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Preliminary Thoughts on Optimal Tailoring of Contractual Rules

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ARTICLES

PRELIMINARY THOUGHTS ON OPTIMAL TAILORING OF CONTRACTUAL RULES

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I. INTRODUCTION

This paper is an extremely tentative analysis of the extent to which default rules should be tailored. In the introduction to my first article on default rules, Rob Gertner and I promised to provide a theory for optimal tailoring.[1] A close reading of that article, however, reveals that we never succeeded in providing such a theory. Although this paper will not correct that failure, I do hope to provide some partial equilibrium insights that might be helpful to others who attempt a fuller analysis.

The paper also tries to relate optimal tailoring to a relatively well-developed aspect of tort theory. This aspect is often termed the degree of "precision"[2] but also is seen under the rubric of "rules vs. standards." One of the most important treatments of this topic is Isaac Ehrlich and Richard Posner's *An Economic Analysis of Legal Rulemaking*.[3] That article provides, along with many other contributions, a recurring example of the difference between rules and standards: "If we want to prevent driving at excessive speeds, one approach is to post specific speed limits and to declare it unlawful per

* Professor, Stanford Law School. Jason Johnston, Todd Rakoff, John Setear and Eric Talley provided helpful comments.

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

2. Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65 (1983).

3. Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974).

se to exceed those limits; another is to eschew specific speed limits and simply declare that driving at unreasonable speeds is unlawful."[4] Colin Diver and Louis Kaplow have also made substantial contributions to this literature.[5] The articles in this "rules vs. standards" discussion attempt to identify when lawmakers should promulgate rules (specific speed limits) or standards (general requirement to drive safely).

This literature, however, has largely ignored how the choice between rules and standards is affected by the ability of private parties to contract around the law.[6] The existing theory then is a theory about the optimal precision of immutable rules rather than a theory about the optimal precision of default rules.

The rather minimal thesis of this paper is that the ability of private parties to contract around rules or standards affects their optimal level of precision.[7] It is not appropriate to simply import the tort, administrative law and immutable rule theories to the contract context where parties have the private option to exit. It may be exceedingly

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4. *Id.* at 257.

5. Diver, *supra* note 2; Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992). Kathleen Sullivan has also just written an excellent analysis of constitutional rules and standards. Kathleen M. Sullivan, *The Supreme Court, 1991 Term—Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 22 (1992); *see also* MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 15-63 (1987); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1687-1713 (1976); Margaret J. Radin, *Reconsidering the Rule of Law*, 69 B.U. L. REV. 781, 783-91 (1989); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577, 592-93 (1988); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985).

6. There are notable published exceptions to this claim. Kaplow has a short discussion of how his theory would relate to default rules. Kaplow, *supra* note 5, at 618-20; *see also* Douglas G. Baird & Robert Weisberg, *Rules, Standards, and the Battle of the Forms: A Reassessment of § 2-207*, 68 VA. L. REV. 1217, 1221 (1982) ("[T]he battle of the forms must be understood in light of a fundamental question in jurisprudence—whether to use formal "rules" or open-ended "standards" to resolve the mutual rights of private parties."); Ehrlich & Posner, *supra* note 3, at 273 ("[W]e observe greater use of strict liability in tort and contract than in criminal contexts and we observe heavy use of quite arbitrary rules in areas of the law such as commercial and real-property law where the parties subject to the rules can transact around them at moderate cost.").

Moreover, there are three important works in progress analyzing rules vs. standards in the contractual setting: Alan Schwartz & Robert E. Scott, The Political Economy of Private Legislatures: An Analysis of the Making of Commercial Law (Aug. 23, 1993) (unpublished manuscript, on file with the *Southern California Interdisciplinary Law Journal*); Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159 (1994); Jason S. Johnston, Balancing Under Rules vs. Standards (1993) (unpublished manuscript, on file with the author). The concurrence of this interest suggests the beginnings of trend.

7. Kaplow, *supra* note 5, at 619 ("Background laws raise different issues, and therefore would require that yet another framework be created.").

hard, however, to provide a general theory. While the works of Ehrlich and Posner, Diver and Kaplow contain compelling insights, none succeeds in providing a truly general or complete analysis—in part because the topic is so amorphous. The normative choice between rules and standards becomes even more difficult when parties can contract around the law. This paper is a preliminary investigation of the default theory of rules vs. standards.

II. DEFINING TERMS

Before proceeding, I will try to define some terminology. It is difficult to be precise in this area (indeed, one might argue that the definitions are more standard-like than rule-like). Ehrlich and Posner distinguish between rules and standards in the following way: "A rule withdraws from the decision maker's consideration one or more of the circumstances that would be relevant to decision according to a standard. . . . The difference between a rule and a standard is a matter of degree—the degree of precision."[8] Louis Kaplow, however, distinguishes between the two terms on different grounds: "[T]he only distinction between rules and standards is the extent to which efforts to give content to the law are undertaken before or after individuals act."[9] Kaplow distinguishes between the degree of complexity and when that complexity becomes known—only the latter determines whether the law is a rule or a standard.[10] Thus, Kaplow envisions four permutations: Simple Rules, Simple Standards, Complex Rules, and Complex Standards.[11] Kaplow's notion of complexity captures Ehrlich and Posner's concern with whether the decision turns on many or few facts—but Kaplow emphasizes that, independent of its complexity, the content of a rule may or may not be known until after individuals act.[12]

Kaplow argues that legal consideration of rules vs. standards often confuses these independent dimensions—wrongly comparing complex standards with simple rules. Instead, he suggests that we

8. Ehrlich & Posner, *supra* note 3, at 258.

9. Kaplow, *supra* note 5, at 560 (emphasis omitted).

10. *Id.* at 586-96.

11. *Id.* at 588-90.

12. Colin Diver sets forth yet another system for capturing the degree of precision which concerns the "transparency," "accessibility" and "congruence" of particular laws. Diver, *supra* note 2, at 67-68.

would do better to compare rules and standards of equal complexity.[13] While Kaplow's distinction between complexity and timing is powerful, in this paper I cleave to Ehrlich and Posner's initial distinction between rules and standards which focuses on the number of facts upon which decisions turn (what Kaplow calls complexity).[14]

III. THEORETICAL INCOMPLETENESS OF THE HYPOTHETICAL CONTRACTING APPROACH

It is useful to try to relate this terminology to standard contract theory. Bob Scott coined the term "off-the-rack" to describe a contractual gap-filler or default rule that applied to all contracting parties. Even though "off-the-rack" clothing often comes in different sizes, these off-the-rack rules tend to be "one-size-fits-all." If the rule doesn't fit, the contracting parties are obliged to change it by an explicit provision. Continuing this sartorial imagery, "tailored" defaults condition legal treatment on particular attributes or conduct of the contracting parties. Untailored ("off-the-rack") defaults are rule-like because they are contingent on fewer variables, while tailored defaults are standard-like because they are contingent on more variables concerning the attributes or conduct of the particular contracting parties.[15]

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13. Kaplow introduces the useful concept of the "rule equivalent to the standard": "For any standard, consider the actual outcomes that would arise for all possible cases. Now, define the 'rule equivalent to the standard' (or the '*de facto*' standard) as that rule which attaches these same outcomes to these cases." Kaplow, *supra* note 5, at 586. This mapping of standard outcomes into rule space is analytically similar to the mapping of indirect mechanisms into direct mechanism space as envisioned by the revelation principle. DAVID KREPS, A COURSE IN MICROECONOMICS 700 (1991).

14. John Setear has pointed out to me that Kaplow's strong claim that complexity and timing are independent may not hold. It is difficult to think of truly simple laws that are not knowable ex ante. Thus, there may not be a "standard equivalent to the rule" that driving faster than 55 is illegal. *See* Kaplow, *supra* note 5, at 587 n.78. A certain amount of complexity might be necessary for a law to be given content ex post. Accordingly, there may only be three broad categories (complex standards, complex rules and simple rules) among which policy makers can choose.

15. This definition of tailored defaults is analogous to Ehrlich and Posner's definition of standards; both describe laws that are, in some way, contingent upon the particular facts of the cases in which they are applied. Ehrlich & Posner, *supra* note 3, at 258-59. Kaplow's distinction between rules and standards (which turns on when people learn the content of the law) can also be made with regard to tailored and untailored defaults. *See* Kaplow, *supra* note 5. For example, tailoring does not necessitate that the content of a tailored law be known ex ante. A tailored law might condition some of its elements on facts that are only known after the contract is formed (ex post). Thus, a tailored default might specify that remedies for breach of contract be expectation damages for retail contracts, and reliance damages for wholesale contracts. This tailored default conditions damages on some facts that are known ex ante (retail vs. wholesale)

Clearly these kinds of categorical divisions can continue *ad nauseum.* I apologize for trying your patience. However, I do it to harmonize the terminology used by "rules vs. standards" and "default" theorists. I also do it to demonstrate that the dominant theory about default choice is incomplete. The received wisdom of a vast law-and-economics literature is that default laws should mimic the hypothetical provisions that the parties would have bargained for.[16] There are, however, at least four different types of tailoring that might be consistent with the hypothetical approach. Hypothetical theorists might advocate:

(1) an untailored (majoritarian) rule that most parties would have wanted;

(2) the tailored rules that particular parties would have wanted;

(3) an untailored (majoritarian) standard that most parties would have wanted; and

(4) the tailored standards that particular parties would have wanted.

The untailored defaults are sometimes referred to as majoritarian because they refer to the laws that most contractual parties would want. For example, non-cumulative voting for corporate directors might be described as an untailored (majoritarian) rule. But hypothetical contract theorists have yet to explain when untailored majoritarian rules are superior to a more tailored hypothetical inquiry. A tailored hypothetical approach would ask whether this particular corporation would have contracted for straight or cumulative voting.

In *Lewis v. Benedict Coal Corp.*,[17] the Supreme Court explicitly employed such a tailored hypothetical approach in deciding whether payments to a third-party beneficiary pension fund should be subject to setoff if the union breaches the underlying labor contract. Although the Court found that most contracting parties "would have

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and some facts which are only known after contracting (market conditions). One could also think of tailoring on the basis of facts that are not common knowledge ex ante. Jason Johnston has written an excellent paper investigating the implications of tailoring on the basis of facts that are only known commonly ex post. Johnston, *supra* note 6. Johnston analyzes the very natural case in which the reasonableness of one side's behavior might be conditioned (under a standard) on private information known by the other side. He shows that standards might be desirable in the contractual setting because they might mitigate the strategic incentives of the party with private information to enter a Coasian bargain for compensation.

16. Ayres & Gertner, *supra* note 1, at 89-90.

17. 361 U.S. 459 (1960).

provided that the promisor might protect himself by such means as would be available against the promisee under a two-party contract,"[18] the Court distinguished what parties to a collective bargaining agreement would have wanted and accordingly established a no-setoff default when the third-party beneficiary is a pension fund.[19]

It is also clear that the hypothetical contract approach does not exclude standards as optimal law. It might be that the majority of contracting parties would prefer to be governed by a "reasonableness" standard rather than any tailored or untailored rule. Alternatively, particular contracting parties might want their actions to be judged by more tailored standards of efficiency or equity.[20]

Because hypothetical contracting theory speaks neither to whether contract law should be tailored or untailored nor to the form of rules or standards, it provides neither a positive theory of what contract law has evolved to be, nor a complete normative theory of what contract law should be.

Divining the optimal amount of tailoring becomes all the more difficult when one admits more general theories of default choice. Rob Gertner and I have argued that penalty or information-forcing defaults might at times be an efficient way of discouraging strategic refusals to share productive information.[21] Yet one might implement penalty defaults through either standards or tailoring (or a combination thereof). For example, it would be possible to announce a tailored punitive standard that seeks to impose an exquisitely tailored pain to induce even the most recalcitrant contractors to reveal information. This kind of standard would be analogous to punitive damage measures in tort which are supposedly tailored to the characteristics of particular defendants to deter certain kinds of tortious behavior. Thus, tailoring defaults might not entail filling gaps with what the particular parties want, but rather filling gaps with what the particular parties *don't want* in order to make all the more sure that all parties have an incentive to contract explicitly.

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18. *Id.* at 468.

19. *Id.* at 469; *see also* Ayres & Gertner, *supra* note 1, at 90 n.21.

20. The process of tailoring itself might be governed by either rules or standards. Thus, some choice of law decisions are governed by rules (*lex loci*) and others are governed by weighing equitable considerations.

21. Ayres & Gertner, *supra* note 1.

IV. KAPLOW'S FREQUENCY ANALYSIS OF IMMUTABLE RULES

Because current contract scholarship has devoted so little attention to developing a theory of optimal tailoring of default rules, it is useful to begin with the existing theories of optimal precision and complexity of immutable rules. For the purposes of this preliminary analysis, I will focus on Louis Kaplow's approach, which is the most recent and comprehensive in the field. Although Kaplow distinguishes the degree of precision from the timing of when a law is given its content, he argues that frequency is the key variable in determining how both dimensions should be structured.[22] Put simply, greater frequency militates toward making laws both precise and known ex ante:

> The central factor influencing the desirability of rules and standards is the frequency with which a law will govern conduct. If conduct will be frequent, the additional costs of designing rules—which are borne once—are likely to be exceeded by the savings realized each time the rule is applied.[23]

Under Kaplow's analysis, rules are more costly to promulgate than standards, but rules are easier for courts to interpret. If the regulated activity occurs often, then incurring the certain costs of ex ante rule making once is outweighed by the savings of ex post interpretation. The intuition is analogous to "turnpike" theorems of economic growth models in that it may be dynamically efficient to spend money in a seemingly inefficient direction if the expenditure can induce more rapid convergence to efficient outcomes in the future.[24]

One of the strengths of Kaplow's analysis is his attention to the costs of parties becoming informed about the law. Kaplow assumes that the relative vagueness makes standards more costly than rules for individuals to learn about. Because of this cost difference, Kaplow envisions situations where individuals may become informed about the legal content of a rule, but not about the legal content of a standard: "[i]f . . . the cost of predicting standards is high, individuals will not choose to become as well informed about how standards would apply to their behavior."[25]

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22. Kaplow, *supra* note 5, at 621.

23. *Id.*

24. *See* OLIVIER J. BLANCHARD & STANLEY FISCHER, LECTURES ON MACROECONOMICS 101-2 (1989).

25. Kaplow, *supra* note 5, at 564. He analyzes an explicit model which leads to three different types of equilibria:

1) parties fail to become informed under either a rule or standard;

Kaplow's assumption about the cost of interpreting standards and rules is plausible and allows him to focus on the important issue of whether parties have incentives to learn about the law—but there are several other ways that parties may react to the vagueness of standards that might alter the optimal choice of legal rules. First, while Kaplow is right that rules are probably cheaper to interpret if one is striving for a precise knowledge of legal contours, it may be that standards give individuals a less expensive way of gaining a rough idea of the law's content. Thus, although the reasonable price default or the lost profit damage default may be more expensive to interpret *precisely* than a more explicit ex ante rule, it might give market participants a rough approximation of damages fairly cheaply.[26] Anyone who has tried to work through the social security disability grids[27] will understand that ex ante precision may increase the costs of making rough estimates. This point is related to the scholarship of Randy Barnett, suggesting that standards may be more transparent than more precise defaults.[28] But this will only be true to the extent that the standards are expressed in terms that have "commonsense expectations" for the "relevant community of discourse."[29] Under this analysis, the process of tailoring would be an inquiry into defining the "relevant communities."[30]

The possibility that standards might give less expensive rough guides to action also implicates a second way that parties can respond to legal ambiguity. If a standard gives a rough indication of legal consequences, it may be cheaper for parties to change their conduct to fall

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2) parties become informed under either a rule or a standard; or

3) parties become informed under a rule, but not under a standard.

Id. at 571-77. This notion is closely related to Randy Barnett's description of individuals' decisions to remain "rationally ignorant" of a background rule. The essence of this argument is that non-frequent players, because they are unable to amortize the fixed costs of becoming informed over the course of their dealings, will rationally choose to remain ignorant. Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821, 887-92 (1992).

26. In more quantitative terms, it might be cheaper to estimate damages to within a $1000 standard deviation using a standard, while it would be cheaper under a rule to calculate damages to within a $100 standard deviation.

27. 20 C.F.R. pt. 404, subpt. P, app. 2 (1991).

28. Barnett, *supra* note 25.

29. Barnett writes:

> If a goal of a consent theory is to have the law of contract honor the subjective consent of the parties to the extent possible in a world of limited access to personal knowledge of intentions, default rules reflecting the commonsense expectation within the relevant community of discourse will lead to fewer interpretive mistakes than some other type of rule.

Id. at 882.

30. Barnett acknowledges the difficulty of defining the relevant communities. *Id.* at 906-07.

within a safe harbor.[31] A recent article by Gillian Hadfield explores the ways that parties may respond to the greater ambiguity of standard-like laws by changing their level of performance—to make sure that they don't run afoul of their performance obligations.[32] If the costs of rough interpretation and small changes in behavior are cheaper under standards than the cost of interpretation under rules, then it is no longer clear that rules are superior for more frequent behavior. Even though rules economize on the sum of promulgation and enforcement costs when the conduct to be governed is frequent, inclusion of the costs of interpretation in the efficiency calculus may lead to the opposite conclusion.

This is particularly true if one considers the frequency *per actor* in the analysis. Even if the conduct to be regulated is relatively frequent in the aggregate, its frequency per actor may be low. For example, while many people may buy wedding rings, few are frequent purchasers. Thus, the costs of learning complex rules may be especially onerous as opposed to the costs of roughly interpreting a complex standard. Relatively transparent standards may economize on the costs of interpretation—particularly when the frequency per interpreter is low.

V. THE OPTION OF CONTRACTUAL EXIT: DEFAULT STANDARDS VS. DEFAULT RULES

Analysts of rules vs. standards emphasize that individuals can react to legal imprecision by investing in information or changing their behavior to make sure that they comply with legal requirements. These are two natural reactions to legal imprecision in immutable rules.[33]

But individuals have an additional option when the legal rule or standard is merely a default or gap-filler: they can contract not only for different substantive provisions, but also for a different degree of precision.[34] Indeed, although default analysis is often couched in terms of substituting one rule for another, parties could contract

31. For a fuller discussion of safe harbors see Peter P. Swire, *Safe Harbors and a Proposal to Improve the Community Reinvestment Act*, 79 VA. L. REV. 349 (1993).

32. Hadfield, *supra* note 6.

33. Barnett has independently discussed the superiority of default rules over immutable rules with respect to similar issues of over- and under-inclusion caused by immutable rules. Barnett, *supra* note 25, at 867-69.

34. Goetz and Scott have stressed at times that the parties can also respond by choosing not to contract—a particularly extreme way of avoiding the costs of legal imprecision. Charles J.

around a default standard for a more precise rule (or contract around a precise default rule for a less precise standard). We see both types of movements along the precision spectrum in actual practice. Parties sometimes will draft "reasonableness" clauses and at other times specify more specific rule-like clauses (such as for liquidated damages).

Kaplow has recognized the importance of this option of contractual exit: "Sometimes . . . it might be cheapest simply to include such provisions in the contract without incurring the cost to determine whether they are necessary. Thus, many contracts contain extensive boilerplate providing for the result an adjudicator would likely reach in any event."[35]

Contracting parties may avoid the costs of becoming informed about a default standard or rule by instead bearing the costs of explicitly contracting around the rule.

An efficiency analysis of rules vs. standards will often turn on whether contractual parties decide to explicitly contract instead of bearing the costs of becoming informed. For this reason, Kaplow argues that the costs of becoming informed will often drop out of the standard vs. rule analysis: "[T]he calculus determining whether [default] rules or [default] standards are preferable would emphasize *ex ante* promulgation costs and *ex post* enforcement costs, giving less attention to costs of advice by contracting parties because they often would not choose to acquire advice about such matters."[36] Kaplow's frequency analysis, however, plays out much differently when the parties have the option of contracting around the rule or the standard. It may no longer be efficient to expend the high promulgation costs of a rule if private parties nonetheless intend to contract for an express private provision. The higher costs of promulgating a rule are only likely to be efficient if the rule deters private parties from contracting to substitute their own provisions.

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 (1985).

35. Kaplow, *supra* note 5, at 620 n.183. Kaplow also implicitly recognizes that standards may be less expensive rough guides for actions: "When parties contemplate entering into a contractual relationship, they have only a limited need to know how a court would fill gaps in their agreement, as long as the court (or another designated decisionmaker) could be anticipated to act as they would wish." *Id.* at 619. Boilerplate also eliminates the risk that courts will change a default and retroactively enforce the new default in pre-existing contracts. *See* John H. Kennedy, *Ex Went to Jail Over Principle of Splitting the Principal*, BOSTON GLOBE, Jun. 10, 1993, at 1 (new Massachusetts default calling for equitable distribution of inherited assets applied to marriage that predated this default change).

36. Kaplow, *supra* note 5, at 619-20.

Alan Schwartz and Bob Scott have recently argued that many U.C.C. provisions are inefficient for the very reason that parties often contract around them.[37] Schwartz and Scott focus on the incentives of the parties to contract around default standards, but either default rules or default standards may induce explicit contracting.[38]

Indeed, any of Kaplow's four permutations of complexity/simplicity and ex ante/ex post content may induce the majority of contracting parties to contract for alternative treatment. Simple (untailored) default rules can act as penalty defaults because of the well-known properties of over- and underinclusiveness. Complex default rules might induce more complete contracting because it is comparatively less costly to write comprehensive provisions than it is to become informed of the complex rule. And, either simple or complex standards could induce more complete contracting if the parties expect that judicial application of the standard will be expensive and/or inaccurate.[39]

There are certain provisions such as price and quantity where private contracts are likely to contract around any default regardless of either its complexity or the precision of its ex ante or ex post implementation. Price and quantity defaults represent a striking counterexample to Kaplow's frequency hypothesis. Regardless of the extremely high frequency of transactions, it would be inefficient for lawmakers to expend resources promulgating more complex and tailored rules, because the expenses in creating this default would be wasted as private parties could be expected to almost universally contract around.

Instead, where parties are likely to explicitly contract, contract law has responded in two ways that entail very low promulgation costs. The default price term is a "reasonableness" standard,[40] while the default quantity term is non-enforcement or a zero-quantity rule.[41] While the zero-quantity default is more explicitly a penalty (because no parties would contract to sell zero), the reasonableness standard

37. Schwartz & Scott, *supra* note 6.

38. *See id.*

39. It is interesting that contract decisions almost never analyze what the parties might have reasonably thought the default rules were at the time of contracting. Because of this failure, parties have an incentive to explicitly contract if they are worried that the default will change in the interim between contracting and performance. It may be better to put in boilerplate language that restates even existing defaults instead of risking that courts will apply changed defaults to preexisting gaps.

40. *See* U.C.C. § 2-305 (1990).

41. *See id.* § 2-201.

acts as a penalty default because almost all parties prefer to incur the costs of explicit contracting rather than leave the matter to ex post court determination.[42]

When contracting parties are going to contract around the defaults, rule-like defaults are least likely to be efficient. The examples of price and quantity terms can help us see that such explicit contracting is most likely to occur when:

(1) the parties have heterogeneous preferences about what the term should be; and

(2) the term relates to a high probability contingency. Price and quantity terms fulfill both of these conditions.

The U.C.C. default rule that the sales price is due at the time of delivery[43] is probably better than a "reasonableness" default because a majority of contracting parties may homogeneously prefer such a term. But there is no clear plurality of contracts that have any particular quantity—because there is an extreme heterogeneity of preferences. This heterogeneity makes any particular quantity default rule act like a penalty default for the vast majority of contracting parties.[44]

Parties are also much more likely, *ceteris paribus*, to contract over contingencies that have a higher probability of occurrence. Thus, we see more explicit and detailed provisions about terms of performance for the normal course of events than we do for low probability contingencies. Since parties are likely to contract about high probability contingencies anyway, it makes less sense to expend resources on a particularized rule.

Even when most people are likely to explicitly contract, different defaults may produce different gains from trade for those who fail, for one reason or another, to contract around the default. The appropriate default choice should grow out of one's theories for why there are contractual gaps. One of the great difficulties of thinking about the appropriate gap filler for price and quantity is that it is hard to model why parties would leave these terms out of their express agreements.

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42. Rob Gertner and I have suggested that the difference between these rules might be efficient since the costs of ex post determination of the hypothetical price is likely to be much cheaper than the ex post determination of the hypothetical quantity. *See* Ayres & Gertner, *supra* note 1, at 95-97.

43. U.C.C. § 2-310(a) (1990).

44. Ehrlich and Posner also argue that the more homogeneous the conduct, the lower the costs of detailedness. Ehrlich & Posner, *supra* note 3, at 277-80.

As a general matter, policy makers should explicitly compare the contractual equilibria resulting from various defaults[45] and choose the type of tailoring that produces the best equilibrium. Efficiency-minded lawmakers, for example, would choose the type of tailoring that minimizes a host of costs associated with contracting: these include the costs of contracting around the defaults (successfully or unsuccessfully) as well as promulgation, application and information costs.[46]

Kaplow cogently argues that many authors conflate issues of complexity together with the timing issue of when the law is given its content.[47] But simple rules will often dominate both complex rules and simple standards, so that policy makers' operative default choices may often devolve to a choice between simple rules and complex standards. Simple rule defaults are likely to dominate simple standard defaults because they are more accessible for the parties and the courts to see and therefore likely to economize on the costs of explicit contracting. Simple standards needlessly interject ambiguity into the law.

	Rule	Standard
Simple	Simple Rule	← Simple Standard
Complex	↑ Complex Rule	Complex Standard

Simple rule defaults are also likely to dominate complex rule defaults. When contracting parties have homogeneous preferences, complex, tailored rules will be unnecessary. And when contracting parties have heterogeneous preferences, it will be extremely costly for courts to provide tailored defaults that succeed at minimizing transaction costs. As I have said with regard to corporate contracting: "[L]egislatures are effectively limited to choosing among the class of untailored and unconditional entitlements and obligations. To put the

45. Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1401 (1992) (book review).

46. Ayres & Gertner, *supra* note 1. As stressed above, this hypothetical approach is unlikely to elucidate how precisely tailored default rules should be.

47. Kaplow, *supra* note 5, at 586-96.

point most simply, any contractual provision that a legislature could write ex ante, corporations could write better."[48] In the non-corporate context, the only "rule-like" defaults that are likely to reduce transaction costs are simple, transparent rules that may allow parties to avoid the costs of contracting over homogeneously preferred provisions.

It should be stressed that in a world without transaction costs, parties may want more fully contingent contractual provisions, but the same costs that prevent private parties from writing fully state-contingent contracts may all the more prevent lawmakers from providing these default provisions. Viewed in this sense, it is unlikely that legislative provision of defaults will make contracts less "incomplete" as the term is used by economists.[49]

It is possible, however, that complex standards may be more efficient defaults than simple rules. In a recent review of Easterbrook and Fischel,[50] I argued that complex standards might make presumptively better defaults for publicly traded corporations, because it would be trivially easy for parties to contract around reasonableness standards for more rule-like provisions in their articles of incorporation (but parties might have much harder time contracting around rules for muddy treatment).

The greater cost in affirmatively specifying complex contractual provisions also makes it more difficult to draw inferences from private contractual behavior. If contracting parties fail to contract around a complex standard default in favor of a simple rule, then one might infer that the complex standard is the superior default. Failure to contract out of a complex standard implies that there is no simple (and therefore cheap to specify) provision that would do better.

In contrast, the failure to contract around a simple rule default for a complex standard does not indicate that the simple rule default is superior: "Because of the substantial difficulties that [contracting parties] will have in affirmatively contracting for fully contingent obligations or entitlements, the failure of firms to try should not persuade

48. Ayres, *supra* note 45, at 1414.

49. Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992); Hadfield, *supra* note 6.

50. Ayres, *supra* note 45.

policy makers that [contracting parties] do not want muddy default rules."[51]

As promised, this section does *not* provide anything like a general theory as to when contractual defaults should be rules or standards. But hopefully it shows that frequency need not lead toward the adoption of rules. Simple rule defaults are likely to be efficient when contracting parties have homogeneous preferences for a particular rule and when the rule addresses high probability events. Unless lawmakers intentionally want to induce contracting (as with information-forcing strategies), evidence that parties generally contract around the simple rule suggests that a standard-like default might be more efficient.

VI. CONSIDERING THE CONDITIONS FOR CONTRACTING AROUND

The foregoing analysis has addressed whether the underlying default should be rule- or standard-like. A similar inquiry could also be applied in trying to determine the necessary and sufficient conditions for contracting around a default.[52]

This latter inquiry investigates whether or not the parties have in fact successfully contracted around the default:

> [B]efore implementing any default standard, courts need to establish, as a logically prior matter, rules for deciding when a contract is incomplete. . . . This question of when a contract is incomplete is identical to the question of what is sufficient to contract around a default. A court's holding that the parties' attempt to contract around a given default is insufficient is identical to a holding that there is still a gap in the contract.[53]

The necessary and sufficient conditions for contracting around a default can themselves be either rule-like or standard-like. At the

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51. Ayres, *supra* note 45, at 1407. The same holds true for failure to contract out of a complex standard. There may be other complex provisions that dominate the complex default, but are prohibitively costly. *Id.*

This notion is consistent with Randy Barnett's implicit consent theory of incomplete contract. Although he argues that the omission of contractual language can often be interpreted as tacit consent by the parties to be governed by the default rules, he notes that this interpretation is only valid "[s]o long as the costs of learning the content of default rules and of contracting around them are sufficiently low . . . ." Barnett, *supra* note 25, at 897.

52. Barnett has analogously examined the necessary and sufficient conditions for enforcing defaults. Barnett, *supra* note 25, at 828, 866, 897-98.

53. Ayres & Gertner, *supra* note 1, at 119-20.

rule-like extreme, contract laws could give parties a "menu" of provisions to choose from and "magic words" that would constitute sufficient conditions for opting for a particular contractual treatment.[54] Rule-like necessary or sufficient conditions for contracting around defaults are extremely rare in either the common law of contract or the UCC. The conditions for contracting around a default are often governed by common law standards—which may over time develop into more rule-like laws. But the process can be extremely slow because courts seldom explicitly state necessary conditions and only decide sufficiency cases on a piecemeal basis.[55]

Litigants often argue about whether given contractual provisions are *sufficient* to contract around a particular default. When the courts find that a contract's particular words are insufficient to contract around the default, the courts usually refuse to articulate what contractual language would be sufficient. For instance, in *Peevyhouse v. Garland Coal & Mining Co.*,[56] the court found that the parties' explicit attempt to contract around the diminution in value default was faulty. But the court failed to announce what kind of provision would be sufficient to allow cost of performance:

> Even though the decision (rightly or wrongly) resolved uncertainty about what the default damages would be, it did little to resolve the uncertainty about how one could contract around this default. Even prospective parties who had read *Peevyhouse* and had known that it "does not interfere with the property owner's right to 'do what he will with his own'" would still face considerable uncertainty about how to exercise that right.[57]

The failure of both common and statutory contract law to provide rule-like sufficient conditions for contracting is inconsistent with contractual efficiency. While complex standards may make the most efficient substantive defaults, the sufficient conditions for contracting around these defaults should at least include rule-like "safe harbors"[58] and currently they do not.

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54. Thus, for example, the Revised Model Business Corporation Act states: "A statement included in the articles of incorporation that 'the corporation elects to have preemptive rights' (or words of similar import) means that the following [six] principles apply except to the extent the articles of incorporation expressly provide otherwise." MODEL BUSINESS CORP. ACT § 6.30(b) (1984).

55. Individual contract litigants seldom have reason to ask courts to find that particular words are necessary to contract around a default, because the parties could always just prospectively choose to use the words that they think are sufficient.

56. 382 P.2d 109 (Okla. 1962), *cert. denied*, 375 U.S. 906 (1963).

57. Ayres & Gertner, *supra* note 1, at 123 (footnote omitted).

58. *See* Swire, *supra* note 31.

The failure of common law courts to establish clear rules for contracting around defaults may be related to an important form of judicial nullification. As already noted, one of the costs of standards is the greater expense of ex post implementation—which includes the (expected) costs of court error in filling the gap. In the contractual context, however, there is another type of cost stemming from judicial error in deciding whether the parties have sufficiently contracted around the default.

Many scholars have noted the disturbing tendency of courts to turn default laws into immutable laws.[59] The *Peevyhouse* case itself might alternatively be interpreted as a disingenuous attempt to establish diminution in value as an immutable rule.[60] Common law courts' hostility toward liquidated damages provisions may also exemplify this tendency. A first-best solution to overcome this tendency might be through statutory rules announcing sufficient procedures for contracting around defaults.

If, however, the tendency to transform default laws to immutable ones is unavoidable, it might inform our choice of the underlying default. As a very preliminary matter, it might be that courts are more likely to make default standards immutable than to make default rules immutable. Courts, for example, have long resisted contractual modification of the expectation damages standard.[61] It may be that courts defend their powers to apply standards by applying greater hurdles to contracting parties who want to avoid them—whereas efforts to contract around simple rule defaults (especially if promulgated by legislatures) may give courts less concern.[62] Moreover, the over- and underbreadth of rule-like defaults often more clearly signal that the lawmaker intended to give private parties the option of contractual mutation. If this tendency exists, one advantage of simple rule defaults is that they may be more default-like than are complex standards.

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59. *See, e.g.*, Goetz & Scott, *supra* note 34.

60. The dissent in *Peevyhouse* suggested as much. Ayres & Gertner, *supra* note 1, at 122.

61. *See* Eric L. Talley, *Contract Renegotiation, Economics, and the Liquidated Damages Rules*, 46 STAN. L. REV. (forthcoming May 1994).

62. A countervailing effect against judicial egoism (which drives judges to turn default laws into immutable laws) is the desire to lead the quiet life by reducing the courts' case load—which might give judges an incentive to eschew standards to maximize the chance of settlement.

VII. CONCLUSION

The choice between rules or standards is extremely complex and becomes all the more complex when one introduces the possibility that parties can contractually alter the law. In many circumstances the dichotomous choice between rules or standards may be a false one, because lawmakers may prefer to enact a complementary set of rules *and* standards. Thus, in most jurisdictions, highway speed is regulated by supplementing a rule with a standard. As Ehrlich and Posner observed: "It can be made unlawful to drive more than 60 miles per hour *or* to drive at any lower speed that is unreasonably fast in the particular circumstances."[63] In areas of contract performance, contract law might specify per se rules of performance and non-performance, but specify a "reasonableness" standard to govern conduct falling outside the rule-governed conduct.

This method of combining rules and standards is clearly the sensible way of governing the conditions for contracting around rules. Rules should establish clear "magic words" that are sufficient to contract for particular kinds of treatment; however, the common law should back up these rules with a general standard of following the commonly understood meaning of the parties' explicit language—even when that language fails to employ the "magic words" for contracting around particular defaults.[64]

At various points, this talk has averred to optimal complexity and tailoring. These terms are exceedingly difficult to define. The more that I think about them, the more pessimistic I am that they are susceptible to a satisfying general analysis.

63. Ehrlich & Posner, *supra* note 3, at 268.

64. Thus even if a corporation's articles of incorporation did not use the term "preemptive rights," it should grant them if the contract verbally describes the shareholder rights that we normally attribute to those words. *See supra* note 55.