

2016

The Common Law of Contract and the Default Rule Project

Alan Schwartz
alan.schwartz@yale.edu

Robert E. Scott
Columbia Law School, rscott@law.columbia.edu

Follow this and additional works at: https://scholarship.law.columbia.edu/faculty_scholarship



Part of the [Common Law Commons](#), [Contracts Commons](#), and the [Law and Economics Commons](#)

Recommended Citation

Alan Schwartz & Robert E. Scott, *The Common Law of Contract and the Default Rule Project*, VIRGINIA LAW REVIEW, VOL. 102, P. 1523, 2016; YALE LAW & ECONOMICS RESEARCH PAPER NO. 533; COLUMBIA PUBLIC LAW RESEARCH PAPER NO. 14-499; COLUMBIA LAW & ECONOMICS WORKING PAPER NO. 528 (2016).
Available at: https://scholarship.law.columbia.edu/faculty_scholarship/1952

This Working Paper is brought to you for free and open access by the Faculty Publications at Scholarship Archive. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Scholarship Archive. For more information, please contact cls2184@columbia.edu.

The Common Law of Contract and the Default Rule Project

Alan Schwartz and Robert E. Scott***

Abstract

*The common law developed over centuries a small set of default rules that courts have used to fill gaps in otherwise incomplete contracts between commercial parties. These rules can be applied almost independently of context: the market damages rule, for example, requires a court only to know the difference between market and contract prices. When parties in various sectors of the economy write sales contracts but leave terms blank, courts fill in the blanks with their own rules. As a consequence, a judicial rule that many parties accept must be “transcontextual”: parties in varied commercial contexts accept the courts’ rule by writing contracts that contain just the gap the rule could fill. A long-standing project of academics and lawyers attempts to supplement common law contract rules with substantive default rules and default standards. This project has produced Article 2 of the UCC and the Second Restatement of Contracts and the project plans to produce more privately created contract law. We show that the “default rule project” could not create substantive default **rules** because the contract terms for which the rules would substitute commonly are context dependent: the terms’ content either is a function of particular parties’ circumstances or a particular trade’s circumstances. Members of the default rule project, whom we call “drafters,” could not access the information needed to create the efficient rules that require such local knowledge. Instead, the drafters supplied commercial parties with default **standards** that courts can apply transcontextually in addition to or as replacements for the common law rules. Contracts sometimes do contain standards, but only when the standards are accompanied by substantive terms from which courts can infer the parties contracting goals and thus apply the standards to advance them. The drafters’ decision to adopt unmoored standards was a mistake because commercial parties do not accept, and thus contract out of, the statutory and restatement default standards. In contrast, the common law’s transcontextual default rules continue to stand. Our analysis here explains the default rule project’s past failures and their current consequences: the article thus illuminates the contract law we have even as it cautions that the default rule project must materially change else it risk repeating past errors.*

* Sterling Professor of Law, Yale Law School; Professor, Yale School of Management.

** Alfred McCormack Professor of Law and Director, Center for Contract and Economic Organization, Columbia University.

This paper benefited from faculty workshops at Bocconi and Yale Law Schools and from comments by Ian Ayres, Bruce Ackerman, Hanoch Dagan, Clayton Gillette, John Langbein, Florencia Marotta-Wurgler, Alvin Klevorick, Ariel Porat, George Triantis and John Witt.

Those who do not remember the past are condemned to repeat it.¹

I. Introduction

Contract laws in advanced economies share three core functions: the state develops criteria for determining which promises are legally enforceable, interprets contracts in order to determine the meaning of the parties' promises, and ensures that parties have an opportunity freely to consent to the promises they make by defining the boundaries of acceptable bargaining behavior.² A contract law is more than these core functions, however, and what individuates the contract laws of particular countries is what constitutes the rest. Because parties are free to make their own deals, the rest of a contract law plays a residual role; that is, the *law* is the rules and standards that specify by default parts of contracts when parties leave them blank. Many scholars believe that filling the gaps is the most important task that private law makers today must perform in order to keep contract law relevant for complex, heterogeneous and evolving economies. In this Article, we challenge that belief.

Our focus is American contract law. Here, the claim that the bulk of contract law is (and should be) comprised of legally created default rules and standards has organized contract law scholarship for the last three decades.³ In the United States, default rules and standards originate in two ways. Courts necessarily create them in the course of deciding cases. Judicial creations that many courts accept and that last for decades (or more) constitute the common law of contract. In addition, the American Law Institute and the National Conference of Commissioners on Uniform State Laws, private lawmaking groups that we collectively call "drafters," have created default rules and standards for Article 2 of the Uniform Commercial

¹ George Santayana, *The Life of Reason*, Volume 1 (1905).

² Courts alone commonly perform the first two functions. The task of policing contracts for fraud and overreaching, and undertaking to prevent unconscionable bargains, is, however, shared among courts, legislatures and administrative agencies. For a discussion see ROBERT E. SCOTT & JODY S. KRAUS, *CONTRACT LAW & THEORY* 3-4 (5th ed. 2013).

³ See e.g., the articles cited in note 103 *infra*.

Code (UCC)⁴ and the two contracts restatements and may propose default rules and standards for other restatement projects that are planned or currently are underway. Some of the default terms that the drafters have produced instantiate aspects of the common law but others have been derived independently.

This article makes three claims. Our first claim is descriptive. Extending prior work,⁵ we show that the default rule project has been unable to supplement the common law of contract with default rules and standards that can efficiently fill gaps in incomplete business contracts.⁶ The drafters implicitly recognized the difficulty of creating efficient default *rules*, and proposed few rules for the Second Restatement of Contracts (Restatement) and the UCC. Our second claim is normative. In place of rules, the drafters proposed numerous default *standards* to replace or to supplement the common law defaults. We argue that the turn to standards was misguided. Third, and returning to positive analysis, we show that the common law is a better institution than the private law making bodies for creating contract law defaults that contracting parties will accept. These claims explain both the failure and the current consequences of past default rule projects and counsel against drafters using the same tools that failed previously when undertaking future restatement or commercial code projects.

⁴ This Essay refers to the collective efforts of the persons who participate directly in creating uniform laws and restatements and to the lawyers and academics who help them as “the default rule project.” In the behavioral literature and elsewhere, the term “default rule” sometimes refers to a contract term that a party supplies and that its counterparty can accept or reject. For example, a firm proposes a particular retirement plan contribution to its employees. We do not discuss such privately supplied terms here. Rather, we address the process by which courts and drafters supply rules and standards to fill gaps in otherwise complete contracts. These rules and standards are legally binding when included in a code unless parties displace them; or are meant to become legally binding in this way when included in a restatement.

⁵ Alan Schwartz & Robert E. Scott, *Contract Theory and The Limits of Contract Law*, 113 Yale L.J. 541 (2003); Alan Schwartz, *Incomplete Contracts* in 2 The New Palgrave Dictionary of Economics and the Law 277-83 (1998); Robert E. Scott, *The Uniformity Norm in Commercial Law: A Comparative Analysis of Common Law and Code Methodologies* in The Jurisprudential Foundations of Corporate and Commercial Law 149 (2000); Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw. L. Rev. 847, 853-56 (2000); Alan Schwartz, *Contract Theory and Theories of Contract Regulation*, 92 Revue D’Industrielle 101 (2000); Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. Cal. Interdisciplinary L. J. 389 (1994); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. Legal Stud. 597 (1990).

⁶ We limit our analysis in the paper to default rules and standards that are designed to fill gaps in contracts between commercial parties. Consumer contracts raise different issues, which we do not address.

Two distinctions will clarify these claims. The first applies the familiar distinction between rules and standards to contract issues. A rule, or a “rule-like” contract term, specifies required behavior in advance of the contracting parties’ actions; a standard authorizes a court later to decide whether actions the parties had already taken satisfied the relevant contractual requirement. Illustrating this distinction, a contract term that obligates a seller to repair or replace defective product parts provided the buyer notifies the seller of a defect within 90 days after sale would be a contractual rule because it tells the parties what to do before they begin to implement the contract. If the 90-day notice rule were enacted in a statute, it would be a legal default rule for the same reason. A contract promise to repair or replace defective parts provided the buyer gives the seller reasonable notice of a defect would be a contract standard because it delegates to a court the question whether the notice the buyer did give was reasonable. Similarly, if the reasonableness requirement were enacted in a statute it would be a legal default standard.

The second distinction we make is between “contextual” rules and standards and “transcontextual” rules and standards. In this article, a “context” is an economic environment populated by agents with the same or similar contracting preferences. A context may be as small as the parties to a particular contract, but commonly is larger. For example, parties that trade wheat use contracts with the same or similar delivery terms and storage requirements. Hence, the wheat trade is a “context.”⁷ Returning to the illustration above, the term requiring notice of defects within a specified time is contextual because parties in different industries likely would choose different periods within which to make claims. An efficient notice term turns on how easy a defect is to discover, the nature of the goods, the seller’s ability to repair or replace and similar factors. Thus, because wheat is perishable while machines are not, the contract term requiring notice of a defect commonly differs between the wheat context and machine contexts.

When a contract does not regulate when the buyer must give notice, a default *rule* could efficiently fill the gap only if it too conditioned on the same variables that would have influenced the parties’ choice of a rule-like term had the parties dealt with the issue. Therefore, default rules governing notice of defects should differ between wheat and machine contexts. In contrast,

⁷ A contract term is “parameter specific” when it conditions on payoff relevant variables that are specific to the parties. Thus, the wheat trade is a context but the quantity term in wheat party contracts is parameter specific: different contracting parties trade different quantities of wheat.

if contracts generally require promisees to give reasonable notice, a court could find that a promisee who notified the promisor of a defect on the 89th day after sale would have behaved reasonably in some industries but not in others. Similarly, a default *standard* of reasonable notice would permit a court to make such context-by-context reasonableness findings. The reasonable notice standard, therefore, is “transcontextual”; courts could apply the same standard to evaluate parties’ behavior in many contexts. And to generalize the example, standards are intrinsically transcontextual while relatively few rules can be efficiently applied across contexts.

These distinctions permit us to state our three claims more precisely. Because most contract terms are contextual, it follows that default *rules* that substitute for those terms must be contextual as well. As a consequence, the Restatement and UCC drafters would have had to create a large number of contextual rules for many contracting problems. For example, had the UCC attempted to regulate notice of breach issues with *rules*, the drafters would have been required to create a menu of rules governing notice, each of which would have solved the problem of choosing an efficient notice period for a particular context or for similar contexts. It may be apparent, and it is our claim, that drafters could not then and cannot now create efficient defaults such as these. The UCC and the Restatement apply to the entire U.S. economy. There are so many contexts in this economy that the drafters could not access the necessary context information (what is maximizing for parties that transacted in context X may not have been maximizing for parties that transacted in context Y); nor could the drafters, even if well informed, create the very large number of rules that parties functioning in these contexts would require.

The default rule project could have responded to this constraint by only proposing transcontextual default rules. There are, however, just a few transcontextual defaults, and most of them had already emerged through the common law process. Here, the drafters wisely followed the common law: most of the transcontextual UCC and Restatement default rules were adopted from prior judicial creations.⁸ The default rule project thus could have narrowly focused on the task of assembling and reaffirming the common law transcontextual defaults, and where

⁸ See text accompanying notes – to --- infra.

possible creating additional default rules that also could function transcontextually. But the drafters rejected this limited objective and instead adopted the common legal strategy of enacting standards.⁹ The UCC and the Restatement thus contain many default standards: business parties must behave “reasonably,”¹⁰ act in “in good faith,”¹¹ perform “seasonably,”¹² observe customs¹³ and the like; and goods must be “merchantable”¹⁴ or “fit for ordinary purposes.”¹⁵

To be sure, transcontextual standards are common in other private law fields. But contract is different from fields such as torts and property. These bodies of law largely operate independently of, or prior to, transactions. Thus, negligence law applies when the parties’ first contact is the accident, and property law creates the rights that parties may later trade. Because tort and property law apply everywhere, courts regulate with transcontextual standards. And because these standards are supposed to channel behavior in particular ways, it is of little moment that the agents on whom the standards operate may prefer to act in other ways. In contrast, contract law applies to trades whose content agents usually are permitted to affect.

These differences make the project of creating default standards for *contract law* incoherent and ineffectual. A good default solution to a contracting problem must satisfy an

⁹ See Shyamkrishna Balganesh and Gideon Parchomovsky, *Structure and Value in the Common Law*, 163 U. Pa. L. Rev. 1242, 1244 (2015) (emphasizing that “... most common law concepts are structured as legal standards.”). We note that the first contracts restatement adhered relatively closely to the prior common law of contract. The second restatement has many more standards.

¹⁰ See e.g., UCC §§ 2-204(3); 2-206(1)(a),(2); 2-208(2); 2-209(5); 2-305(1); 2-309(1); 2-609; 2-504; and Restatement (Second) Contracts, §§ 30; 33; 34; 41; 53; 56.

¹¹ See e.g., UCC 2-209, comment 2; 2-306(1); 2-305(2); 2-311(1); 2-325(1),(2); 2-508(1).

¹² See e.g., UCC § §2-206(1)(b); 2-207(1); 2-311(3).

¹³ UCC §§ 1-205(2); 1-201(3).

¹⁴ UCC § 2-314(1).

¹⁵ UCC § 2-314(2)(c). The drafters sometimes create standards to avoid deciding difficult political questions: a standard delegates power to courts, and drafters choose them when they want to create the impression that the drafters have solved a problem that they actually have delegated to judges. See Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. Pa. L. Rev. 595 (1995). We discuss this motive briefly in Part V below, but our principal focus here is on another drafter motive for enacting default standards -- the practical difficulty of creating efficient default rules.

“acceptability constraint:” many parties must prefer the default to alternative resolutions.¹⁶ Thus, the drafters’ role is to provide public goods: the UCC and the Restatement should supply default terms that solve contracting problems when typical contracting dyads need but cannot afford to solve those problems for themselves. Parties, however, can write a standard -- behave “reasonably” -- *at virtually no initial cost*. Therefore, the function of providing default standards cannot be justified by the drafters’ ability to solve those contracting problems that transaction costs prevent private parties from solving. Moreover, as we will show, the drafters’ actions are ineffectual because commercial parties dislike transcontextual standards: the broad discretion they grant to courts increases the costs of contract enforcement while not reducing the costs of contract drafting. Hence, publically supplied standards increase total contracting costs.¹⁷ Commercial parties thus contract away from legally supplied standards to the extent the law permits: parties prefer to solve contracting problems with rules and *contextual* standards.¹⁸ In sum, the Restatement and UCC drafters could not create many new default rules and should not have created new default standards. A properly functioning default rule project thus would at best have a very limited objective.¹⁹

¹⁶ The text’s phrase was first used in Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. Cal. Interdisciplinary L. 87 (1994).

¹⁷ See Part V *infra*. Total contracting costs are a function of both the “front end” costs of negotiating and drafting a contract term and the “back end” costs of enforcing that term in case of a dispute. The effect of a default standard is to shift contracting costs from the front end to the back end by delegating broad discretion to a later court to apply the term to the particular context that presents *ex post*. As we show below, parties opt out of default standards because the shifting of costs to the back end in this way actually increases total contracting costs. For earlier analyses, see Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 Yale L. J. 814 (2006); Robert E. Scott & George G. Triantis, *Incomplete Contracts and the Theory of Contract Design*, 56 Case Western L. Rev. 187 (2005).

¹⁸ We later show that parties often use what we call “contextual standards.” See Part VI *infra*. As an example, a franchise contract may list a large number of carefully specified duties – i.e., rules – to govern the franchisee’s behavior, and also require the franchisee to use “best efforts” to conduct the business. The standard applies to franchisee actions (or inactions) that the parties could not anticipate. A court can infer the parties’ contracting goals from the rules they did write, however, and use these goals to evaluate the unforeseen actions. Scott & Triantis, *Anticipating Litigation*, *supra* note 17, at 848-56. The drafters of a UCC or a Restatement section cannot create such standards because they cannot know what antecedent context specific rules would be apt. To continue with our example, the residual drafting strategy of telling parties in every industry just to make contract claims within a reasonable time is unmoored: such a standard gives courts no contextual guidance.

¹⁹ The comparison we analyze is between courts as rule creators and drafters as rule creators. A legislature may well have advantages over both institutions at creating rules, but *contract law* is not a legislative creation.

This conclusion leads to our third claim: the common law has been a good vehicle for creating transcontextual default rules. There are two interrelated reasons why common law courts enjoy a comparative advantage in rule creation. First, courts necessarily apply common law rules in various contexts. Second, courts cannot continue to apply a contract default rule that commercial parties would reject because parties would have filled the gap with their own solution: the gap that prompted the original rule thus would vanish. Hence, a judicially created default rule can become part of the common law of contract *only if* parties in various contexts accept it. Thus, in theory, and also in fact, the rules that constitute much of the common law of contract are transcontextual; their solutions to contracting problems apply generally.²⁰ These rules have two features: they are general and they are definitive. Market damages are a general rule because they create a transcontextual formula: courts can compare the market price to the contract price wherever there are market prices. A definitive rule clearly resolves a case. The common law impossibility doctrine- in which the performance of the contract depends on the continued existence of a given person or thing - is an example: it tells courts either to enforce the contract or to excuse the promisor, depending on whether the parties intended to make continued existence of the person or thing a condition of the seller's duty to tender.²¹ The Restatement and UCC rules that business parties commonly accept thus unsurprisingly have been drawn from the common law.²²

The Article proceeds as follows. In Part II we address history to show how common law courts developed rules and standards when contract enforcement was divided between law and equity. With the merger of law and equity and the embodiment of the merged doctrine in the prototype of the executory contract, the creation of new defaults through the common law courts slowed. Part III then unpacks the mechanism by which the common law courts have created the

²⁰ Common law standards have survivorship value in some fields because courts can infuse them with new meanings over time. See Balganesh & Parchomovsky, *supra* note 9. We argue, though, that contract law standards created by drafters have little survivorship value in business contexts. In contrast, the common law standards that continue to survive are primarily mandatory obligations such as those that prohibit fraud and duress.

²¹ See e.g., *Taylor v. Caldwell*, 122 Eng. Rep 309 [K.B. 1863]; *Howell v. Coupland*, 1 Q.B.D. 258 [Ct. App. Q.B. Div.]. For discussion of the definitive characteristics of the common law impossibility doctrine, see SCOTT & KRAUS, *supra* note 1 at 84-94.

²² For example, the Restatement (Second) and the UCC republish the common law impossibility doctrine in sections 262 -263 and 2-613 respectively.

defaults that satisfy an acceptability constraint: common law default rules necessarily are transcontextual because they can become *rules* only when and because parties that function in very different contexts accept them rather than contract out.

In Part IV, we show why the default rule project not only has been unable to replicate the common law process of creating *transcontextual* defaults but *also* has been incapable of creating *contextual* default rules that can satisfy an acceptability constraint. We analyze majoritarian, penalty and sticky defaults and show in each case that the drafters have faced a Hobson's choice: either reproduce (or attempt to enhance) the limited set of common law transcontextual default rules or develop standards to further regulate business contracts. The drafters chose to propose standards, and in Part V we argue that this approach was a mistake. Part VI then turns to contractual practice and explores how business parties combine rules and standards in context specific ways: these contract terms commonly condition on information that is particular to the parties. This Part stresses the lack of fit between UCC and Restatement standards and what business parties commonly do. Finally, Part VII briefly summarizes our principal claims.

We conclude this introduction with three comments. First, our deconstruction of the UCC and the Restatement has current relevance. Courts today must apply these privately created laws to business contracts. Their work should be aided by a better understanding of why the laws actually are unsuited to regulate the contracts the courts see. Second, our analysis of the default rule project both explains the present and constitutes a caution for the future. The drafters' failure to create useful default terms for business contracts in the Restatement and the UCC is an object lesson for future drafting projects that may similarly seek to create default rules for commercial parties. There are ongoing efforts to produce a Restatement of Liability Insurance, a new Restatement of Property and a Restatement of Consumer Contracts. Although these projects, together with the recently approved Restatement of Restitution, raise different challenges than the provision of default terms for business contracts, they will inevitably consider issues that involve the creation of new or different default rules that also may depart from those that have emerged through the common law process. Moreover, a project to draft a 3rd Restatement of Contracts may well be launched within a year or two, and it is conceivable that pressure will mount for drafters to attempt once again a comprehensive revision of Article 2

(notwithstanding the failure of earlier revision efforts).²³ We show here that if current drafters use the current law making process to create future products, those products likely will be as unsuccessful as the contract law that governs today. Third, and relatedly, this article is not normative in the usual sense: We do not ask what a good business contract law would be; rather, we ask what contract law is possible in an advanced economy with a general commitment to freedom of contract. Our ultimate substantive claim, in brief, is that it is not possible to go much beyond the common law without abandoning this commitment.

II. The Historical Roots of Default Rules and Standards

A. *The Roots of the Default Rules of the Common Law.*

Although now firmly entrenched in doctrine, the contemporary understanding of state supplied default rules and standards is a relatively recent development in contract law.²⁴ At early common law, there was no cause of action for breach of an informal (unsealed) executory promise. The only actions available for breach of contract were the action for debt and the action in covenant (for promises under seal).²⁵ The notion of default rules for breach was foreign to either action. The action for debt lay only for the recovery of a sum certain. One party was seeking relief for a debt that was due and owing, fixed by the parties prior agreement and realized in a judgment. The court would award payment or not, but there was neither a judicial

²³ The default rule project is considering future projects because today's law is out of date. Article 2 was largely completed by 1952 and the Second Restatement of Contracts was adopted in 1979. A future Article 2 or restatement would have a wealth of new legal scholarship from which to draw and sixty three or thirty six years, respectively, of new case law to consider. For prospects of a 3rd restatement, see email from Richard Revesz, Executive Director of the ALI (on file). For discussion of the reasons for the failure of the earlier efforts to revise Article 2, see William H. Henning, *Amended Article 2: What Went Wrong?*, 11 Duq. Bus. L.J. 131 (2009).

²⁴ This part draws on Robert E. Scott & George G. Triantis, *Embedded Options and the Case Against Compensation in Contract Law*, 104 Colum. L. Rev. 1428, 1436-47 (2004).

²⁵ JAMES BARR AMES, LECTURES ON LEGAL HISTORY 92 (1913); *Id.* at 92, 122-23; A. W. B. SIMPSON, A HISTORY OF THE COMMON LAW OF CONTRACT 47-48 (1986); JOHN H. LANGBEIN, HISTORY OF THE COMMON LAW 322 (2009).

gap-filling role nor court awarded compensation for breach.²⁶ Throughout the 18th century, contract law was still dominated by the action in debt and commercial exchange was not conceived in terms of future returns: as a consequence, default rules that assigned unanticipated risks and specified the consequences of nonperformance were simply inapt and thus unknown.²⁷ The common law courts that granted recovery for an action in debt were, in essence, specifically enforcing the parties' actual bargain.

Executory contracts thus were not enforced in the United States until the early 19th century.²⁸ This development coincided with a period of commercial expansion and with the emergence of markets in stock transactions and commodities.²⁹ Courts began awarding market-based damages for failure to deliver stock certificates in a rising market,³⁰ and for the breach of

²⁶ AMES, LECTURES ON LEGAL HISTORY at 88-89. Where a seller tendered goods to a buyer and the buyer refused to accept delivery, the seller could sue in debt for the purchase price and force the buyer to take delivery of the goods (for which title had passed under the contract). Alternatively, if the buyer tendered the purchase price and the seller refused to transfer goods that were then available, the buyer's only recourse was to bring an action in equity for specific performance because the remedy at law was inadequate.

²⁷ Morton Horwitz, *The Historical Foundations of Modern Contract Law*, 87 Harv. L. Rev. 917 (1974). Horwitz cites only two English cases in the 18th century that even raise the issue of a default measure of damages. In *Fleureau v. Thornhill*, 96 Eng. Rep. 635 (C.P. 1776), the court limited the plaintiff to restitution damages, holding that "plaintiff could not be entitled to damages for the fancied goodness of the bargain which he supposes he has lost." In the United States, only a few actions for breach of executory contracts were brought before the Revolution. See, e.g., *Boehm v. Engle*, 1 Dall. 15 (Pa. 1767) where the seller was allowed to sue for the price of a breached contract for the sale of land. *Id.* at 922.

²⁸ See *Sands v. Taylor*, 5 Johns. 395 (N.Y. 1810). Under the older common law rule, when a buyer breached a contract to purchase goods, the seller would have been required to tender the contract goods and sue for the contract price. But in *Sands*, the seller covered on the market by reselling the goods to a third party and then sought damages based upon the contract-market differential. The court conceded that this was a case of first impression in America and granted market damages to the plaintiff. *Id.*

²⁹ See Horwitz, *Historical Foundations*, *supra* note 27 at 921-22 (1974) (arguing that enforcement of executory promises did not occur until the rise of industrialization and the development of commercial markets in the late eighteenth and early nineteenth centuries). Horwitz's basic thesis—that prior to the industrial revolution, the common law of contract was dominated by notions of equity and fairness and that it was thereafter adapted to legitimate the inequalities of the nineteenth century market economy—has been vigorously contested. See e.g., A.W.B. Simpson, *The Horwitz Thesis and the History of Contracts*, 46 U. Chi. L. Rev. 533 (1979). Simpson's critique does not, however, challenge the basic point that courts did not regularly enforce executory contracts until the nineteenth century. Rather, the penal bond was the only device for legal enforcement of commercial exchange transactions in the 17th and 18th centuries.

³⁰ See e.g., *Groves v. Graves*, 1 Va. (1 Wash.) 1 (1790).

fixed-price forward contracts for the delivery of commodities.³¹ The rule awarding market damages for non-performance of stock and commodities transactions was adopted as the default for executory contracts where the parties had made relation-specific investments. This link between commodities and stock transactions and executory contracts led to one of the principal default rules for determining breach of market contracts: the risks associated with performance of an obligation assumed by contract are assigned by default to the promisor (absent prevention by an act of God, the law, or another party to the contract).³² Other default rules evolved to protect the reliability of market contracts during this period, including the perfect tender rule in the case of sales of goods,³³ the common law indefiniteness doctrine that instructed courts to declare contracts void for indefiniteness if the parties failed to specify the outcome for realized states of the world,³⁴ and the many default rules governing the process of offer and acceptance of terms.³⁵ Contract thereafter became an instrument for managing exogenous price changes in well-developed markets.³⁶

³¹ See e.g., *Shepherd v. Hampton*, 16 U.S. (3 Wheat.) 200 (1818).

³² The origins of this rule date to *Paradine v. Jane*, Aley 26, 82 Eng. Rep. 897 [K.B. 1647]. The issue before the court was whether a lessee's duty to pay rent was dependent upon his possession of the property. In answering that question, the court said:

[W]hen the party by his own contract creates a duty or charge upon himself he is bound to make it good, if he may, notwithstanding any accident by inevitable necessity, *because he might have provided against it by his contract*. And therefore if the lessee covenant to repair a house, though it be burnt by lightning, or thrown down by enemies, yet he ought to repair it. Dyer 33.a. 40 E.3. 6. h. . . . [emphasis added].

82 Eng. Rep. at 897-98.

³³ See e.g., *Reuter v. Sala*, 27 W. R. [1879]; *Beals v. Hirsch*, 211 N.Y. Supp. 293, aff'd 242 N.Y. 529 (1925) (“the seller is bound to tender the amount of goods contracted for in order to hold the buyer for performance.”).

³⁴ See e.g., *Shepard v. Carpenter*, 55 N.W. 906 (Minn. 1893).

³⁵ See e.g., *Adams v. Lindsell*, 1 Brun. & Ald. 681, 106 Eng. Rep. 250 (King’s Bench 1818); *Fitzhugh v. Jones*, 6 Munf. 83 (18--); *Carlill v. Carbolic Smoke Ball Co.*, 1 Q.B. 256 (Court of Appeal 1893). For discussion see Arthur Corbin, *Offer and Acceptance, and Some of the Resulting Legal Relations*, 26 Yale L.J. 169 (1917).

³⁶ Horwitz, *supra* note 27 at 941. A market damages default rule was established in England in 1826 with the publication of the first treatise announcing a general rule of damages for failure to deliver goods:

In an action for assumpsit, for not delivering goods upon a given day, the measure of damages is the difference between the contract price and that which goods of similar quality and description bore on or about the day when the goods ought to have been delivered.

Id. at 941. It was at this point that contract fully separated from property and courts, for the first time, granted promisees a property right in the contract itself.

Over the next one hundred years, as the industrial revolution took hold first in England and then the United States, courts continued to imply terms by default in order to interpret disputed commercial contracts.³⁷ These rules had a distinctive character: they were independent of context. The offer and acceptance rules structured the contracting process but not its substance and the emerging damages rules provided transcontextual measurement formulas. Thus, for example, by the mid 1840's treatise writers could announce a general default rule governing damages for breach of contract: the breaching party is liable for losses that fairly were in contemplation of the parties at the time of contract; that is, the “plaintiff must have turned the mind of the defendant to the consequences likely to ensue from default.”³⁸ Thereafter, the decision in *Hadley v. Baxendale* served to *extend*, rather than to limit, the damages default rule, granting recovery of consequential damages where the plaintiff had “communicated special circumstances” to the defendant indicating that his damages would be unusually large.³⁹

Over time, courts developed a justification for implying default terms as part of a common law court’s interpretive responsibility. In 1863, in *Taylor v. Caldwell*, Justice Blackburn explained the emerging impossibility default rule as follows:

This implication [of an excusing condition] tends to further the great object of making the legal construction such as to fulfill the intention of those who entered into the contract. For in the course of affairs, men in making such contracts in general would, if it were brought to their minds, say that there should be such a condition.⁴⁰

³⁷ See *Globe Refining Co. v. Landa Cotton Oil Co.*, 190 U.S. 540, 544 (1903) (explaining that the measure of damages “depends on what liability the defendant fairly may be supposed to have assumed consciously, or to have warranted the plaintiff reasonably to suppose that it assumed, when the contract was made”).

³⁸ THEODORE SEDGWICK, *A TREATISE ON THE MEASURE OF DAMAGES* 112 (2d. ed. 1852).

³⁹ See Richard Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J. Legal Stud. 249, 279-83 (1975) (discussing the conventional understanding of *Hadley*).

⁴⁰ *Taylor v. Caldwell*, 122 Eng. Rep. 309 (1863).

In the court's view, had the parties thought about it, they would have written a term that would have excused the landlord from providing a hall when fire destroyed the hall through no one's fault.

Subsequently, in *Globe v. Landa*, Justice Oliver Wendell Holmes generalized the reasoning in the Taylor case. Courts, he explained, should fill gaps with rules that would be facilitative for future parties like the parties before the court:

It is true that, as people when contracting contemplate performance, not breach, they commonly say little or nothing as to what shall happen in the latter event, *and the common rules have been worked out by common sense, which has established what the parties probably would have said if they had spoken about the matter*. A man never can be absolutely certain of performing any contract when the time of performance arrives, and, in many cases, he obviously is taking the risk of an event which is wholly, or to an appreciable extent, beyond his control. The extent of liability in such cases is likely to be within his contemplation, *and, whether it is or not, should be worked out on terms which it fairly may be presumed he would have assented to if they had been presented to his mind*. (Emphasis added)⁴¹

Judicial default rules thus originated in the presumed intentions of actual parties, and courts chose them also to be acceptable to future parties who resembled the ones in the originating case.⁴² In *Globe v. Landa* itself, Justice Holmes endorsed the common law default rule of consequential damages as requiring a tacit agreement that the breaching party would be liable for losses caused by special circumstances.⁴³

B. Rules versus Standards: The Contrasting Approaches of Law and Equity

The emergence of a set of general, definitive default rules through the process of common law adjudication was mirrored by a parallel development: the invocation of broad

⁴¹ *Globe Refining Co. v. Landa Cotton Oil Co.*, supra note 37. Some years later, Justice Cardozo used the same reasoning in *Jacob & Youngs v. Kent*, to adopt the rule of substantial performance in construction cases on the grounds that "intention not otherwise revealed may be presumed to hold in contemplation the reasonable and probable." 230 N.Y. 239 (1921).

⁴² We further elaborate the courts' rule creating function in Part III below.

⁴³ *Globe v. Landa*, supra note 37 at --.

standards by courts of equity to soften the sharp edges of the common law. The English common law applied two different sets of doctrines to interpret a disputed contract.⁴⁴ The first consisted of rules cast in objective terms that minimized the need for subjective judgment in their application. The rules were administered strictly, without exceptions for particular contexts in which the application of a rule appeared to defeat its purpose. These doctrines originated in King’s Bench and Common Pleas, the English courts that produced the corpus of the common law from the twelfth to the nineteenth century.⁴⁵ The second set of doctrines consisted largely of equitable principles originating in the English Court of Chancery, which began to exercise overlapping jurisdiction with the common law courts to hear cases that “in the ordinary course of law failed to provide justice.”⁴⁶ Significantly, these doctrines were framed as transcontextual standards-- principles that provided exceptions to the common law rules in contexts where the rules seemed to work harsh or unfair results.⁴⁷

The Chancery provided an independent and alternative forum as a response both to the procedural constraints imposed on the common law courts, and to the strict, rule-bound inclinations of common law judges. In contrast, “the Chancellor’s eyes were not blinkered by

⁴⁴ The discussion in this part draws on Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. Rev. 1023, 1035-45 (2009).

⁴⁵ J. H. BAKER, AN INTRODUCTION TO ENGLISH LEGAL HISTORY 12 (4TH ED. 2002). However, very little common law governing contracts was established before the nineteenth century. It was then that many questions that had been left to jury discretion as matters of fact began to be isolated as questions of law, with the common law providing relevant precedents. LANGBEIN, *supra* note 24, at 449-50.

⁴⁶ BAKER, *supra* note 45 at 117; *see also* LANGBEIN, *supra* note 25, at 320. (“Chancery also developed the practice of relieving against a contractual obligation that was enforceable at common law, in circumstances in which permitting enforcement would have been unjust.”)

⁴⁷ The common law courts entertained actions only by plaintiffs who presented a writ that specified the type of claim that the plaintiff was authorized to bring and the kind of relief to which the plaintiff would be entitled should he prevail. BAKER, *supra* note 45 at 54. The forms of action authorized in the writs thus defined the content of judicially cognizable rights. However, the King retained authority to hear exceptional cases in which he believed the common law was “deficient.” As these “exceptional” private suits became more common, they were referred to the King’s council. Later, parties addressed their bills directly to the Chancellor, who, under the authority of the council, took responsibility for assigning them to appropriate courts for resolution. *Id.* at 101. The Chancery always had the power to create a new writ that would provide a form of action suitable to a plaintiff’s complaint. But when the plaintiff’s claim was based on idiosyncratic facts rendering existing forms inadequate, rather than a common complaint for which no form of action existed, the Chancery sought an ad hoc or “contextual” solution rather than the creation of a new form of action. *Id.* at 102.

[the rules] and he could go into all the facts to the extent that the available evidence permitted.”⁴⁸ The Chancery focused solely on the equities of the case at bar, *not* the prospective effects of its ruling. Achieving equity required the Chancery to apply a broad, general standard to overcome the result of a common law rule that would have directed the outcome in the particular case. These equity interventions were not meant to, and did not, displace any of the common law rules. Indeed, for many years the Chancery’s decrees had no formal precedential effect,⁴⁹ which freed the Chancery from any concern that its contextualized rulings could undermine the consistency and predictability of adjudication.⁵⁰

C. Rules and Standards in American Contract Law.

The system of transcontextual standards created by the Chancery has left an indelible impression on contemporary American contract law. The division between the common law courts and the court of Chancery was a barrier between two incompatible legal regimes. But in the nineteenth century the Chancery was eliminated and law and equity were merged in both England and the United States. The result was an uncomfortable combination of legal rules and equitable standards; and it was this awkward amalgam that formed the matrix of American contract law.

To this day, therefore, American contract law is torn between the prospective view of common-law rules and the retrospective dispute-resolution view of equitable standards.

⁴⁸ BAKER, *supra* note 45 at 104. In its earliest incarnation, the procedure in Chancery was the antithesis of the procedure in common law courts: no writ was necessary, multiple issues could be joined, evidence was taken free of formal rules, decisions were made by Chancellor rather than a jury, the court was always open and trials could take place anywhere (including the Chancellor’s home). *Id.* at 103.

⁴⁹ “In Chancery, each case turned on its own facts, and the Chancellor did not interfere with the general rules observed in courts of law. The decrees operated *in personam*; they were binding on the parties in the cause, but were not judgments of record binding anyone else.” BAKER, *supra* note 45 at 104. “So long as chancellors were seen as providing ad hoc remedies in individual cases, there was no question of their jurisdiction bringing about legal change or making law.” *Id.* at 202.

⁵⁰ As an example, though common law courts strictly enforced penalty clauses in breached contracts, equity courts began enjoining such enforcement in the sixteenth and seventeenth centuries, creating the doctrine “equity suffers not advantage to be taken of a penalty or forfeiture, where compensation can be made.” LANGBEIN, *supra* note 24, at 324.

American default *rules* originating in the English common law courts include the rules of offer and acceptance,⁵¹ conditions,⁵² impossibility,⁵³ expectation damages,⁵⁴ foreseeability,⁵⁵ and indefiniteness. Along with these default rules, American contract law also absorbed and extended *mandatory* standards originally developed in Chancery “to mitigate the rigours of the Common law.”⁵⁶ Such standards include fraudulent and innocent misrepresentation,⁵⁷ fraudulent non-disclosure,⁵⁸ unilateral and mutual mistake,⁵⁹ specific performance and other injunctive relief,⁶⁰ as well as standards specifically designed to vitiate clear common law rules, including the penalty doctrine,⁶¹ the forfeiture doctrine,⁶² and the doctrines specifically inviting the court to

⁵¹ DAVID IBBETSON, A HISTORICAL INTRODUCTION TO THE LAW OF OBLIGATIONS 222 (1999).

⁵² A number of “structural “default rules were developed under the broad heading of the law of conditions, including the doctrines of constructive conditions of exchange, work before pay and several others. For discussion, see SCOTT & KRAUS, *supra* note 2 at ---.

⁵³ IBBETSON, *supra* note 51 at 224.

⁵⁴ *Id.* at 87-90.

⁵⁵ *Id.* at 229-32.

⁵⁶ IBBETSON, *supra* note 51 at 203. In general, equity evolved contract doctrines designed to provide far broader protection against perceived fraud than the common law provided. In particular, the core equitable contract doctrines provided relief where an agreement was not fully voluntary or informed. *Id.* at 208.

⁵⁷ The equitable defenses of negligent or innocent misrepresentation were the precursors to the contemporary doctrines of fraudulent and material misrepresentation. IBBETSON, *supra* note 51, at 208; *see also* RESTATEMENT (SECOND) OF CONTRACTS §§ 162 and 164 (1981). Originally, the equitable anti-fraud doctrines operated to bar relief for promisees but did not affect the promisor’s right to sue at law. *See* IBBETSON, *supra* note 51, at 209.

⁵⁸ The equity defense of wrongful silence was the precursor to contemporary non-disclosure doctrine. *See* RESTATEMENT (SECOND) OF CONTRACTS §§ 161& 164 (1981).

⁵⁹ IBBETSON, *supra* note 51, at 210.

⁶⁰ *Id.* at 206, 213. “The scope of specific performance was unclear, and plaintiffs seeking such a remedy were drawn into the Chancery.” BAKER, *supra* note 45, at 320.

⁶¹ The penalty doctrine voids any contract clause providing for liquidated damages in excess of the parties’ actual or expected compensatory damages. “By the seventeenth century liability in contract was seen as absolute, in the sense that, once the parties had reached an agreement, they would in principle be held to it unless the defendant could point to duress, fraud, or some other vitiating factor. Consistent with this position, the courts’ remedies would normally give effect to the agreement. . . . This principle was subject to the important qualification that the courts would not enforce penalties.” IBBETSON, *supra* note 51 at 213. For discussion of the evolution of the contemporary penalty doctrine, *see* Scott & Triantis, *Embedded Options*, *supra* note 24 at 1436-47.

⁶² BAKER, *supra* note 45 at 202-03. The forfeiture doctrine authorizes courts to set aside implied and express conditions. *See* RESTATEMENT (SECOND) OF CONTRACTS § 229 (1981) (“Excuse of a Condition to Avoid Forfeiture: To the extent that the non-occurrence of a condition would cause disproportionate forfeiture, a court may excuse the

rely on the factual context of the particular dispute in derogation of the common law rules of interpretation.⁶³ Thus, the rules versus standards tension was an inevitable consequence of the merger of law and equity.⁶⁴

Samuel Williston, the author of one of the great twentieth century treatises, smoothed the friction between common law rules and equitable standards by proposing a purportedly coherent set of default rules (and exceptions) that could be applied predictably by common law courts.⁶⁵ Willistonian rule formalism rested on two basic claims: contract terms could, and should, be interpreted according to the meaning a typical English language speaker would attach to them; and written terms and the common law defaults have priority over the context that situates a particular case.⁶⁶ Serving as the principal drafter, Williston enshrined his formalist approach to contract doctrine in two private law initiatives: the Uniform Sales Act⁶⁷ and the First Restatement of Contracts.⁶⁸ The Sales Act and, to a lesser extent the First Restatement, essentially codified the common law default rules.⁶⁹

non-occurrence of that condition unless its occurrence was a material part of the agreed exchange.”); *see also id.* § 225, cmt. a (“Where discharge would produce harsh results, this . . . effect may be avoided by rules of interpretation or of excuse of conditions.”); *id.* §227, cmt. b and cmt c.

⁶³ *See, e.g.*, WILLIAM STORY, COMMENTARIES ON EQUITY JURISPRUDENCE, §§ 153-157 (W.E. Grigsby, ed. 1884) (describing the equitable exceptions to the parol evidence rule).

⁶⁴ The balance of this part draws on Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Text and Context: Contract Interpretation as Contract Design*, 100 Cornell L. Rev. 23, 50-53 (2014).

⁶⁵ As an example, see WILLISTON ON CONTRACTS 631 (3d ed. 1961) (“The parol evidence rule requires, in the absence of fraud, duress, mutual mistake or something of the kind, the exclusion of extrinsic evidence, oral or written, where the parties have reduced their agreement to an integrated writing.”). For discussion, see Dennis M. Patterson, *Good Faith, Lender Liability, and Discretionary Acceleration: Of Wittgenstein, and the Uniform Commercial Code*, 68 Tex. L. Rev. 169, 187-88 (1989).

⁶⁶ Patterson, *supra* note 65 at 187-88.

⁶⁷ The Uniform Sales Act was promulgated by the National Conference of Commissioners on Uniform State laws in 1906. It was largely based on the English Sale of Goods Act of 1894. Sale of Goods Act, 1894, 56 & 57 Vict.

⁶⁸ Restatement of the Law of Contracts (1932).

⁶⁹ *See e.g.*, Uniform Sales Act §§ 41 & 44 (conforming tender), §§64 & 67 (market damages), §8 (excuse for destruction of identified goods), §§12 & 15 (express and implied warranties), §22 (risk of loss). Similar defaults were also codified in the English Sale of Goods Act. *See generally*, FRANK NEWBOLT, THE SALE OF GOODS ACT, 1893 (Sweet & Maxwell, pub 1894).

But the tension between rules and standards persisted beneath the surface of the newly unified law of contract. Because the process of developing transcontextual default rules had slowed, courts had relatively few general, definitive default rules which with to fill gaps in incomplete contracts.⁷⁰ The traditional common law response was to dismiss such contracts as being too indefinite to enforce.⁷¹ The inability to “find” agreement, together with other perceived limitations of the common law defaults, was elevated to prominence by the legal realists under the leadership of Arthur Corbin and Karl Llewellyn. In particular, Corbin believed that the common law response of dismissing incomplete contracts frustrated the parties to them when the parties apparently intended to make a legally binding deal. His solution was to authorize courts, through the use of standards, to fill in the gaps ex post.

Corbin also advanced the view that the Willistonian default rules for resolving contractual disputes were legal fictions and that, properly understood, *all* interpretation issues were context specific.⁷² In his view, courts did (and should) apply contract law tactically in order to implement meta principles of fairness and natural justice. When a court was asked to fill gaps in an incomplete contract, the just result was to determine the actual intention of the contracting parties.⁷³ According to Corbin, in order to capture this intent, all relevant contextual evidence should be considered on any interpretive issue. Corbin’s approach not only severely undercut the application of the traditional parol evidence and plain meaning rules, but it called into question the claim of generality of the common law default rules. Adjudication, he believed, could not reach a fair result unless the court considered the context of each transaction, and the instruments for undertaking that examination were the transcontextual standards of

⁷⁰ See Robert E. Scott, *Rethinking the Default Rule Project*, 6 Va. J. 84 (2003).

⁷¹ The common law indefiniteness doctrine is grounded in the presumed intentions of the parties. Where the parties did not make their intentions clear, the common law presumed that the failure to reach an agreement on material terms, where no terms could be objectively supplied, implied an intention not to be legally bound. *See e.g., Varney v. Ditmars*, 217 N.Y. 223 (1916),

⁷² Arthur Corbin, *The Interpretation of Words and the Parol Evidence Rule*, 50 Cornell L. Q. 161, 189 (1965).

⁷³ 6 CORBIN ON CONTRACTS §577 (1951).

reasonableness, fairness and good faith.⁷⁴ Corbin's view that rules were insufficiently transcontextual greatly influenced the drafters of the Second Restatement of Contracts, who proposed many transcontextual standards in place of the (seemingly) limited reach of the relevant common law default rules.⁷⁵

Llewellyn advocated a similar commitment to specific context, although he induced the meta principle that courts should apply from the common "working rules" that commercial parties used to govern their affairs.⁷⁶ On this principle, evidence of the parties' prior dealings, together with the usages in their trade, should be admissible on the question of what the parties' explicit contract meant. This is because practice and custom formed the implicit background against which merchants practicing within any particular commercial community contracted.⁷⁷ But since the working rules arose from practice and custom their jurisdiction was uncertain: they needed the imprimatur of the state. Legal incorporation was necessary, therefore, in order to tailor the rules to particular practices and to resolve the troublesome cases where the relevant norms were in dispute.⁷⁸

⁷⁴ Corbin's view was that even if the contract was an unambiguous integration – i.e., it appeared to contain the parties' entire agreement --, all relevant extrinsic evidence should be admissible on the issue of what the contract meant, including evidence of the parties' subjective intentions. 5 CORBIN ON CONTRACTS §24.7 - 24.9 (KNIFFIN 1998); Corbin, *The Interpretation of Words*, supra note 72 at –.

⁷⁵ The move from common law rules to broad standards in the Second Restatement (R2d) is palpable. See, e.g., the standard of reasonableness that replaced the pre-existing duty rule (R2d § 89), the new indefiniteness standard (R2d §33(2)), the commercial impracticability doctrine that supplemented the common law impossibility doctrine (R2d §261), the reason to know test that replaced the tacit agreement test of consequential damages (R2d §351), the reasonableness test of methods of acceptance that replaced *Adams v. Lindsell* (R2d §30(2)), and the reliance option (R2d §87(2)).

⁷⁶ Llewellyn was committed to the idea of filling contractual gaps with default terms that mimicked the arrangement most (or at least many) commercial parties would have made for themselves. In his mind, the solution to the dilemma of the poor fit between insufficiently contextual legal default rules and complex commercial relationships seemed straightforward. Rather than use abstract, general standards to regulate these relationships, the law should simply identify and incorporate the "working rules" already being used successfully by parties themselves. See Robert E. Scott, *The Rise and Fall of Article 2*, 62 La. L. Rev. 1009, 1023-4 (2002); Alan Schwartz, *Karl Llewellyn and the Origins of Contract Theory* in THE JURISPRUDENTIAL FOUNDATIONS OF COMMERCIAL AND CORPORATE LAW 15 (2000).

⁷⁷ See e.g., U.C.C. § 1-303(d), (formerly §2-208 & Comment 1).

⁷⁸ Scott, *Rise and Fall*, supra note 76, at 1023-4; ROBERT E. SCOTT & GEORGE G. TRIANTIS, FOUNDATIONS OF COMMERCIAL LAW 15 (2009).

This notion of incorporation of practice and custom through the device of transcontextual standards is deeply imbedded in Article 2 of the Uniform Commercial Code, of which Llewellyn was the principal drafter. Here, Llewellyn addressed the incorporation objective by reversing the Willistonian presumption that parties intended their writings to contain the dispositive elements of the deal.⁷⁹ Rather, the Code invites contextualization by first defining an agreement as “the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance....”⁸⁰, and then defining a contract as “the total legal obligation the results from the parties’ agreement.”⁸¹ In addition, the Code’s parol evidence rule permits courts to infer the parties’ intentions from trade usage even where the meaning of the express terms would have been clear to an ordinary English speaker and the contract seemed “integrated.”⁸²

And so, the tension between rules and standards persists to our day. The common law courts have continued to be remarkably faithful to the common law default rules that evolved during the 19th century. This is especially true in New York, the largest commercial state, whose courts retain most, if not all, of the common law default rules even though the drafters of the UCC and the Restatement replaced many of them with more contextually sensitive standards.⁸³

⁷⁹ Id. at 1078-82.

⁸⁰ UCC §1-201(3).

⁸¹ UCC §1-201(12).

⁸² UCC § 2-202, cmt 1,2 (2003). Because Llewellyn’s purpose was to incorporate the actual context that commercial parties had developed through their practices, he needed a mechanism by which these local norms could be identified by courts. He believed that the best mechanism was the merchant tribunal, made up of a panel of experts that would find specific facts—such as whether the behavior of a contracting party was “commercially reasonable” in the context of the particular dispute. The idea of the merchant tribunal was too radical for the commercial lawyers who dominated the UCC drafting process. Ultimately, Llewellyn abandoned this key device for discovering the relevant context, while still retaining the many transcontextual standards as the architecture of incorporation. As many have suggested, eliminating the merchant jury while retaining the pervasive notion of ex post incorporation of commercial norms was a serious drafting mistake. See James Whitman, *Commercial Law and the American Volk: A Note on Llewellyn’s German Sources for the Uniform Commercial Code*, 97 Yale L. J. 156, 174 (1987); Zipporah B. Wiseman, *The Limits of Vision: Karl Llewellyn and the Merchant Rules*, 100 Harv. L. Rev. 465, 505-06 (1987); Scott, *The Rise and Fall*, supra note 76, at 1040.

⁸³ For a discussion of New York’s role as the guardian of traditional common law rules, see Geoffrey P. Miller, *Bargains Bicoastal: New Light on Contract Theory*, 31 Cardozo L. Rev. 1475, 1478 (2010) (“New York’s formalistic rules win out over California’s contextual approach. As predicted by theory, sophisticated parties prefer formalistic rules of contract law.”)

To be sure, only a minority of courts has followed the Second Restatement’s preference for replacing rules with standards, but the UCC, which regulates sales of goods, embodies much of Llewellyn’s incorporation project, and it is law everywhere.⁸⁴ Indeed, the UCC remains regnant though courts seldom have attempted the empirical inquiries that, Llewellyn believed, were required in order to apply the Code’s transcontextual standards so as to facilitate commercial contracting.⁸⁵

III. Courts as Creators of Default Rules

In Part II we showed that the common law of contract, as created by courts, is composed of a limited number of transcontextual default rules and a few mandatory standards imported from equity. But what kinds of rules and by what process did the common law produce this body of contract law? And, is this a process that drafters could replicate today? In this Part, we set out to answer these questions. We first define more precisely the types of rules the common law has created, and then describe the mechanism that produced them.

The default rules that are created by common law courts have a particular quality that is a function of how courts conceive their role in resolving contract disputes. Courts invoke the gap filling – or default rule – function of contract law when the contract does not deal with the relevant issue.⁸⁶ Gaps can exist because parties find it too costly to create terms to govern *every*

⁸⁴ Id.

⁸⁵ There is virtually no evidence that courts, even those operating under the UCC’s invitation to examine context broadly, actually undertake such empirical investigations, and hence little reason to imagine they could succeed if they did. Recent research on the medieval law merchant, the formation of rules regarding commodity exchanges in early 20th century trade associations and the current practices of a closed community of cattle-feed traders strongly suggest that on-going, “traditional” dealings never crystalize into well defined, customary rules at all. Emily Kadens, *The Myth of the Customary Law Merchant*, 90 Tex. L. Rev. 1153 (2012); Lisa Bernstein, *Custom in the Courts*, 110 Nw. L. Rev. 63 (2015) (showing that neither parties nor courts introduced rigorous evidence of custom but rather cases were decided on party assertions or casual testimony); Lisa Bernstein, *Merchant Law in a Modern Economy* 11-12 (U. Chi Working Paper #639 (2013)). This evidence suggests that many courts, lacking expertise, fall back instead on interested party testimony and generic standards of reasonable commercial behavior rather than a careful evaluation of complex evidentiary submissions. Id.

⁸⁶ In contrast, courts invoke the interpretive function of contract law when a contract’s language applies to an issue, but it is arguably unclear just how the parties wanted the issue resolved.

future state in which they may transact; rather, parties draft terms to govern likely occurrences. There is a gap when an unlikely state materializes.⁸⁷ The judicial goal in contract cases is to recover and then enforce the parties' apparent intentions, as they existed at the time of contract. This goal implies that courts are reluctant to fill gaps with rules that are inconsistent with the ex ante intentions of the contracting parties, in so far as a court can recover those intentions from the issues the contract did resolve. Hence, the contracting parties' prospective intentions function as a constraint on, and sometimes as a guide to, the courts' rule creating function. But because courts know they are creating rules, they also consider the likely intentions of parties as viewed objectively rather than subjectively; that is, they ask whether future parties *like the parties at bar* would accept the courts' default solution when those parties consider the issue.

This judicial perspective explains why most common law default rules are either structural or formulas. A structural rule sets out the rules of the contracting game; hence, it governs everywhere. As examples, an acceptance is effective when mailed,⁸⁸ the risk of loss passes from the seller to the buyer with a transfer of possession,⁸⁹ and delivery of the goods and payment of the price are concurrent conditions.⁹⁰ Parties create substance within these general rules, but courts need not know in advance what the various substantive solutions will be.

Formulas are transcontextual because they are content free. Consider two common law examples: (1) A court should protect the disappointed promisee's expectation by putting her in the position she would have been in had the contract been performed,⁹¹ (2) A court should award

⁸⁷ Part V discusses additional reasons for gaps in contracts.

⁸⁸ Restatement (Second) of Contracts §63.

⁸⁹ See UCC §2-509(3). The early common law default rule passed the risk of loss from seller to buyer with the transfer of title to the property. See *Tarling v. Baxter*, 6 B. & C. 360, 9 D.& R. 272 [1827]. The same risk of loss rule was instantiated in the English Sale of Goods Act § 20 and the Uniform Sales Act § 22. Llewellyn successfully argued that this structural default should be changed to attach the risk of loss to the party in possession of the goods.

⁹⁰ See e.g., *Paynter v. James*, L.R. 2 C. P. 348[1867]. This structural common law default was codified in the English Sale of Goods Act, 1893 in §28, then replicated in the Uniform Sales Act in §42, and finally repeated again in the UCC. U.C.C. §§ 2-507 & 2-511.

⁹¹ The compensation principle that underscores the expectancy default rule was first announced as a general principle in *Jaquith v. Hudson*, 5 Mich. 123 (1858). The rule has been incorporated in both the Restatement (Restatement (Second) §347 and the UCC (U.C.C. § 1-305(a) [formerly §1-106]).

the disappointed promisee the difference between the contract and the market price when there is a market.⁹² The first rule directs the court to compare the relevant counterfactual to the contract; the second rule directs the court to compare the market to the contract. Courts can apply these formulas wherever there is an accessible market price. Courts and commentators should ask whether such formulas are efficient or otherwise desirable in general, and the answers commonly can be derived using plausible examples.⁹³

We next attempt to explain the process that produced the body of transcontextual common law defaults with a formal story. Consider a “super set” of commercial parties, denoted N , which is composed of subsets of contracting parties, or dyads, who function in various economic sectors. One such subset in N thus may be auto parts makers; another subset may be wheat farmers. We begin with auto parts makers and denote the first dyad to present a court with a particular contracting gap as $n_{1A} \in N_A$, where N_A is the subset of auto parts makers and n_{1A} is the originating dyad. The court’s task is to fill the gap with a rule. There is a set of rules, denoted S^K , from which the court can draw.

The actual judicial goal in contract cases is to recover and enforce the parties’ intentions, as those intentions are objectively manifested at the time of contracting. This goal implies the two constraints that restrict common law contract adjudication. First, courts create rules that are consistent with each litigating dyad’s type, as the court discerns that type from gaps the contract did fill and the evidence.⁹⁴ Parties would reject a rule that failed to satisfy this constraint were the rule called to their attention.⁹⁵ In this example, in the case of first instance a court would

⁹² The market damages default was formalized in England in 1826. Horwitz, *supra* note 27, at 941.

⁹³ On the general desirability of protecting the expectation interest, see Daniel Markovits & Alan Schwartz, *The Myth of Efficient Breach; New Defenses of the Expectation Interest*, 97 Va. L. Rev. 1939 (2011); on the general desirability of market damages, see Alan Schwartz & Robert E. Scott, *Market Damages and the Economic Waste Fallacy*, 108 Colum. L. Rev. 1610 (2008).

⁹⁴ A contracting dyad’s “type” – the dyad subset in which it functions – just is the parties’ intention in making the deal. Courts must recover the type when interpreting a contract because the interpretive task is to see whether the performance the promisor rendered is consistent with the dyad’s type. Thus, a delivery of cottonseed oil would be nonconforming if the dyad’s type meant to trade linseed oil. See Alan Schwartz & Joel Watson, *Conceptualizing Contract Interpretation*, 42 J. Legal Stud. 1 (2013). The text argues that courts will not fill a gap with a rule that is inconsistent with type.

⁹⁵ Courts can make mistakes but we assume that courts commonly recover party intentions accurately.

only choose rules from S^K that would be consistent with, or advance, an auto parts dyad's contracting goals. The second constraint holds that the rule must decide the case at bar. An example is the impossibility rule, which courts apply either to excuse or to enforce. Rules that satisfy the second constraint are "definitive:" they decisively resolve the case.

We let the court choose the contracting solution -- rule s^A -- from the set S^K to decide the first case raising the particular gap, which we summarize as $\{N_A\} \rightarrow s^A$. Because other possible contracting dyads in the auto parts industry are likely to be similar to the dyad the court first sees, the notation indicates that rule s^A is consistent with the originating dyad's type and likely is acceptable to later similar parties. We also assume that s^A decides the case.

Suppose that the next case the court sees involves a contract between parties in the copper pipe industry. We now describe the originating dyad as $n_{IC} \in N_C$: the dyad is drawn from the subset N_C of copper pipe parties. This dyad's contract also has a gap: it does not cover a problem that is apparently similar to the problem the prior auto parts manufacturer's contract left unresolved. The court can resolve the dispute by filling this gap with a rule. One party urges the court to use rule s^A because this rule favors that party and it is a precedent. The court, however, will choose rule s^A in this different context only if s^A satisfies both constraints: the rule appears to be consistent with, or advances, the contracting goals of parties in the copper pipe industry, and it is definitive. We let $\{N_A, N_C\} \rightarrow s^A$ summarize the result if the court "follows precedent": this tells us that rule s^A decides cases for both the auto parts makers and the copper pipe makers--dyad subsets N_A and N_C .

Now let this process iterate. The court sees cases drawn from a variety of industries and trades in the superset N and *continues* to decide them with rule s^A . The process runs forever but it may be affected by an economic change or terminated by systematic contracting out. Business to business internet contracting illustrates the effects of an economic change: traditional offer and acceptance rules are unsuited to internet contracts, and the new rules that appear to be emerging may induce changes in the traditional rules.⁹⁶ Alternatively, the process can terminate with widespread opting out. Common law courts created the implied warranty of

⁹⁶ See SCOTT & KRAUS, CONTRACT LAW AND THEORY, *supra* note 2 at 259-78.

merchantability, which made sellers liable for any damage caused by a breach of warranty. Beginning in the 1930s, however, manufacturers routinely disclaimed liability for consequential damages and began to disclaim the warranty itself. As a consequence, courts no longer could create or refine implied warranty default rules; contracts no longer contained “warranty gaps” that the rules could fill.

That parties can and do opt out of substantive default rules such as the implied warranty of merchantability means that some contracts may not contain all of the terms that are necessary to make an agreement binding. When such “gap cases” arise, common law courts apply a transcontextual default: the indefiniteness rule.⁹⁷ This rule creates an incentive for future parties to fill gaps with terms that permit courts to apply the remedial formulas, else their contracts will not be enforced. The rule is transcontextual because it applies to every contract everywhere that does not fill in those blanks, *but* the rule does not specify how the blanks should be completed. Put another way, the indefiniteness rule is a structural information-forcing rule that satisfies the acceptability constraint.

Assume, however, that in future cases that raise the “rule s^A problem,” the common law process continues without interruption by an economic change or a new contracting practice. Hence, courts use rule s^A to decide cases involving every dyad type in the contracting superset N whose contracts contain “ s^A gaps.” We summarize the outcome of this process as $\{N\} \rightarrow s^A$, which states that s^A is the *common law rule*. And this result permits us to state the common law mechanism: the judicial rule creating process *could not* iterate in the way we describe if rule s^A were not a good transcontextual default. This is because courts could not apply s^A to fill contractual gaps in a wide variety of contexts unless contracting parties in those contexts *let the gaps exist*. Hence, when s^A has attained the status of a common law contract default rule, s^A necessarily satisfies the acceptability constraint. No one has to predict, at some time zero, which

⁹⁷ The indefiniteness rule directs courts to dismiss a case for indefiniteness when the contract at issue is obligatorily incomplete. A contract is obligatorily incomplete when it lacks terms, such as a specified quantity to be traded, that permit a court to supply a remedy on breach. *Id.* at 30-42.

of the possible rules – s^A , or s^B or s^C – will come to be widely acceptable. Common law contract rules are widely acceptable *because they are the rules we see*.⁹⁸

The common law rule creating mechanism *does not* depend on the assumption that the common law is a good institution for creating contract law defaults because common law judges are better rule creators than drafters or other lawmakers.⁹⁹ Rather, the common law mechanism is effective because it provides courts with repeated opportunities to apply their rules across contexts. And those opportunities exist because parties accept just the rules that can be applied in that way.¹⁰⁰

IV. The Limits of State Created Default Rules

In Part II, we showed that the common law can (and did) create a limited set of transcontextual default rules, and in Part III we explained how the common law process of contract rule creation works.¹⁰¹ As Part II showed, during the twentieth century the process of

⁹⁸ We suppose that a default rule is a part of the law if it is “active;” that is, the rule is used to decide cases through time. A rule announced in, say, an 1850 case that courts never use again, though on the books if not overruled, is not a part of the living contract law. New York is the leading common law jurisdiction. A study of the current New York digests shows the same few rules continually are being cited in a very wide variety of contexts. A consideration of the digests twenty years ago reveals the same pattern: the rules that are cited today were cited then, also in a wide variety of contexts.

⁹⁹ To be fair to the default rule project, the model below of the drafters’ rule creation process assumes that drafters are excellent rule creators when sufficiently informed, and that they are public spirited in the sense that their rule choices attempt to maximize social welfare. See Part IV *infra*.

¹⁰⁰ A way to view the common law mechanism is as a set of experiments, in the vein of Charles Sabel’s work. See e.g., Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 Colum. L. Rev. 267 (1998). In the analysis above, the “experiment” is to create a particular common law rule. The experiment would be on the way to success if the copper pipe makers invited the court to apply the “auto parts makers’ rule” by leaving the relevant gap in the copper pipe maker contracts. And the experiment would succeed – would ultimately aggregate into a rule -- as dyads in more industries leave the same gap.

¹⁰¹ This process is often characterized as an effort to replicate a “hypothetical bargain” between typical contracting parties. Although this conceptualization may be a useful pedagogical heuristic, it is nonetheless quite misleading. The effort to mimic a hypothetical bargain is often thought to be an invention of scholars in the 1970s, who wanted to shift the focus of judicial analysis of contract disputes toward an *ex ante* perspective and away from the then

rule creation slowed while the American economy continued to grow.¹⁰² The legal realists and then the drafters sought to modernize the common law by suggesting or creating more sophisticated and more broadly applicable defaults. In this Part, we show why that project largely restricted itself to the creation of standards: creating contextual default rules was too difficult. Part V then exhibits the unsuitability of regulating business contracts with the restatement and UCC standards.

Our discussion of the tension between rules and standards that characterizes the history of the common law of contract may seem to suggest that there are only two types of defaults courts use to fill gaps. But understanding the difficulties facing drafters who seek to add to the existing stock of default rules requires a more complete typology. In fact, there are three distinct types of contractual default rules in addition to the structural and formulaic defaults we have just discussed: (1) majoritarian and tailored defaults; (2) penalty (or information-forcing) defaults; and (3) sticky defaults. When the default rule project began, the common law structural and formulaic defaults were already in place. The drafters could, and did, propose that the UCC and the Restatements reproduce many of these common law defaults. On the other hand, there is a limited role for a project that only recreates what already exists.¹⁰³ The search for a distinctive and desirable new contribution from the default rule project thus must turn to other default types.

dominant view that courts should interpret contracts as of the time of litigation. But this view of what courts do is mistaken, as Part III showed, and it also confuses the courts' role with the drafters' role, as is made apparent below.

¹⁰² While the process of common law default rule creation has slowed, it has not stopped completely. A recent example of a new transcontextual default that has become widely accepted is the “binding preliminary commitment” that governs cases where the parties to a preliminary agreement contemplate further negotiations. The new default rule requires parties to a preliminary agreement to “accept a mutual commitment to negotiate together in good faith in an effort to reach final agreement.” *Teachers Insurance and Annuity Association of America v. Tribune Co.*, 670 F. Supp. 481, 488 (S.D.N.Y. 1987). Neither party, however, has a right to demand performance of the transaction; rather, if the parties cannot ultimately agree on a final contract, either may abandon the deal. A federal court recently referred to this way of enforcing preliminary agreements as the “modern trend in contract law.” *Beazer Homes v. VMIF*, 235 F. Supp. 2d 485, 498 (4th Cir. 2003). For discussion see Alan Schwartz & Robert E. Scott, *Precontractual Liability and Preliminary Agreements*, 120 Harv. L. Rev. 662, 674-76 (2007).

¹⁰³ Participants in restatements sometimes stress the restatements' “aggregation function”: collecting the common law of a field in one place, along with explanations. This is a useful function and outside our analysis. We do note, though, that state law digests duplicate the aggregation function to a considerable extent. The contracts digests (see, e.g. New York) thus contain tables of contents that state and categorize all of the rules. The digests then illustrate how the rules have been applied with summaries of the case law relevant to each rule.

*A. Majoritarian and Tailored Defaults*¹⁰⁴

Judicial defaults originate in the intentions of actual parties, and courts choose them also to be acceptable to future parties who resemble the ones at bar. Drafters cannot create defaults in the context of adjudications.¹⁰⁵ Rather, drafters must either create new rules, select a common law rule to adopt in the infrequent cases when the common law rules differ, or encourage the law to develop in a particular direction by the rules they favor and the language they propose. In all of these cases, the drafters exercise discretion, and they need a normative criterion to guide their choices. We initially suppose that drafters prefer efficient defaults -- those that maximize the utility of the universe of future parties.¹⁰⁶ The literature guides the drafters in this task primarily with the admonition to create rules that “the majority” of future parties prefer. This admonition, however, is too difficult to follow: the drafters, we next show, cannot create default rules that party majorities would prefer unless those rules are transcontextual.

We use a simple model to develop this conclusion. Recall that N is the superset of contracting parties or dyads. We partition N into sets N_A , N_B and so forth. As before, each set functions in a sector of the economy. Because these sectors can be large and the dyads in them

¹⁰⁴ There is a rich literature on the nature of majoritarian default rules. For a sampling, see Barry E. Adler, *The Questionable Ascent of Hadley v. Baxendale*, 51 Stan. L. Rev. 1547 (1999); Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 Yale L. J. 729 (1992); Randy Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 Va. L. Rev. 821 (1992); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 Mich. L. Rev. 1815 (1991); Jason Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 Yale L. J. 615 (1990); Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. Leg. Stud. 597 (1990); Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Contracting*, 88 Mich. L. Rev. 489 (1989).

¹⁰⁵ The drafters are professors and lawyers who serve on ALI or NCCUSL drafting committees.

¹⁰⁶ More precisely, drafters want to maximize net social welfare. The default rules we analyze affect business parties, whom we assume are risk neutral. Risk neutral business parties' utility functions are linear in money. Hence, net social welfare, with regard to a possible rule, is the positive monetary return a rule would create for the business parties that prefer it less the negative monetary return, if any, the rule would create for business parties that do not prefer the rule, and less the disutility, monetary and otherwise, the drafters would incur from creating the rule. We focus below on the drafters' difficulty in predicting the business parties' monetary returns. Drafters sometimes choose standards with other normative goals in mind. We discuss this effort in Part V below. The drafters' task is sometimes described as creating rules that future parties would otherwise voluntarily adopt were their contracting costs lower. But because future (business) parties choose contract terms to maximize expected monetary returns, this goal is equivalent to the goal of maximizing net social welfare.

may have different preferences over terms, we divide the sets of N , such as N_A , into subsets such as n_{aa} , n_{ab} , and so forth. A subset such as n_{aa} can have one or more members. For example, if N_A is auto parts makers, we now suppose that there may be more than one auto part maker type; the contracting dyads in a particular subset are a context because they have the same contracting preferences, but preferences may differ across contexts. Thus, every auto parts member of n_{aa} has the same preferences, but n_{aa} types may prefer different contracting solutions than the n_{ab} auto part types prefer.¹⁰⁷ If so, the n_{aa} and n_{ab} types function in different contexts. All contracting parties are risk neutral, and collectively they constitute the demand curve for efficient solutions to contracting problems.

For parties to make a contract K , they must solve $P(K) > 1$ contracting problems. A contracting problem can be creating a delivery term, choosing a remedy, specifying quality and the like. A particular problem is denoted $p_i(K)$; a second problem is denoted $p_j(K)$ and so forth. There is a set of solutions for each problem, where a solution is a potentially maximizing contract term. The set of potentially efficient solutions to problem $p_i(K)$ is denoted $S(p_i) \geq 1$; that is, there may be more than one possible solution to the problem $p_i(K)$. The drafters proceed first by deciding what contracting problem they want to solve with a default rule. Let's assume the drafters consider problem $p_i(K)$, which now is to choose a termination clause for contracts between electronics manufacturers and their retailers. The drafters' second step is to identify $S(p_i)$ -- the set of potentially efficient termination clauses. The third step is to decide which of the theoretically efficient solutions in $S(p_i)$ the drafters should cast in the form of a default rule for actual parties to follow.¹⁰⁸

¹⁰⁷In Part III, we assumed for convenience that, say, all auto parts contracting dyads had the same contracting preferences. This assumption was innocuous: as the analysis there showed, if it was materially false, courts could not create a rule that would be acceptable to the "auto parts makers." Here, we relax this homogeneity assumption because we are analyzing substantive (rather than transcontextual) default rules: economic agents are more likely to have divergent preferences over substance.

¹⁰⁸The text models the drafters' task as choosing a new default rule: that is, a rule that would direct the efficient solution to a contracting problem. The model applies to the other drafter tasks as well. Thus, if the drafters are choosing between inconsistent common law rules, they should choose the rule that maximizes social welfare, which is defined here as the rule that maximizes parties' net monetary benefits. See note 105, *supra*. Using the text's notation, the set $S(p_i)$ would include the two common law rules, and the drafters would have to decide which of them to propose as the maximizing restatement or code default. Similarly, if the drafters want to encourage the law to move in a particular direction, the set $S(p_i)$ would include the rules, or versions of rules, that the drafters believed would cause courts to decide cases such as to shift the law "correctly". But if the drafters' goal is to maximize

We make two general assumptions when analyzing the drafters' problem. First, cases such as $\{N_E\} \rightarrow S(p_i)$ do not exist. In such cases, every contracting dyad in the relevant set – here, all of the electronic industry dyads, would prefer the same rule. A corollary of the first assumption holds that the drafters cannot propose a rule for every possible contracting preference. In the usual case, at least one dyad set in N_E will dislike the rule the drafters propose. Second, we assume that industries and trades are small relative to the domain of possible rules. The UCC and the Restatement of Contracts satisfy this assumption because the domain of UCC and Restatement rules is the entire United States economy; no industry or trade is large relative to the entire economy.¹⁰⁹

We focus on the drafters' third task: to choose an efficient implementable rule to propose as the default. Recall that the problem $p_i(K)$ is to create a termination clause for contract K , made between members of the electronics industry. To simplify this problem, we assume that $S(p_i) = 2$: the drafters can identify two possible solutions to $p_i(K)$, denoted rule s^1 and rule s^2 . We also assume that the set of electronics industry dyads N_E can be decomposed into only two contexts: those in which the n_{ea} types function and those in which the n_{eb} types function. In the example, $0 < \alpha < 1$ of the set N_E are n_{ea} types, who prefer rule s^1 , and $(1 - \alpha)$ are n_{eb} types, who prefer rule s^2 . Rules create benefits, where a benefit is the increment to the contract's expected surplus that the rule yields. Rule s^1 creates the same benefit b_1 for every n_{ea} type; rule s^2 creates the same benefit b_2 for every n_{eb} type; $b_1 \neq b_2$; and, just to begin, both $b_1(s^2)$ and $b_2(s^1) = 0$. The last two assumptions hold that the n_{ea} dyads derive a different benefit from "their rule" than the n_{eb} dyads derive from theirs; and that dyad types that function in a particular context are unaffected when drafters choose a default rule for types in other contexts.¹¹⁰

social welfare, the correct direction is the social welfare maximizing direction. Hence, the drafters should select from $S(p_i)$ the rules or rule versions that are directionally appropriate because they are maximizing. Thus, no matter how we, or the drafters, define their task, when drafters have discretion, they must choose from the sets of possible rules the rule that best advances a normative goal. The model below shows how difficult these choices have been, and will be, to make when the goal is social welfare maximization.

¹⁰⁹ The smaller the domain over which a possible rule would apply, the easier it is for the rule creator to predict how the rule would function. There is less for the rule creator to know.

¹¹⁰ The last assumption implies, for example, that dyads that prefer rule s^1 will not contract out if the drafters choose s^2 . The assumption is unrealistic: in the usual cases, dyads that prefer s^1 will either get some benefit from s^2 or incur a cost from s^2 . We discuss these cases below.

The question is whether drafters that want to maximize net social welfare should propose rule s^1 or rule s^2 as the legal default. Rule s^1 would be the correct choice if it would create greater total benefits for the members of N_E than s^2 would. This would be the case if

$$\alpha N_E(b_1) > (1 - \alpha)N_E(b_2).$$

The left hand side of this inequality is the total benefits the n_{ea} dyads would realize from rule s^1 , and the right hand side is the total benefits the rule n_{eb} dyads would realize from rule s^2 .

Rearranging terms, the drafters should propose rule s^1 if

$$1) \quad \frac{b_1}{b_2} > \frac{1 - \alpha}{\alpha}$$

This simple result teaches several lessons. Initially, the drafters cannot just propose the rule the majority prefers. For example, if 2/3 of the market for a solution to problem $p_i(K)$ prefer rule s^1 – the n_{ea} dyads --, the drafters nevertheless should choose rule s^2 if the n_{eb} dyads value s^2 more than twice as much as the n_{ea} dyads value their rule.¹¹¹ And if the n_{ea} dyads are 60% of the market, the drafters should propose rule s^2 if the n_{eb} dyads value it more than 1.5 times as much as the n_{ea} dyads value their rule. In addition, a tailored default rule is said to be efficient even though a minority prefers it when the rule creates greater benefits over all. Our analysis shows that the tailored default rule concept is subsumed under the general category of welfare maximizing defaults.

Of greater significance, the empirical burden facing drafters is severe even in this very simple case. To see why, assume that in choosing between the two termination rules the drafters proceed individual context by context, investigating how the two rules would apply to contracts between retailers that sell electronic equipment and the equipment makers. The drafters would have to know how many such contracts would be made in the United States in a particular period – the N_E in the analysis; the portion of the parties that make these contracts that prefer one rule or the other -- the α in the analysis; and the total returns the N_E dyads would get from the rules -- the b terms. Our assumption that every n_{ea} dyad and every n_{eb} dyad get the *same* benefit from

¹¹¹ To clarify the arithmetic, if $\frac{2}{3}$ of N_E prefer s^1 , the right hand side of Expression (1) = $\frac{1}{2}$. Let $b_2 > 2b_1$. Then the left hand will be less than $\frac{1}{2}$ so the drafters should propose rule s^2 .

their preferred rule simplifies the problem of finding benefits: the drafters can sample a dyad that prefers s^1 and a dyad that prefers s^2 to learn their benefits from the termination term they like and then multiply the results by αN_E and $(1 - \alpha)N_E$. It is more realistic, however, to suppose that different contracting dyads in different industry contexts and in different geographic areas get different benefits from termination clauses. If this is so, the drafters would have to learn the benefits that various firms would realize from rules s^1 and s^2 and then sum these up in order to solve their maximization problem.

We next relax the assumption that firms are unaffected when drafters do not choose their preferred rules. In the first case, we let contracting parties that prefer rule s^2 get benefit $b_2(s^1) > 0$ from rule s^1 . Then the drafters should choose rule s^1 if

$$(2) \quad \frac{b_1}{b_2 - b_2(s^1)} > \frac{1 - \alpha}{\alpha}$$

Inequality (2) is easier to satisfy than inequality (1) above because the left hand side is larger. Intuitively, rule s^1 becomes more attractive relative to rule s^2 if the rule n_{eb} dyads get a positive benefit from s^1 . But now the drafters also must learn how much these dyads benefit from the rule they prefer less.

Next, we consider the canonical case in which $b_2(s^1) < 0$: choosing s^1 as the default imposes costs on the n_{eb} dyads. Rule s^1 nevertheless would be preferable if

$$(3) \quad \frac{b_1}{b_2 + (b_2)(s^1)} > \frac{1 - \alpha}{\alpha}$$

Inequality (3) is harder to satisfy than inequality (1) because the left hand side is smaller. Intuitively, rule s^1 becomes less desirable relative to rule s^2 if s^1 imposes costs on the n_{eb} dyads, which prefer their own rule. The drafters thus must know how costly s^1 actually would be for the n_{eb} types.

The drafters may have to know two more things. First, the n_{eb} dyads may contract out to rule s^2 if s^1 is costly to them. Initially, suppose that every dyad in $(1 - \alpha)N_E$ has the same contracting cost, $c(s^2)$. Then every n_{eb} dyad would contract out when the contracting cost is less

than the rule mismatch cost: $c(s^2) < b_2(s^1)$. Substituting the contracting cost into inequality (3) reduces the left hand side, and thus makes the inequality easier to satisfy. Intuitively, rule s^1 becomes more desirable relative to s^2 the lower the costs that s^1 imposes on the n_{eb} dyads; and s^1 would impose the lowest cost when the n_{eb} dyads would contract out of it. The drafters could sample one of the n_{eb} dyads to learn its contracting out cost and then calculate the total assuming every dyad has the same costs. But contracting costs likely vary across firms. If so, then some n_{eb} dyads may contract out while other dyads for whom s^1 also is costly may not. In this case, the drafters would have to learn what the total contracting costs would be for the dyads that contract out, how many such dyads there are and what the total costs would be for the dyads that accept rule s^1 .¹¹²

Second, we have assumed that rule s^2 would not impose costs on the n_{ea} dyads. This assumption seems unrealistic. If we relax it, the numerator in Expression (1) becomes $b_1 + b_1(s^2)$ and the Expression is easier to satisfy: rule s^1 would become more favorable relative to s^2 . Intuitively, the benefits to the n_{eb} dyads would have to be large enough to overcome both the lost benefits to the n_{ea} dyads and the costs that rule s^2 would impose on them. But now the drafters would have to know what those costs would be.

A numerical example may illuminate this presentation. Assume that two thirds of the industry prefer rule s^1 , so the right hand side of the inequalities above equals one half, and let b_1 , the benefit n_{ea} dyads get from their rule, equal 100. Then by inequality (1) the drafters should propose s^1 if b_2 , the benefit the n_{eb} dyads would get from their rule, is less than 200. But if $b_2 = 220$, the drafters should propose s^2 though only a minority prefer it. Next suppose that the n_{eb} dyads get a positive benefit b_2 of 50 from their less preferred rule s^1 . Then their foregone gain from s^1 falls to 170 and, by inequality (2), rule s^1 should be proposed: it would be the “majoritarian default.” Suppose next, however, that $b_2 = 175$ but rule s^1 also imposes a cost of 50 on the n_{eb} dyads. Then the left hand side of the denominator in Expression (3) becomes $175 +$

¹¹² The costs of contracting out of a default rule may include more than legal and drafting costs. For example, one party’s request to contract out may permit the counterparty to draw an adverse inference about the party’s type (requesting an extensive warranty may indicate carelessness in use) or permit the counterparty to price discriminate. See Omri Ben-Shahar & John Pottow, *On the Stickiness of Default Rules*, 33 Fla. State U. L. Rev. 651 (2006); Alan Schwartz, *Incomplete Contracts* in 2 The New Palgrave Dictionary of Economics and the Law 277 (1998). Because these costs are particular to parties, drafters will find it difficult to sum up total “contracting costs” and compare them to gains.

50 = 225 and the drafters again should propose rule s^2 , though a majority prefers s^1 . Now assume that it would cost the n_{eb} dyads 30 to contract for the rule they like. Because this is less than $b_2(s^1) = 50$, these dyads would contract out and the denominator in inequality (3) would fall to $175 + 30 = 215$. The left hand side would still be less than one half, though, so the drafters should continue with rule s^2 . In this last case, however, assume that rule s^2 would impose a cost of 50 on the n_{ea} dyads. Then the left hand side of the Expression becomes .7, which exceeds one half; rule s^1 is again the best.

To summarize the simplest case we can analyze: the drafters attempt to solve a single contracting problem of drafting an optimal termination clause for contracts between electronics manufacturers and their retailers. There are only two solutions to the problem – rule s^1 or rule s^2 ; and there are only two possible contexts – those in which agents prefer s^1 and those in which agents prefer s^2 . But drafters who want to maximize welfare would not choose either of these rules just because a majority of the agents prefers it. Rather, as the analysis and the example shows, the drafters would have to know the size of the majority, the benefit each of the possibly desirable rules would create for the contracting dyads that prefer it, the benefits and costs of the rule for the dyads that do not prefer it, and the costs the disfavored dyads would incur if they contracted to their preferred rule. Moreover, because the relevant parameters are likely to change over time the drafters would have to revisit their rule choice periodically.

The drafters are lawyers who create restatements and uniform laws over conference tables and they seldom could fill in the requisite blanks – to know which welfare maximizing term, s^1 or s^2 , would be best when both rules are implementable. In addition, when the drafters consider other industries, the $S(p_i)$ set probably will change: the optimal termination default for clothing manufacturer/retailer contracts likely differs from the optimal termination default for electronics manufacturer/retailer contracts. If so, the drafters could not apply the electronics industry solution – say rule s^1 – to the clothing industry; that is, s^1 would be a contextual rule. As a consequence, the drafters would have to solve the different problem the clothing industry would present. It is quite improbable that the drafters could choose efficient contract default rules to regulate important aspects of every sale of goods in every industry in the United States: there are too many contexts, too many possible rules and too many contracting types. Indeed, in Part VI we show that the solutions to many contracting problems are parameter specific, which

implies that the set of contracting preferences in an industry is coextensive with the set of contracting dyads. The drafters could not satisfy this high demand for rules.¹¹³

B. Penalty Defaults¹¹⁴

Penalty defaults do not attempt to create optimal solutions to common contracting problems. Rather, a penalty default is facilitative: the default should induce the informed party to a potential contract to disclose private payoff relevant information to her counterparty. The penalty default mechanism is supposed to work by creating a default rule that the better informed party dislikes. The uninformed party can infer the informed party's private information from the contract term the informed party proposes to displace the disfavored default. As measured by the literature, penalty defaults are widespread; as measured by the ability of drafters to create them, they have been and will continue to be a null set. This is because penalty defaults make at least as challenging information demands on drafters as do majoritarian defaults.

The drafters could not create an efficient penalty default unless they know the solution set – the set of possibly efficient terms -- for the contracting problem that the penalty default is supposed to illuminate. Drafters who know the solution set can identify the better informed party and discover the private information that the lesser informed party needs in order to make an efficient contracting choice. The drafters, however, also would have to know the informed party's best responses to particular rules that the drafters could propose. Knowledge of best responses is necessary because different penalty defaults would induce the informed party to communicate different information to the uninformed party. The best penalty default would induce the most informative disclosure. It is difficult for drafters to access the requisite information regarding the range of solutions, the best responses of informed parties and the relevant contracting costs in order to choose efficient penalty defaults. In addition, there is a theoretical difficulty with penalty defaults: contracting parties sometimes may be able

¹¹³ When contractual solutions are parameter specific, there is a set of potential solutions to the problem at issue for *each* contracting dyad in the electronics industry set N_E . Our heterogeneity assumption – that at least one dyad's preferred solution differs from the solutions other dyads prefer – then implies that the drafters would have to solve the problem for many of these dyads. This seems unfeasible.

¹¹⁴ Penalty defaults were first proposed as a separate default category in Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L. J. 389 (1994).

conveniently to motivate the revelation of private information on their own, which then contradicts the rationale for having a penalty default.

We can illustrate the challenge facing drafters with a simple example. The particular contracting problem is to induce sellers in a competitive market to make an investment that would reduce the probability that the sellers will breach. The efficient investment by sellers should turn on the buyers' types. Thus, a seller should take more precautions to prevent breach when buyers place a high value on performance than when buyers place a low value. The sellers, we assume, do not know the valuations of particular buyers, but they do know the distribution of buyer values. One possible solution to the sellers' problem (and to the drafters' problem) would be for the sellers to invest at the level that would maximize the average buyer's return. This solution would induce the sellers to propose contracts to potential buyers with the associated "average" price. Above average buyers may dislike this contract because the seller invests too little in precautions for them, and below average buyers also may dislike the contract because the seller invests too much for them. The average price contract, however, may be an efficient "penalty contract" if either the high valuing or the low valuing buyers would reject it in favor of a contract that better suits their preferences. The rejecting buyers thereby would reveal their valuations and by doing so reveal the valuations of the buyers who accept the average price contract. As a consequence, the seller could efficiently tailor her precautions to the buyers' types. A penalty *default rule*, following this example, would replicate the contractual solution: the default would require sellers to pay average damages to buyers in the event of breach rather than pay each buyer his actual valuation.¹¹⁵

We can now make this example more concrete in order to exhibit the strong information demands that creating efficient penalty default rules would make on drafters. Assume that parties are in the shipping industry. Following the model above, and also to keep things simple, assume $S(p_i) = 2$. There are two implementable solutions to the problem of inducing efficient seller investment to ensure on-time deliveries: here rule s^1 requires breaching sellers to pay every buyer the low valuation v_i ; rule s^2 , the "full compensation default", requires breaching sellers to pay every buyer its valuation, whatever that valuation turns out to be. There are two

¹¹⁵ As all contract teachers will recognize, this example draws from the celebrated case of *Hadley v. Baxendale*, 156 Eng. Rep. 146 (1854).

shipper/buyer types: n_l buyers place a low value on on-time deliveries and n_h buyers place a high value on on-time deliveries. We have as values $v_l < v_h$. The question is whether s^1 or s^2 is the efficient penalty default rule.

We begin with rule s^1 , that requires seller/carriers to pay disappointed shipper/buyers the low valuation v_l . The sellers invest $i(v_l)$ in precautions to prevent breach, and offer contracts that charge the price p_l , which equals investment cost because price equals cost in competitive markets. The n_l low valuing buyers accept this contract because it efficiently reflects the cost of serving them. The n_h high valuing buyers have an incentive to propose a different contract because the contract that rule s^1 induces would undercompensate them by restricting their damage recovery to the low value v_l . The different proposed contract would require a seller/carrier to pay the n_h buyers the high valuation v_h in the event of breach. If the n_h buyers do propose the different contract, however, the seller/carriers will know the buyers' valuations, and will charge these buyers the higher price p_h . Hence, if c is the cost to a buyer of contracting out of the default, the n_h buyers will propose the different contract when $v_h - p_h - c > v_l - p_l$, or when

$$(4) \quad v_h - v_l > p_h - p_l + c$$

The left hand side of Expression (4) is the marginal gain in the high valuing buyers' return from the correct contract; the right hand side is the marginal cost – the increase in the price the high valuing buyers would have to pay for full compensation plus the cost of proposing the different contract. The n_h buyers will contract out of the low compensation default when the marginal gain exceeds the marginal cost. If these buyers do contract out, which we now assume, the sellers will know both their valuations and, because there are only two buyer types, the n_l buyer valuations as well. Hence, rule s^1 would be a good penalty default: it induces buyers to separate into the two types, and so enables the sellers to take efficient precautions for both.

Now consider rule s^2 that would award a buyer/shipper its valuation, whatever that valuation turns out to be. Rule s^2 increases the seller/carriers' expected liability from v_l to the market average, which lies between v_l and v_h . The sellers thus increase their investment in precaution and propose contracts that charge a higher price to reflect their increased cost. The

new investment level is $i(v^*)$ and the new price is p^* , which is greater than p_l but less than p_h . The n_h buyers now *will not* propose the different, accurate contract because they are fully compensated if the seller breaches and they pay a price that is lower than the full compensation price (which recall would be p_h).

The low valuation n_l buyers also would benefit from rule s^2 because the sellers' increased investment in precautions that the rule induces increases the likelihood that the sellers will make on time deliveries; this increases an n_l buyer's expected return. These buyers, however, would have to pay a price that exceeds the prior low valuation price p_l . We denote the benefit to an n_l buyer when the seller takes the average precaution level v_l^* . These buyers also will let the rule s^2 default stand, rather than propose the contract that is correct for them, when the value increase from the sellers' higher precaution level exceeds the necessary price increase plus the cost of contracting for the lower price, or when

$$(5) \quad v_l^* - v_l > p^* - p_l + c$$

The left hand side of Expression (5) is the marginal gain in the low valuing buyers' breach return; the right hand side is the marginal cost – the increase in the contract price, which contracting out would save, plus the cost of getting the correct contract. To summarize, rule s^2 is an inefficient penalty default when, as is now assumed, both Expressions (4) and (5) are satisfied, because *both buyer types* will let the rule s^2 default stand. Under the pooling contract this default induces, where neither buyer type is revealed, the sellers will choose the inefficient average precaution level rather than tailor their precautions to each buyer type.

We can now illustrate the information demands that penalty defaults make on drafters by reversing the results of the two Expressions. First reconsider the s^2 full compensation default. As said, the n_h buyers would accept it but, if inequality (5) *were not satisfied*, the low valuing n_l buyers would propose the low valuation contract because it would be best for them. The increase in these buyers' expected return in consequence of the sellers' greater precautions that rule s^2 induces would be lower than the price increase the buyers would avoid plus the contracting cost of getting the lower price. Hence, rule s^2 now would be a good penalty default because it would induce the low valuing buyers to disclose, thereby also revealing the high valuing buyers'

identities. Next reconsider the rule s^1 default. As said, the low valuing n_l buyers would accept it but, if inequality (4) *were not satisfied*, the n_h buyers would accept it as well: their gain from greater precautions would not be worth the increased price they would have to pay plus their cost of getting the correct contract. Now rule s^1 , which awards only the low valuation on breach, is the inefficient penalty default: because both buyer types would let it stand, the carrier/sellers could not know which buyers are which.

Whether rule s^1 or rule s^2 should be the penalty default must turn, as in the analysis in Part IVA above, on particular parameters -- the value of various precaution levels to shippers, the cost of various precaution levels to carriers, and the costs of contracting out.¹¹⁶ Continuing with this example, there are railroad carriers, trucking carriers and airplane carriers; and there are many shipping types. There likely would have to be penalty defaults for many transportation contexts. In addition, our illustrations are too simple because the drafters also will have to know the proportion of each buyer type in the market. For example, if one buyer type is much more numerous than the other, the default, other things equal, should induce the minority to propose the different contract. This would reduce total contracting out costs.

The penalty default concept entered into the contracts literature after the Restatement and the UCC were created. The popularity of the concept with academics, who often are drafters, suggests, however, that the default rule project may attempt to include penalty defaults in any third restatement or a revised Article 2. We show here that this would be a mistake: The drafters would again be defeated by heterogeneity among party types and among contracting contexts and by the high demand for rules. In short, it likely would be impossible for future default rule projects to propose efficient penalty default rules.¹¹⁷

Turning more directly to theory, a penalty default may be unnecessary to resolve the parties' contracting problem in this shipping example. Let carriers agree to pay shippers their valuations for delay or non-delivery, whatever those valuations turn out to be – the full

¹¹⁶ The example assumed that every buyer in the market has the same contracting costs. The problem becomes more difficult if contracting costs vary.

¹¹⁷ Eric Posner uses different reasoning to reach the same solution. See Eric Posner, *There Are No Penalty Default Rules in Contract Law*, 33 Fla. State U. L. Rev. 563 (2006).

compensation default – but charge two prices: p^* to shipper/buyers who remain silent and $p^* - \lambda$ to buyers who *announce* their valuations rather than propose different contracts, where λ is positive but small. Because every buyer type would be fully compensated under this contract, all of the buyers would take the small price reduction and make the announcement. There would then be full revelation without either buyer type incurring contracting out costs.¹¹⁸ The theoretical questions this example raises are whether its solution would work if it also were costly for buyers to make credible value announcements and whether similar revelation contracts exist in other contexts.¹¹⁹

Ian Ayres has argued that examples such as the one we analyze here are too restrictive. In his view, a penalty default is a rule that induces parties to reveal otherwise private information, and many current contract law rules successfully perform this function.¹²⁰ But even substantive defaults reveal information to the other side when parties contract out of them. Hence, Ayres' claim risks collapsing the penalty default category into the general category of maximizing defaults. To avoid this risk, the analyst should focus on the property of penalty defaults to induce disclosure *when disclosure would permit more efficient contracting performances*. But because this property is context dependent, we show here that the drafters did not, and future drafters could not, create efficient penalty defaults.¹²¹

¹¹⁸ This solution was developed in Eric Maskin, *On the Rationale for Penalty Default Rules*, 33 Fla. State U. L. Rev. 557 (2006).

¹¹⁹ The example in the text assumed that sellers function in competitive markets, so that prices equaled investment costs. When sellers have market power, they can price discriminate against the buyers, charging higher prices to the higher valuers. See Alan Schwartz, *Price Discrimination with Contract Terms: the Lost Volume Problem*, 12 Am. L. & Econ. Rev. 394 (2010). Buyers thus become reluctant to disclose. How penalty defaults would work in such imperfectly competitive markets is poorly understood. Some of the complexities are explored in Barry E. Adler, *The Questionable Assent of Hadley v. Baxendale*, 51 Stan. L. Rev. 1547 (1999) and Jason Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 Yale L. J. 615 (1990).

¹²⁰ Ian Ayres, *Ya-Huh: There Are and Should Be Penalty Defaults*, 33 Fla. State U. L. Rev. 589 (2006).

¹²¹ Ayres begins his argument that many penalty default rules exist by citing a Wisconsin statute that sets the default interest rate for consumer loans, and so induces lenders who want to charge higher rates to say so. *Id.* at 590. As the text notes, every rule that parties can change communicates information when a party changes it. The issue is whether such changes facilitate more efficient performances.

C. *Sticky Defaults*

A relatively new default rule concept is the “sticky default”. A default rule is sticky when the costs to parties of contracting out are high relative to the gains. Some defaults are naturally sticky: the relevant problem is hard for parties to solve in a different way.¹²² A decision maker can cause a default to be sticky either by choosing the default that is naturally sticky or by creating obstacles to contracting out of the default the decision maker proposes. Neither strategy is consistent with the purpose of a default rule when parties understand the rule and their contracts do not impose externalities on third parties.¹²³ A majoritarian default’s purpose is to solve a problem for many parties that the parties cannot conveniently solve for themselves. If a rule fails to solve the problem for a particular contracting dyad, the state should attempt to reduce rather than increase the dyad’s cost of adopting a more suitable rule. Moreover, structural defaults and formulas do not need to be made sticky because parties accept them, and penalty defaults are created just so parties will contract out of them. Making structural and formula defaults sticky thus is unnecessary and making penalty defaults sticky contradicts the rationale for the default. Because these are all the default types there are, presumptively every default should be “smooth.”

There may be a justification for sticky defaults, however, when parties are uninformed about their legal relationship. Suppose that certain contract terms or default rules are unlikely to be salient to typical parties who would be bound by them. Courts and drafters respond to this salience concern with clear statement rules. For example, a warranty disclaimer must be

¹²² See MITU GULATI & ROBERT E. SCOTT, *THE 3 1/2 MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN* 33-44 (2013).

¹²³ See Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 *Yale L.J.* 2032, 2084-88 (2012) (identifying paternalism and negative externalities as core justifications for quasi-mandatory or sticky defaults.) We consider the paternalism justification below. Because we focus here on contracting between commercial entities and restrict our analysis to contract law as such, we do not address the issue of how lawmakers can efficiently use sticky defaults to reduce negative externalities. The externalities that firms create commonly entail costs such as imposing environmental harms on society generally or erecting barriers to entry. These behaviors are regulated by the environmental and antitrust laws and not by defaults created by common law courts and drafters.

conspicuously set out and use certain key words.¹²⁴ A well-grounded clear statement rule makes a default sticky, but in the service of making contracting more informed.

A sticky default may also seem efficient if parties hold incorrect beliefs. Suppose, for example, that a party is likely to mistake the effect of a default rule. Using the example set out in Part IVA above, there are three cases to consider: the majority of contracting dyads in N_A (1) incorrectly believe that rule s^1 is better for them than rule s^2 and so would let s^1 stand if drafters propose it; (2) incorrectly believe that s^2 is better for them than s^1 but would accept s^1 if it is proposed because their wrongly understood gain from contracting to s^2 is less than transaction costs; (3) incorrectly believe that s^1 is better for them than s^2 and will contract for s^1 if drafters propose s^2 . In the first case, the drafters should propose s^2 and in the second case, the drafters should propose s^1 . In the third case, the drafters may consider proposing s^2 but making it difficult to change – creating a sticky default -- because mistaken dyads would otherwise incorrectly contract for rule s^1 . But if s^2 really is best, the drafters apparently should make the rule mandatory.¹²⁵ Under a mandatory rule, s^2 will provide the contracting solution for every dyad rather than only for high transaction cost dyads. The case for such a mandatory rule is that the state should not defer to incorrect beliefs.

The case for a sticky default begins with the view that a party may mistake her self-interest regarding a particular contracting choice because the issue is not salient to her or because she is prey to cognitive error. Enacting s^2 as the default may induce parties to take a second look: to reconsider the reasoning that led them to prefer s^1 in light of the state's clearly expressed view that s^2 is the better term. Thus, the argument goes, a sticky default may be a good

¹²⁴ See e.g., UCC § 2-316(2). The UCC contains some sticky defaults in the sense just explained, but the drafters' purpose was not to make the defaults "sticky". Rather, they wanted to induce efficient disclosures.

¹²⁵ *But see* Ayres, *supra* note 123, at 2084 et seq. Ayres argues that a quasi-mandatory, sticky default can be justified in a case such as that discussed in the text because contracting parties are likely to be heterogeneous. Thus, the degree to which the mistakenly favored term is actually less beneficial than the chosen default will vary with different dyads. Hence, he argues, permitting contracting out in circumstances where paternalism concerns are lower for some parties than others can, in theory, improve efficiency. This argument, however, imposes informational demands on drafters and other rule makers that are as equally implausible to satisfy as the informational demands needed to create efficient majoritarian or penalty defaults. See Parts IVA & IVB *supra*.

compromise between implementing efficient solutions and respecting party autonomy.¹²⁶ This discussion seems unrealistic, however, because it presupposes that drafters know what the efficient rule is, know the existence and extent of incorrect buyer beliefs, and know the size of the relevant transaction costs. As we have argued, drafters seldom will know these things.¹²⁷ Thus, apart from clear statement rules, drafters cannot, and did not, create efficient sticky defaults.

We can now summarize what we have learned from the analysis in Parts III and IV. First, we now better understand why the Restatement and the UCC largely solve the same problems that the common law has solved – where possible they propose additional transcontextual default rules, and otherwise republish the common law rules. And we further understand why the Restatement and the UCC largely eschew the attempt to solve common substantive contracting problems with default *rules*. The inability of drafters to create contextual defaults explains both phenomena. Second, future default rule projects apparently will employ the same default rule process: that is, the American Law Institute and the National Conference of Commissioners on Uniform State Laws will continue to use lawyers and academics who usually lack business expertise, who are unpaid and who have limited time to devote to creating restatement and UCC rules. The default rule project itself also has no fact finding arm: the

¹²⁶ This argument has much less traction in the commercial contexts we study here. Default rules for commercial contracts commonly affect firms and the usual presumption is that firms can make efficient choices.

¹²⁷ In the individual context, a sticky default is a “nudge”. Because consumers are more likely to mistake their self-interest than business parties are, a nudge may improve welfare. For example, if an employer’s retirement plan defaults employees away from IRAs, consumer costs of changing terms are high and IRAs are best, the state perhaps should default consumers into IRAs. The nudge solution is problematic, however, for two reasons: (a) it can be difficult to identify the biases that produce the behavior the regulator wants to change. See Alan Schwartz, *Regulating for Rationality*, 67 *Stan. L. Rev.* 1373 (2015); (b) autonomy may be better protected with mandatory rules. See Christopher McCrudden & Jeff King, *The Dark Side of Nudging: The Ethics, Political Economy and Law of Libertarian Paternalism*, Toronto Law School Public Law and Legal Theory Workshop Series, Paper No. 485 (2015). Jacob Goldin recently developed methods for recovering consumer preferences, and so knowing how to nudge, when the relevant cognitive error is inconsistent choice. These methods make strong demands on regulators, such as knowing the proportion and characteristics of the inconsistent choosers in relevant contexts. See Jacob Goldin, *Which Way to Nudge?*, forthcoming 124 *Yale L. J.* (2015). Goldin’s methods thus should help a regulator create nudges in highly specified contexts, but cannot support making general categories of defaults sticky. And any nudge raises the question asked above: if the state believes that IRAs are best, should it implement this belief with a default or a mandatory rule?

drafters cannot hold hearings or call expert witnesses. Nor have default rule projects the resources to retain experts or commission studies. Thus, the best grounded prediction is that future products emanating from today's default rule process will be as unsatisfactory as the current products: A future contracts restatement or revised Article 2 will not attempt to implement efficient default rules but likely will implement inefficient default standards.

We conclude our discussion of default rules by responding to the argument that contract law cannot do without defaults because contracts inevitably contain gaps. In the nature of things, however, a residual judicial default always exists. These residual defaults take two forms. The first default is dismissal under the doctrine of indefiniteness. As noted above, in many common law jurisdictions, and especially in New York, courts dismiss cases brought to enforce obligatorily incomplete agreements.¹²⁸ The other residual default is to choose a rule or standard that decides the case. Whatever the comparative merits of these solutions, there always is a default that will resolve an actual contract dispute. The relevant question, therefore, is whether drafters should *replace* the residual common law defaults with *new* rules or standards. We have just argued that the common law is a better vehicle for creating rules (and that few, if any, transcontextual rules remain to be discovered), and we argue immediately below that efficient contractual standards are better created by private contracting than by the default rule project. On our view, therefore, drafters should let the common law residual defaults stand.

V. Standards

The analysis thus far shows why the Restatement and the UCC contain few default rules that regulate a transaction's substance or function as penalties; such rules would have had to condition on particular contexts, particular party preferences and particular costs and benefits. In contrast, the defaults that emerged during the common law development of contract had a special feature: they are context independent. As most of these defaults were created before the default

¹²⁸ See note 71 *supra* and accompanying text. In certain types of preliminary agreements, courts enforce a duty to bargain in good faith despite the lack of agreement on material terms. This doctrine, however, is limited to the recovery of verifiable reliance costs in cases where a party has behaved strategically in delaying a promised investment. For discussion, see Schwartz & Scott, *Precontractual Liability*, *supra* note 102.

rule project was underway, there was little current space for drafters to create additional transcontextual rules. Thus, the drafters faced a choice: to reenact the common law and to create new transcontextual defaults, if any were possible, or to adopt transcontextual standards that apply in all contexts as context is revealed to a court *ex post*. The UCC and the Second Restatement drafters chose to adopt many standards—some replacing common law default rules and others applying to substantive contracting problems. In this Part, we argue that their choice was misguided, and that it would be a serious error to repeat it.

A. Default Standards.

Drafters propose default standards for three reasons. In some cases, the subject is controversial and strong interests on several sides lobby the drafters intensively. Here, there are two possible equilibria.¹²⁹ In the first, the default rule project fails because each contending force can block others' proposals. As examples, neither the proposed UCC Article 6 revision nor, more recently, the proposed Article 2 revision eventuated in changes to the Code, despite years of effort.¹³⁰ In the second equilibrium, the drafters propose standards because they satisfy the drafters' need to appear effective and do not disadvantage the interest groups; rather, the political problem is shifted to courts. As examples, the Restatement of Products Liability and the Convention on the International Sale of Goods use the word "reasonable" repeatedly in some sections and have scattered the reasonableness standard throughout many others¹³¹

Drafters also propose standards in the absence of political pressure. As we discussed above, standards are proposed when it is practically impossible to propose rules. In these cases, the drafters' choice is to do nothing or to propose standards. Because drafters agree to serve in order to be (and to appear) effective, they often propose standards. Drafters also propose standards – the third reason – when they believe the common law is too restrictive. For example, as we noted in Part III, the common law created the indefiniteness rule, which provided that

¹²⁹ See Schwartz & Scott, *Political Economy*, *supra* note 15.

¹³⁰ The European Draft Common Frame of Reference, which proposed major changes to European contract law, also failed, apparently for similar reasons.

¹³¹ See Schwartz & Scott, *Political Economy*, *supra* note 15 at --; and Clayton P. Gillette & Robert E. Scott, *The Political Economy of International Sales Law*, 25 *Int'l Rev. L. & Econ.* 446 (2005).

parties were not bound to an agreement that failed to specify all material terms.¹³² Drafters of the UCC and the Restatement reframed the rule as a standard, thus permitting courts to enforce contracts that lack material terms when courts believed that the parties meant to be bound.¹³³

The first two reasons explain the existence of standards but cannot justify them; the third reason states a normative case. We argue here that, whatever the reason, default standards fail the acceptability constraint. We begin by distinguishing between real and supposed contractual gaps. A real gap exists when a court interpreting a contract cannot find a written term that governs the problem at issue. The court necessarily will either fill the gap and enforce the contract or dismiss the case. In Part III, we argued that courts pursuing the gap-filling strategy will attempt to fill real gaps with terms that are consistent with the contract parties' intentions as other terms reveal those intentions. In contrast, a supposed gap exists when drafters believe that contracting parties will not create a term for a problem the parties may face. The drafters are not constrained by actual party intentions, but rather by their view of what future parties would accept. Unfortunately, the drafters have held mistaken views of what commercial parties would accept.

Default standards do not make informational demands on drafters. For example, the drafters can propose a default standard that tells contracting parties in every context to behave reasonably without knowing how any of those contracting dyads actually behave or what their contracting problems are. There is no need for drafters to provide such a standard, however, because parties can create a contract term at virtually no cost that tells each of them to behave reasonably as well.¹³⁴ One might argue, however, that even though it is costless for parties to draft standards, it sometimes is costly for parties to decide whether to regulate their relationship

¹³² See e.g., *Varney v. Ditmars*, 217 N.Y. 223 (1916).

¹³³ See UCC § 2-204(3); Restatement (Second) § 33(3). Part IV assumed that drafters want to maximize net social welfare. Reversing the common law indefiniteness rule in favor of a standard, though mistaken in its effect, is consistent with an effort to pursue this goal. We assume here that when drafters cannot enact a default rule because of political or information constraints, the drafters sometimes prefer to maximize their reputations: that is, the drafters would rather substitute a standard for a rule than appear to be ineffectual.

¹³⁴ As we noted in the introduction, commercial parties can create contract standards of reasonableness at virtually zero drafting costs. But as we point out here, such contract terms shift contracting costs to the enforcement function. Because unmoored contractual standards increase moral hazard risk and create other enforcement costs, parties reject them; the savings in drafting costs are outweighed by the increase in expected enforcement costs. See Scott & Triantis, *Anticipating Litigation*, supra note 17.

with a standard or a rule. It also is costly for parties to decide whether to accept a default rule or to leave a contractual gap, however. It is not customary to count such cognitive costs when choosing default rules because parties always have to think through their choices. Rather, the policy relevant question concerns the parties' marginal cost, above the costs of thinking, of creating either a rule or a standard. As we have seen, the marginal cost of creating a rule can be high because rule creation would require drafters to investigate many contexts; the marginal cost of creating a standard approaches zero because standard creation frees drafters from investigating context altogether. Hence, the cognitive cost case for standards does not get very far.

In addition, the cognitive argument just restates the case for majoritarian defaults and it encounters the same difficulty. A contracting dyad's choice between a rule and a standard, and if a standard just what type, is contextual. It turns on whether a rule can give clear notice of required behavior, whether relevant information is more convenient to access ex ante (a rule) or ex post (a standard), the risks and rewards of parties' sharing decision making power with a court, the relative costs of enforcing a rule or a standard, and other factors.¹³⁵ Drafters cannot identify the contexts in which a dyad's choice of a rule or a standard would require thought and be consequential, and also be a choice that is too costly for parties to make themselves. As a consequence, drafters cannot access the relevant information to make rule/standard choices that would satisfy the acceptability constraint. Hence, the case for standards proposed by drafters is weak even if parties' cognitive costs are added to their drafting costs.

A second justification for proposing standards is that parties sometimes do accept default standards. The best example is Delaware, whose corporate code regulates the relationships among shareholders, managers and directors with both rules and standards. There are two problems with using Delaware as an example, however. First, many of its standards are mandatory. When they are not, parties frequently contract out.¹³⁶ Also, and importantly here, Delaware corporate law violates the assumption made in Part IVA that industries and trades are

¹³⁵ See generally, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 Duke L.J. 557 (1992); Scott & Triantis, *Anticipating Litigation*, supra note 17.

¹³⁶ See Ronald J. Gilson and Alan Schwartz, *Corporate Control and Credible Commitment*, 43 Int. Rev. of Law & Econ. 119 (2015) (Companies routinely contract out of the duty of care and contract out of the duty of loyalty whenever possible).

small relative to the domain a rule or standard is intended to effect. In the case of contract law, the domain is the United States economy. Yet in Delaware, the “industry” and the rule and standards’ domain are coextensive. The industry is corporate governance and the domain in which Delaware rules and standards operate is corporate governance. Moreover, Delaware standards are applied by the Delaware Chancery Court -- a specialized court whose judges are corporate experts and who see the same type of case repeatedly.¹³⁷ Because Delaware corporate law applies over a very limited domain, its legislature can create defaults based on well-grounded predictions regarding the comparative merits of rules and standards. In contrast, the domain of Delaware common law *is* the economy generally. Given this larger domain, the common law of contract in Delaware unsurprisingly resembles New York contract law, with a set of transcontextual defaults rules and few standards.

The case against default standards is illuminated by considering why parties often reject externally imposed standards but sometimes create their own. Part V focuses on the former issue; Part VI considers the latter. To begin, commercial parties generally prefer gaps to standards when standards create moral hazard. A party disappointed by how a deal turns out may attempt to escape its obligations by claiming that its counterparty behaved “unreasonably,” in “bad faith,” “unconscionably,” violated a custom and the like. Because such strategic claims sometimes may escape summary judgment, parties prefer not to give each other the opportunity to make them.¹³⁸

Applying this general insight to an important case, contract terms which parties would use when they are symmetrically informed about payoff relevant information create moral hazard when information is incomplete. In these cases, parties eschew the “full information terms” – that is, they leave gaps -- in favor of the option to renegotiate subsequently. In some later states of the world, both parties will want to perform the initial contract; in other states, at least one party will not. The terms that the parties did write are the disagreement points that channel the ex

¹³⁷ For discussion of the special advantages of the Delaware Chancery Court and other expert tribunals in applying standards, see Gilson, Sabel & Scott, *Text and Context*, supra note 64 at 73-75, 88-92.

¹³⁸ Robert E. Scott, *Contract Design and the Shading Problem*, 95 Marquette L. Rev. 1 (2015). Bernstein, supra note 85, shows that parties routinely attempt to prevent courts from using custom evidence. See *id.* at 71, 76, 83-102.

post renegotiation bargaining game. Were a standard to be potentially applicable, however, one party might believe that it could do better by avoiding renegotiation and instead attempting to persuade a court to apply the contractual standard in its favor. By increasing the burden on a court to characterize a contracting party's behavior accurately, a standard also increases the likelihood of a court making a mistake in interpreting the contract's terms. Correspondingly, it increases the incentive for the party disfavored by subsequent events to engage in opportunistic litigation. Parties *ex ante* prefer a gap to a default standard that would permit this strategic behavior.

Examples may help clarify this point. Consider a firm that has sales agents visit potential customers in various locations but the firm cannot observe how the agents conduct visits. The contracts between firms and these agents do not condition the agent's compensation on her behavior, which they would do if the principal could observe the behavior. If the contract did pay the agent more if she worked harder, the agent may claim she made many sales visits and sold as diligently as she could. Hence, the usual contract conditions the agent's compensation on her output – a variable that typically is measurable. If exogenous events cause the sales scheme to be unusually successful or unusually unsuccessful, the parties may renegotiate to change the contract's terms. As another example, a complete contract between a manufacturer and its retailers would vary the price with the demand in the retailers' markets by charging high prices in high demand states and low prices otherwise. But parties do not make such contracts when the manufacturer cannot observe demand. If the contract did condition prices on demand, the retailers always would report low demand in order to get lower prices. Parties thus use simple fixed price contracts that suit the most likely demand states. When the *ex post* state differs materially from the average, parties often renegotiate the contracts.¹³⁹

Now consider how possible default standards might regulate these cases: (a) Sales agents should “exert the effort that is reasonable under the circumstances;” or (b) the price should be “reasonable in light of actual demand.” Contracting parties eschew standards such as these *not* because they are costly to create but because the reasonable effort standard would condition on

¹³⁹ Part V below describes simple linear contracts that attempt to induce optimal investment in the subject of the contract.

the sales agents' behavior and the reasonable price standard would condition on the retailers' demand. Both standards thus would make possible the strategic behavior that the parties sought to avoid by writing simple incomplete contracts.¹⁴⁰

To summarize, contracts between business parties either contain the standards that parties prefer or the contracts deliberately contain gaps. In the former case, a legal default standard is unnecessary and in the latter case parties prefer the gaps.¹⁴¹ Thus, there is no space for a *default standards project* to occupy. The analysis in Part VI bolsters this conclusion by describing contracts in common use. Its goal is to show that parties often prefer “rule like” terms to standards, and that standards are only used in combination with such terms where they are contextualized to the contracting parties' circumstances.¹⁴² Before reaching this subject, we briefly consider mandatory standards.

B. Mandatory Standards

A mandatory standard channels behavior rather than facilitates contracting. Substantive standards are justifiable when contracts creates negative externalities or the contracting process is flawed. But drafters cannot propose such standards to regulate effectively either externalities or the bargaining process. When externality behavior is systematic, it usually is outside the drafters' jurisdiction. Price fixing and environmental degradation are examples of externalities that are regulated by antitrust and environmental law. As noted above, flawed contracting processes are regulated under the common law rules of fraud and duress and the unconscionability doctrine, or by statute or agency rule. When behavior is context specific, it should be regulated by rules. And then the concerns explicated in Part IV apply here. The drafters' limited ability to find facts and their limited time would prevent the drafters from regulating common externalities or the bargaining process with effective context specific rules.

¹⁴⁰ See Alan Schwartz, *Incomplete Contracts*, 2 New Palgrave Dictionary of Economics and Law 277 (1997); Gilson, Sabel & Scott, *Text and Context*, supra note 64 at 60-63.

¹⁴¹ We show in Part VI when and how contracting parties use standards.

¹⁴² Louis Kaplow observes that a court functioning under a standard can create a rule-like solution by using evidence that is revealed ex post. This does not convert the standard into a rule, however, because future parties will lack much of the information that the prior court used. Thus, the standard remains a standard for the future parties. See Louis Kaplow, *Information and the Aim of Adjudication: Truth or Consequences*, 67 Stan. L. Rev. 1303 (2015).

Even a critic of standards may believe that the mandatory standards of good faith and commercially reasonable behavior should be a part of contract law. These standards are helpful in contracts between individual persons and between firms and consumers. They are inapt regulators of business behavior, however. Begin by distinguishing the duty of good faith from the substantive standards discussed above. The good faith duty, in commercial contexts, actually is an interpretive rule: courts apply the duty by inferring the parties' contracting goals from the written terms, and then evaluate behavior that the contract did not explicitly regulate in light of those goals. The duty thus seems duplicative because the existing interpretive rules authorize courts to make precisely these evaluations. Moreover, the duty should be mandatory only if interpretive rules generally should be mandatory. We have argued elsewhere that interpretive rules should be defaults.¹⁴³ Therefore, there apparently is no role in a business contract law for an independent duty of good faith or for a commercial reasonableness standard to play.¹⁴⁴

VI. Contracting Behavior

We have argued thus far that the set of problems that the default rule project can solve narrows considerably if solutions to many contract problems are parameter specific: that is, different contracting dyads would solve similar problems with different terms. This claim supports two contentions that we have advanced thus far. The first contention is that there are relatively few transcontextual default rules and most of those have already emerged through the common law process. The second contention is that contracting parties reject default standards because they fail to solve the specific problems contracting dyads face. Yet, not *all* solutions are context or parameter specific, and that suggests an additional explanation for contracting gaps. In the common view, parties leave a gap in their contract when the costs of solving the relevant problem exceed the gains or when a term would condition on unobservable information. Parties

¹⁴³ See Alan Schwartz & Joel Watson, *Conceptualizing Contract Interpretation*, 42 J. Legal Stud. 1 (2013); Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 Yale L.J. 926 (2010).

¹⁴⁴ Schwartz & Scott, *Contract Theory*, supra note 5, at 596-98; Schwartz & Scott, *Interpretation Redux*, supra note 143 at 944-47; Victor P. Goldberg, *Discretion in Long-Term Open Quantity Contracts: Reining in Good Faith*, 35 U.C. Davis L. Rev. 319 (2002).

also leave gaps when they *accept the legal default*. Indeed, it is this practice that makes the process of common law rule creation possible. It follows, that if contracting parties accept the transcontextual defaults but reject the others, our argument that solutions to common contracting problems are parameter specific would be strengthened. There is some evidence that parties do act in this way. For example, parties seem never to contract out of market or cover damages, which are formulas.¹⁴⁵ In contrast, parties routinely contract out of consequential damages.¹⁴⁶ Consequential damages are parameter specific – one buyer’s valuation differs from another’s – and valuations and profits usually are unverifiable.¹⁴⁷

In this Part, we offer further support for our earlier claim that many commercial contracts are parameter specific by briefly summarizing contract types in common use. Rules that regulate business practices but do not rest on an understanding of those practices have had, and will have, little survivorship value. We begin with long-term procurement contracts. The common goal of parties’ to these contracts is to ensure that current period prices are consistent with current period costs. Parties pursue this goal with a mechanism – the index clause – that links current prices to verifiable data, such as exogenously posted prices or price indices, that correlate with the parties’ (unverifiable) actual costs or demand. Index clauses commonly are negotiated and the information they use and the pricing formulas they create vary across contracting dyads.

Long-term procurement contracts also must adjust to exogenously induced changes in the efficient quantities of goods the buyer requires or the seller is obligated to supply. The Restatement and the UCC regulate these requirement and output contracts by combining a formula with a contextualized standard: a buyer cannot demand nor can a seller produce a quantity that is “unreasonably disproportionate” to the quantities *the parties themselves* traded in prior periods.¹⁴⁸ The formula component of the rule is everywhere applicable because it requires

¹⁴⁵ Schwartz & Scott, *Market Damages*, supra note 93 at 1624-29.

¹⁴⁶ ALAN SCHWARTZ & ROBERT E. SCOTT, *SALES LAW AND THE CONTRACTING PROCESS* 204-207 (1991).

¹⁴⁷ It is sometimes suggested that parties omit remedy terms because they do not think about breach. This claim is inconsistent with the common practices of excluding consequential damages, disclaiming warranties and writing liquidated damage clauses (which are parameter specific because they condition on the buyer’s expectation).

¹⁴⁸ See e.g., UCC § 2-306(1) (“any minimum or maximum set by the agreement shows a clear limit on the intended elasticity. In similar fashion, the agreed estimate is to be regarded as a center around which the parties intend the

the court just to compare two numbers: past and current orders. The standard component is not free floating because courts adjudicate disproportion by anchoring on the parties' experience under the contract. Consistent with our argument, although parties commonly create parameter specific index clauses to regulate needed price changes, they often accept the legal default for needed quantity changes.

Sellers with market power facing buyers whose demands are private information sometimes permit the buyers to choose the governing contract from a menu the seller supplies. The contracts in these menus vary by price, quality, down payment or other feature. As in the penalty default rule example above, different buyer types prefer different contracts; hence, a buyer's choice reveals its demand and may reveal the demands of other buyers. The seller thus can charge higher valuing buyers more than it charges low valuing buyers.¹⁴⁹ Menu contracts are parameter specific because sellers with market power usually face different distributions of buyer values. Therefore, a contract menu that induces revelation in one context would not induce it in another.

Contracts also attempt to induce parties to invest efficiently in the contract transaction or to produce and trade efficient quantities or qualities. Because parties seldom can observe each other's investment behavior, efficient investment-inducing contracts can be complex.¹⁵⁰ In practice, however, contracting parties often use simple linear contracts. To see how such a contract works, assume that a buyer cannot observe the seller's investment level but the buyer can observe the seller's output. The parties may then create a schedule that specifies a payment for every possible output level the seller could produce. Because the schedule is set in advance, the seller becomes the residual claimant: it keeps the difference between the price the schedule dictates and her production cost. Consequently, the seller chooses the output level that

variation to occur." 2-306 cmt. 3); Cf., *Empire Gas Corp. v. American Bakeries Co.*, 840 F.2d 1333 (7th Cir. 1988) (Posner, J.).

¹⁴⁹ See Schwartz, *supra* note 119; and Eva I. Hoppe & Patrick W. Schmitz, *Do sellers offer menus to separate buyer types? An experimental test of adverse selection theory*, 85 *Games & Econ. Behavior* 17 (2015).

¹⁵⁰ For a summary of early theoretically efficient contracts see Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 *J. L. Econ. & Org.* 1 (2004).

maximizes the difference between these variables.¹⁵¹ These efficient contracts are parameter specific because they condition on the buyer's needs and the seller's production capacity.

Linear contracts may also be used in other common principal and agent contexts. For example, assume that a principal knows some of the actions the agent may take to produce goods or services, but she does not know the full set of actions available to the agent. The principal can maximize her return by specifying each party's share of the surplus accruing from whatever output the agent produces. This share divides the surplus from the best possible action available to the agent and known to the principal (equal share splits are common). Because the agent can keep 50% of every possible surplus the agent could produce, the agent is induced to choose the action that generates the biggest surplus. The principal thus realizes the pre-specified share of the maximum feasible surplus even though the principal cannot know all of the actions the agent might take.¹⁵² These linear contracts also are parameter specific because they condition on particular agent's choices.

In another common case, a buyer may contemplate making a sunk cost investment that would increase the transaction's value, but the buyer believes that the seller will renegotiate the price upward when the seller learns that the buyer has invested. As a consequence, the buyer may not make the investment. A possibly efficient solution to this problem is a contract term that conditions the buyer's payoffs on the possible outcomes from investing that various buyer types could potentially achieve. The contract has an updating mechanism so that when the buyer announces the result of its investment, the contract conditions the buyer's payoff on an updated distribution of buyer values that is consistent with the buyer's announcement. In this way, the buyer is induced to invest efficiently because he is ensured a part of the surplus his investment creates and the contract is never renegotiated: the buyer thus is never disadvantaged by sinking

¹⁵¹ See Arup Bose, Debashi Pal & David E. Sappington, *On the Performance of Linear Contracts*, 20 J. Econ. & Management Strategy 159 (2011). In some distribution contracts, the surplus is a function of both the gross revenues and the agent's costs and the latter may be unobservable. In this case, parties will avoid a "net profits" solution and, instead, tie the agent's efforts to a share of the gross revenues. See Charles G. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 Va. L. Rev. 1089, 1106-1111 (1981); cf., Victor P. Goldberg, *The Net Profits Puzzle*, 97 Colum. L. Rev. 524 (1997).

¹⁵² See Gabriel Carroll, *Robustness and Linear Contracts*, 105 Am. Econ. Rev. 536 (2015).

costs in the contract project. As the paper describing these updating mechanisms recites, “what outcome functions are optimal will depend on the particular circumstances....”¹⁵³

Parties to franchise or distribution contracts often require franchisees or distributors to use their “best efforts” (and similar standards) in performing the contract. Such standards, however, often are preceded by instructions that contextualize the broad standard. For example, parties may describe in the contract the context that will be relevant—what industry, what kind of products and, when possible, the evidence the court should use to measure performance under the standard.¹⁵⁴ Alternatively, the contract may provide a list of specific actions the agent is required to undertake as exemplars of behavior that meets the best efforts standard. A reviewing court can infuse content into a standard such as best efforts by inferring the parties’ general goals from the contract’s descriptive whereas clauses and the contract’s detailed rules.¹⁵⁵ Hence, when a party takes an action that the rules do not regulate, the court can evaluate that action in light of those goals. A court, for example, could distinguish efficient best efforts in a franchise context from efficient best efforts in a distribution context.¹⁵⁶ Courts do not receive similar guidance from a Restatement or UCC standard that requires parties to perform contracts “reasonably” because statutory standards cannot be preceded by context specific rules.

Turning to unforeseen circumstances (rather than unforeseen actions), the franchisor or distributor also contracts for its counterparty’s expertise: an ultimate aim of the contract is to secure the counterparty’s active exercise of judgment. When circumstances change in an unanticipated way, the agent’s obligation is to apply its expertise to adjust effectively to the new conditions. This form of relationship is memorialized in a formal contract through

¹⁵³ See Robert Evans & Sonje Riche, *Contract Design and Renegotiation*, 157 J. Econ. Theory 1159, 1160 (2015).

¹⁵⁴ Gilson, Sabel & Scott, *Text and Context*, supra note 64 at 58-60.

¹⁵⁵ A standard on its own gives the court a relatively large space within which to decide whether the agent’s actions constitute best efforts. Where the parties combine standards and rules that relate to the same subject matter, the *ejusdem generis* canon applies, whether the general language is preceded or followed by the enumerated precise terms. The meaning of the general language is then limited to matters similar in kind or classification to the enumerated precise terms. See, e.g., *Tate v. Ogg*, 195 S.E. 496, 499 (Va. 1938) (holding that an enumeration which included “any horse, mule, cattle, hog, sheep, or goat” excluded turkeys).

¹⁵⁶ See, e.g., Scott & Triantis, *Anticipating Litigation*, supra note 17; Scott & Triantis, *Incomplete Contract*, supra note 17 (describing the various contract maxims that contextualize the standard).

contextualized standards that limit the court's discretion by specifying in greater detail the context that will be relevant and, when possible, the relevant proxy the court should use to measure performance under the standard. Here, the contractually specified standard directs the court to make use of context, but limits its inquiry into contexts that are relevant to the particular obligation embedded in the standard.¹⁵⁷

Finally, under conditions of high uncertainty, firms may form collaborative contracts (or “hybrid arrangements”) to create a new product, such as a drug, a software platform or an aircraft design.¹⁵⁸ Collaborative contracts are formed when the parties to them have complementary skills, such as research and marketing. These arrangements are not governed by procurement contracts because, at the outset, there is nothing to procure: there as yet is no new drug and there may never be one. These agreements present unique contracting problems because each party's actions, and the results of those actions, commonly are unobservable to the other party. Hence, a party may shirk in the hope its partner will invest actively, or misreport the results of its investment to renegotiate to a better division of the surplus. The agreement will fail, however, if parties underinvest or misreport, or it may not form when potential partners anticipate such strategic behavior. Parties nevertheless form collaborative contracts and govern them under complex “framework agreements” that create dispute resolution mechanisms, punish defectors and allocate expected surplus so as to induce efficient behavior.¹⁵⁹ The framework agreements are parameter specific because they are individually designed.

¹⁵⁷ Scott & Triantis, *Anticipating Litigation*, supra note 17 at 851-56. As noted in text, commercial contracts often include both precise rules and contextualized standards, and courts actively interpret and enforce such standards by reference to prescribed context evidence. In terms of the tradeoff between ex ante and ex post contracting costs, the use of a standard—even a contextualized one-- as opposed to a rule necessarily increases ex post contracting costs. It is harder to verify performance when specified by a standard; the court must first identify a “proxy” against which to measure performance, an intermediate step that is not required when the contract specifies precisely the terms of performance. For this reason, disagreement over whether a performance standard has been met is much less amenable to pre-trial resolution than is a rule, and the potential for moral hazard – the party disfavored by the change in circumstances opportunistically resorting to litigation to mislead a court into reallocating the burden of events in its favor – is increased.

¹⁵⁸ For discussion see Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Contracting for Innovation: Vertical Disintegration and Interfirm Collaboration*, 109 Colum. L. Rev. 431 (2009).

¹⁵⁹ Detailed descriptions of how collaborative contracts and other hybrid arrangements are created, function and should be interpreted are in Gilson, Sabel & Scott, *Contracting for Innovation*, supra note 158; Ronald J. Gilson, Charles F. Sabel & Robert E. Scott, *Braiding: The Interaction of Formal and Informal Contracting in Theory*,

To summarize, commercial parties solve the substantive contracting problems they face with parameter specific, rule-like terms and contextualized standards. These parties primarily need the state to provide efficient enforcement, accurate interpretation and deterrence of bad behavior.¹⁶⁰ They do not need substantive default rules, which drafters cannot effectively create, or default standards, which would permit a dissatisfied contracting party later to undo the parties' contractual scheme. Contracting parties do benefit, however, from transcontextual defaults such as those that have evolved through the common law process because these efficiently solve certain contracting problems and so save parties the costs of creating the defaults themselves.

VII. Conclusion

The Anglo-American nineteenth century contract law contained relatively few default rules and these rules had a particular character: they could be applied almost everywhere. Thus, the rule that an acceptance had to mirror the offer could be applied just by comparing the offer and the acceptance, whatever the content of those communications. Twentieth century commentators and, largely in consequence of their views, the drafters who embarked on the default rule project believed that there were too few common law rules given the complexity of modern contracting behavior. Also, when a rule was apt, courts often applied the rule rigidly, without an appreciation of the parties' actual intentions or the parties' context. The drafters' project, as the UCC recited, was to "modernize" commercial law by expanding the set of default rules courts could use, and by empowering courts, through the use of standards, to enforce the parties' actual deal rather than the deal that could be inferred only from what the parties wrote down.

Practice and Doctrine, 110 Colum. L. Rev. 1377 (2010); and Gilson, Sabel & Scott, *Text and Context*, supra note 64. A theoretical explanation of hybrid arrangement contracts is Tracy R. Lewis & Alan Schwartz, *Pay for Play: A Theory of Hybrid Relationships*, 17 Am. L. & Econ. Rev. 462 (2015).

¹⁶⁰ Consistent with the arguments we have advanced in this paper, our ultimate claim is that it is the parties (through contract design) and not the courts that better know (a) the agreements they wish courts to enforce, (b) the interpretive style they prefer courts to use in resolving disputes, and (c) how best to reduce the risks of opportunism in contract performance. Schwartz & Scott, *Preliminary Agreements*, supra note 126; Schwartz & Scott, *Interpretation Redux*, supra note 143; and Scott, *The Shading Problem*, supra note 138.

The lawyers and academics who began the default rule project misapprehended both the value of the common law process and their capacity to provide useful improvements. The common law of contract was well suited to business behavior just because it was the common law. Because the law was a set of defaults, a rule could exist through time only if later parties in different contexts than the one that constituted the originating case accepted it. Therefore, enduring common law rules have to be transcontextual; that is, they must be satisfactory to parties over broad sections of the economy. The common law of contract has few default rules because few rules can satisfy the structural requirement that they are (almost) everywhere applicable just because commercial parties (almost) everywhere like them.

This “acceptability constraint” bound the original drafters as well as the judges. When the default rule project began, most of the transcontextual rules were already widely recognized and new substantive rules would be acceptable to business parties – they would solve parties’ contracting problems -- only if the rules conditioned on the parameters that parties themselves would make dispositive. The drafters implicitly recognized that they functioned under a severe constraint: they had neither the time nor the resources to identify acceptable parameters for the almost countless contracts that heterogeneous parties make in a large modern economy. And this is especially the case because many contracting solutions are “parameter specific:” the efficient index clause in the contract between Smith Co. and Jones Co. differs from the efficient index clause in the contract between Roe Co. and Doe Co. Drafters could not write as many index clauses as there are parties who want them both because the drafters lack the information and because there are too many parties. Facing these difficulties, the drafters created few contextual default rules.

Rather, the drafters’ failure lay in making the wrong choice between doing a few things well and doing many things poorly. This is especially the case in the decision to replace common law default rules with standards. Standards are attractive to drafters for three reasons: (a) they are intrinsically transcontextual (parties everywhere can be told to behave reasonably); (b) they satisfy the need to do something rather than do nothing; and (c) in the view of some, they permit courts to complete contracts in fair and efficient ways. Some commentators have observed that business parties frequently use standards. Hence, to supply standards to parties whose contracts lack them was seen as performing the usual gap filling function.

This view also was mistaken. Creating rules to solve complex contracting problems is costly for parties; creating broad standards to solve complex contracting problems commonly is costless for parties. Hence, the drafters should have asked why so many commercial contracts contain gaps that parties could have filled with broad standards of reasonableness, good faith and the like. Contracts contain “standards gaps” when the parties prefer other solutions to the problem of adjusting to unforeseen actions or future states. For example, parties often expect to renegotiate their contract to achieve efficient solutions when the realized state of the world differs materially from the state the parties expected probably would present. Also, commercial contracts contextualize the standards they do adopt: the contracts combine standards with specific rules or instructions so as to define the constraints or delimit the space within which the standard is meant to function. Courts can infer the parties’ goals from these rules and instructions, and thus apply the standard to advance those goals. Drafters could not write such contextualized standards for the same reasons they could not write rules: they lacked the information and the demand is too great. And unmoored standards – those not combined with specific rules or illuminated by instructions elsewhere in the contract-- fail the acceptability constraint: they make possible too much strategic behavior. In sum, it was a mistake for the drafters of the UCC and the Second Restatement of Contracts to attempt to replace or to supplement effective contract law transcontextual defaults with transcontextual standards because these are either ineffective or mischievous in operation.

Our analysis of the Restatement and the UCC should enable courts to better understand why these defaults have the shape they do, and why that shape largely reflects mistaken beliefs as to how best to regulate business contracting. In particular, the UCC is law, the Restatement is not. New York closely follows the traditional common law in cases not involving sales and it is widely popular with business parties. We show that courts today should draw from the New York experience to the extent they have discretion to do so.

This paper’s argument also has important implications for the future. A project to draft a 3rd Restatement of Contracts is likely to be launched within the next several years,¹⁶¹ and the effort to revise Article 2 may be revived. Because there apparently is no movement to change

¹⁶¹ Email from Professor Richard Revesz, Executive Director of the American Law Institute (on file).

the structural limitations of the default rule project, there is a serious danger that these projects will repeat the failures of the past. Perhaps the best that can be done is for future drafters to look to the experience of business parties with the UCC and the Second Restatement. Drafters enlisted in future restatement projects should heed the New York experience and consider restoring the common law defaults that were replaced by standards.

In any case, the unfortunate history of the default rule project is a cautionary tale for future restatement and statutory efforts to create efficient contractual defaults. To be sure, an historic function of the ALI restatement projects has been to harmonize common law rules as they emerge in different jurisdictions and choose the most apt and accurate formulation of the common law rules.¹⁶² This translation function serves to capture the rule in contemporary language and can reduce misunderstanding and ambiguity. It remains an open question, however, whether that function alone is of sufficient value to justify further drafting efforts.

March 2, 2016

¹⁶² In truth, as Grant Gilmore noted, a great deal of harmonization has already occurred in contract and commercial law, spurred particularly in the second half of the nineteenth century owing to the role of the Supreme Court of the United States as a “great commercial court:”

The rules which [the Court] announced were, in nine cases out of ten, gladly followed by the state courts as well as, of course, by the lower federal courts. A remarkable degree of national uniformity in the law applicable to commercial transactions was in fact achieved over a remarkably long period of time.. Grant Gilmore, *Commercial Law in the United States: Its Codification and Other Misadventures*, in *Aspects of Comparative Commercial Law: Sales, Consumer Credit and Secured Transactions* 449 (Jacob S. Zeigel & William F. Foster eds. 1969).