the offeror.

A number of default cases turn on the question of sufficiency. When the parties to a contract 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 v. Kent* and in *Peeveyhouse v. Garland Coal Co.*, 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. These cases exemplify a major failing of the common law: to wit, the failure to specify how private parties can contract for alternative results. The traditional "judicial restraint" dodge that courts should only resolve "cases or controversy" is routinely violated in other arenas where judges provide "dicta" that guide future action -- as can be easily seen in a useful footnote in *Miranda v. Arizona* which provided police officers with a safeharbour warning (which is now universally known by the US citizenry). Judicial holdings and statutes of this kind could similarly create contractual safe-harbours for parties who want to establish alternative terms.

There is at times then a seemingly intentional unwillingness by lawmakers to provide standards for contracting around particular default rules. Many areas of law -- even after decades of decisions -- resist clear statements of the necessary and sufficient conditions for contracting to a particular result. In classic "sufficiency" cases (such as *Peeveyhouse* and *Jacob and Youngs*), it is still unclear what *ex ante* contractual language would have reversed the result. Cynics might view this as the back door creation of immutable rules, and Goetz & Scott (1985) have detailed a tendency for judges over time to make it increasingly difficult to contract around defaults -- effectively changing defaults into immutable rules. An interesting issue for further research is whether there might be other reasons for the law to intentionally make it difficult to contract around. A different way of characterizing these cases is that they are attempting to make particular provisions immutable for some contractual parties but not for others (who are willing to undertake the difficult and uncertain process of attempting to contract around) (Ayres & Gertner, 1989:125).

At times, contract law has established *necessary* conditions for contracting around a particular default -- as in the U.C.C. provision requiring waivers of the implied warranty of merchantability to use the word "merchantability" and to be conspicuous. (U.C.C. §2-316(2)). The legal choice of these necessary conditions can provide valuable information to a variety of people. Most important, the words used to supplant default provisions are the most direct manifestations of the parties' consent. Rules regarding the verbal as well as the nonverbal conditions (e.g., conspicuousness, separate initialling) can insure that the non-drafting party is aware of particular terms and thus help police the quality of the parties' consent. But manipulating the conditions for contracting around defaults can also provide information to third parties. Requiring explicit manifestations of intent can give courts information about the scope of the contract. Especially when a penalty default is chosen because of its information-forcing quality, policy makers will want to make sure that the method that parties use to contract around the default reveals the intended type of information. For example, damages for consumer breach might usefully be changed from lost profit 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 (Ayres, 1989; Goldberg, 1984). Or less radically, one might merely extend the *Hadley* principle to apply to sellers' damages. If sellers could only recover foreseeable lost profits, they -- like the buyer in *Hadley* -- would have enhanced incentives to disclose when their profits were inordinately high. Providing profit information might both allow consumers to take more efficient precautions against breach (such as searching for financing) and give consumers more bargaining power. The first goal (of facilitating efficient consumer precaution) can be accomplished by simply requiring that the liquidated damages clause makes clear to consumers that the consequence of not purchasing will be an obligation to pay a certain amount of money. But to further the second goal, the law might want to enforce stipulated damages for lost profit only if the damage clause explicitly designates the liquidated amount as 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.

Conclusion. The ability of Congress to contract around (i.e., overrule) judicial statutory interpretation has led both scholars and the courts to realize that rules of *stare decisis* should be more stringently applied when courts revisit a statutory ruling (relative to a constitutional ruling which cannot as easily be modified). But lawmakers often fail to appreciate how the possibility of private reordering should affect the interpretation of a contract.

Moreover, in areas which are socially-constructed not to be "contractual," theorists often argue that one immutable rule should replace another immutable rule without considering the possibility of intermediate default alternatives. In many cases, the argument against a particular regulation is more an argument against its immutability than against its content (Coleman & Kraus, 1986). Let me end with three examples of how policy analysis can be misguided when analysts ignore the possibility of default rules. In each example, a scholar suggests repealing an immutable regulation -- and thereby implicitly would replace the immutable regulation with a default rule that would allow the parties to opt back into the preexisting regulatory regime. But the scholars never explain why an opt-in default is superior to an opt-out default. At most, they only provide reasons why the preexisting rule should not be immutable.

1. In *Forbidden Ground* (1992), Richard Epstein argues that Title VII's immutable prohibition against race discrimination in employment should be repealed. Epstein, a faithful libertarian, makes several (unpersuasive) arguments against Title VII's immutability. But as long as Epstein would allow prospective employers to covenant that they will not discriminate in employment (and as a hard-core believer in freedom of contract Epstein would), his proposal is really that Title VII should become an opt-in regime -- with "no potential liability" being merely a default. Epstein needs to explain why an opt-in regime is preferred to an opt-out regime -- i.e., merely making Title VII a default rule. While I am not in favour of either change, I think that changing Title VII to a default that an employer could only disclaim 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.

2. In *Freedom's Law* (1996), Ronald Dworkin argues that the First Amendment should be read to effectively ban most actions for libel. But Dworkin's argument makes the mistake of only considering one immutable rule (no libel liability) as a substitute for another immutable rule (potential libel liability). Specifically, he never considers transforming the current law into a default around which speakers could contract by making clear to their audience that they are not willing to defend the truthfulness of their assertions in a court of law. I cannot imagine that Dworkin would say that an opt-in regime -- where speakers voluntarily contracted for potential liability if their statements were subsequently found

to be libelous -- is unconstitutional. Currently many contractual parties warrant the truthfulness of their representations -- and thereby contract for liability if one of their representations is false (even if the misrepresentation was not made maliciously). The Constitution similarly should not prohibit laws that allow individuals to affirmatively opt into potential libel liability for (non-malicious) misrepresentations. 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 merely a default rule and not (as it seems) immutable.

But 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 couldn't the 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's analysis fails to provide a reason why a "no liability" default is to be constitutionally preferred to a "potential liability" default (Ayres, 1997). Such issues are invisible to most constitutional theorists who are so inured to thinking only about choices among immutable rules that they overlook default rule options.

3. My last example concerns the point at which criminal plea bargains should become specifically enforceable against the government. Courts have split on whether the agreement should become enforceable when the defendant substantially performs (say, by cooperating with prosecutors pursuant to an agreement) or whether it should only become enforceable when the defendant pleads guilty (see, e.g., *People v. Navarroli* and *Nebraska v. Howe*). The half-dozen courts that have faced this issue speak as if they are choosing among immutable rules and almost without exception choose rules favouring the state. But there is a strong and simple argument that the appropriate rule should make the plea bargains enforceable against the state at an early stage of defendants' cooperation -- but that this rule should be merely a default that the parties can contract around. This default rule would give the state -- the quintessential repeat player -- the appropriate incentive to make clear at what point the plea bargain would become effective (Richman, 1996). This is particularly true because the current plea bargain rule goes so much against common perceptions about when contracts become binding (Barnett, 1992). Prosecutors in offering rewards know how to add language so that the offer will only become enforceable upon the receipt of information "leading to arrest and conviction." It would not impose an undue hardship for them to draft words making clear when they intended their plea agreements to become enforceable. The example is illuminating in part because as soon as judges venture outside traditional contract land -- even when they are adjudicating the effects of plea *agreements* -- they lose their ability to think contractually (as in remembering the *contra proferentum* canon of contractual interpretation).

These examples illustrate how disparate areas of law can be improved by thinking about whether and how legal rules could be privately re-ordered. There will always be many immutable rules and most defaults should inevitably be majoritarian, but a deeper appreciation of how people contractually react to alternative rules has a promise for improving the workings of the market. In an age where command and control regulation is properly out of favour, renewed attention to the content of default rules has the potential for ameliorating the excesses of the market without restricting contractual freedom.

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