THE DEFAULT RULE PARADIGM AND THE LIMITS OF CONTRACT LAW

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I. INTRODUCTION

Default rule analysis has become a central feature of modern contracts scholarship. This scholarship is illuminating but less helpful than it could be for two reasons: first, there are several types of default rules but the literature does not distinguish adequately among them; second, legal institutions vary in their ability to write helpful defaults but the question which institution should create what kind of rule has not been seriously asked. This essay addresses both deficiencies.

A. TYPES OF DEFAULTS AND THIS ESSAY'S SUBJECT

Contract law rules can be immutable or defaults. Parties cannot change immutable rules. Therefore, a default rule can be defined as a rule that parties are free to change. This definition is too broad because there are important differences among the mutable rules. At least six kinds of defaults have been identified.

(i) Problem-solving defaults: a problem-solving default supplies a satisfactory solution to a contracting problem to parties whose contract lacks that solution. A decision maker writing such a default solves for the equilibrium contract term—the term typical parties would have written had they been informed, rational and faced with zero transaction costs.¹

(ii) Equilibrium-inducing defaults: an equilibrium-inducing default rule induces parties to choose the welfare-maximizing term. Parties respond to an equilibrium-inducing default either by accepting it or by contracting to another term. The default is correctly designed if parties accept it when it directs the efficient outcome, and contract to the efficient term otherwise.²

(iii) Information-forcing defaults: an information-forcing default rule causes parties to focus on an important contracting problem. To understand this function, let a set of parties, say retailers, understand the commercial subject and the law relevant to it while the other set of parties, say consumers, does not. An information-forcing

¹ Problem-solving defaults were the earliest defaults scholars identified and have been the most analyzed. For an early discussion, see Alan Schwartz & Robert E. Scott, Commercial Transactions: Principles and Policies 1-15 (1st ed. 1982).

² The concept of equilibrium-inducing defaults was introduced into the literature in Ian Ayres & Robert Gertner, Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules, 101 Yale L.J. 729 (1992) [hereinafter Ayres & Gertner].
default rule is chosen because it is unfavorable to sophisticated parties: the new contract the sophisticated parties propose to displace the unfavorable default is supposed to inform the unsophisticated parties of the subject's relevance and of the terms that will govern disputes unless these parties speak up.3

(iv) Normative defaults: a normative default rule directs a result that the decision maker prefers on fairness grounds but is unwilling to require. The policy is advanced if a fair number of parties let the rule stand.4

(v) Transformative defaults: a transformative default rule is adopted to persuade parties to prefer the result the rule directs. Transformative defaults are similar to normative defaults because both attempt to produce fair or just results. The two defaults differ because the decision maker's purpose is frustrated when typical parties reject a normative default but is not necessarily frustrated when parties reject a transformative default: that the rule remains on the books, the decision maker hopes, will ultimately transform parties' preferences.5

(vi) Structural defaults: structural rules define the nature of the contracting game. For example, a structural rule tells parties how to make their agreement legally binding. Some structural rules are immutable but others are defaults. The rule that silence can constitute acceptance is a structural default: the offeror contracts out when he requires an explicit acceptance.6


It is perhaps helpful to view default rules as a Venn diagram. The rules that parties are free to change constitute the encompassing set. Default rule types (i) to (vi) are subsets of the encompassing set. Other rule types may also be included but scholars have paid little attention to them.

This essay neglects information-forcing default rules because its subject is the rules that govern sophisticated contractors. These parties commonly understand commercial subjects, the terms of their contracts, and the applicable law. The essay also does not consider structural default rules. To do that would make the essay too long. Two claims about the other four default types are made here: (a) contract law seldom can, and therefore seldom should try to, create efficient problem-solving and equilibrium-inducing default rules; (b) the state should not create normative or transformative default rules at all.

B. Normative Constraints

Two related normative constraints should bind the state when it creates problem-solving defaults. The first is that a default rule must solve a problem that a reasonable portion of contractors will face in a way that is acceptable to those contractors. A rule that fails the former aspect of this test is wasted effort; a rule that fails the latter aspect will not survive in the marketplace. The test itself is called here the "acceptability constraint." The second normative constraint derives from the function of a problem-solving default rule: to guide future parties and courts when a dispute arises. Rules that require for their application information that is inaccessible either to parties or to courts cannot perform this guidance function. The second constraint, referred to as the "information constraint," thus holds that a good problem-solving default "conditions on" accessible information. For example, the default rule that awards a disappointed promisee the difference between the contract and market prices satisfies the information constraint: the rule conditions on the two prices, and price information usually is accessible to parties and to courts.

The relation between the two constraints as they apply to problem-solving defaults is this: satisfying the information constraint is a necessary but not sufficient condition for satisfying the acceptability constraint. Respecting necessity, parties will contract away from

7. Part II.B gives a cost/benefit account of the acceptability constraint.
problem-solving default rules that condition on information whose existence they cannot ascertain or establish in court. Thus an efficient default must satisfy the information constraint. Respecting sufficiency, a problem-solving rule that conditions on accessible information still may not solve the parties’ problem optimally. Thus an efficient default also must satisfy the acceptability constraint.

The relation of these constraints to the other default rule types is this: the acceptability constraint is irrelevant to the creation of equilibrium-inducing defaults. These are chosen to induce efficient equilibria, not because typical parties would prefer them were the parties to have thought about the matter. The information constraint binds for these defaults, however: a decision maker cannot induce desirable equilibria if she lacks access to the necessary information. The acceptability constraint binds for normative defaults but not for transformative defaults. Respecting the former, if too many parties would change a normative default, adopting it would raise transaction costs with no corresponding gains. Respecting the latter, the goal of a transformative default is to alter preferences, not to satisfy them; hence, whether parties would accept such a default in the short run is not germane. Finally, the information constraint seldom is relevant to normative and transformative default rules because neither conditions on information that parties would find germane when creating or adhering to contracts (these latter defaults would violate an aspect of the information constraint were they to condition on information that courts could not easily get, such as whether a party was motivated by personal animus).

This essay’s central theme is that satisfying the two normative constraints is much more difficult to do than is commonly supposed. As a consequence, it is much more difficult to create helpful problemsolving, equilibrium-inducing and normative defaults than is commonly supposed. Transformative defaults are objectionable for other reasons.

C. THE RELATION OF INFORMATION STRUCTURES TO DEFAULT RULE CREATION

To make these claims clear, even in a preliminary way, realize that parties to a contract face an “information structure”—what each

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8. Part I.C states the results that this essay reaches. Some of these results are self-evident; others are defended in later sections.
of them knows about relevant economic variables and about the other. Four information structures are relevant to the analysis here:

(a) **Complete and verifiable:** Each party can observe all relevant economic variables and every relevant feature of her contract partner, and can verify the existence of those variables and features to a third-party decision-maker such as a court.

(b) **Complete:** Each party can observe all relevant information, but only a subset of that information can be verified to third parties.

(c) **Incomplete but Symmetric:** Some relevant information is not observable, but each party knows what the other knows and does not know what the other does not know. A subset of observable information may also be verifiable.

(d) **Incomplete and Asymmetric:** One party can observe a relevant economic datum—for example, its production cost—that the other party cannot observe. Information that cannot be observed cannot be verified.

Parties can achieve efficiency when facing information structure (a) because they can write contracts that require each of them to take the optimal action given the particular realization of the economic variables, and they can prove in court both that realization and what action each party actually took or failed to take. Contracts nevertheless contain gaps in structure (a) situations because of bounded rationality or because the costs of providing for some contingencies can exceed the gains.

Default rules for structure (a) situations satisfy the information constraint definitionally: to say that information is observable and verifiable means that it is accessible to parties and to courts. Nevertheless, contract law can contain few acceptable problem-solving defaults in structure (a) situations. This is because contract law aspires to regulate every type of contract; hence, a “contract law solution” must solve a problem that many contracting parties face in a way that is acceptable to a reasonable portion of those parties. In diverse economies, there are few contracting problems that almost everyone faces; hence, contract law addresses few contracting problems. Also,

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9. The argument of this essay applies to contract and sales law because the same institutional and economic considerations commonly affect sales and nonsales contracts in the same ways. The *Restatement (Second) of Contracts* contains many sections that originated in Article 2 of the Uniform Commercial Code, which regulates sales of goods. This overlap evidences general recognition of the very close relationship between these two legal fields.
broadly applicable solutions to these few problems are rare. Consequently, problem-solving contract law defaults commonly fail to satisfy the acceptability constraint.

Writing efficient contracts was thought to be difficult when parties faced information structures (b) and (c). In these situations, relevant information is unverifiable; that is, its existence cannot be proved in court. Efficiency is hard to achieve when only reputational constraints prevent a party from taking advantage of the other party's inability to enforce important terms. Recent economic scholarship shows that parties can create constrained efficient contracts in these situations, at least in theory. The "trick" is to create a contract that uses the information that is available to the parties, and that contains a series of sanctions that apply to a party who fails to take verifiable actions that the contract requires (for example, delivering the specified quantity).

Replicating such contracts as problem-solving defaults is difficult. If the default rule solves the parties' substantive problem but does not contain sanctions, it will fail the information constraint. A court could not apply the default because it could not access the unverifiable information on which the optimal solution is partly conditioned. Thus, the default rule must contain sanctions based on a failure to take verifiable actions. The sanctions should be relatively individuated; that is, they should depend on the nature of the breach and its gravity in the circumstances. Contract law's generalist aspirations prevent it from enacting such individuated sanctions in connection with problem-solving defaults. Generalized sanctions, however, will fail the acceptability constraint.

Finally, efficient contracts cannot be written when parties face information structure (d). The strategy of creating contracts that condition on a combination of observable and verifiable information is unavailable when parties cannot observe some information at all. Because the decision maker seldom knows more than parties do, she will have the same difficulty creating a problem-solving default. When contracting costs are not trivial, so that the legal default constrains the set of contracting opportunities, the decision maker may attempt to choose defaults that will induce welfare-improving equilibria. As will become apparent, these equilibrium-inducing defaults

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10. See, e.g., infra note 23. A constrained efficient contract is not "first best"—i.e., it is not on the Pareto frontier—but the contract does maximize the utility of the parties to it given the information structure.
commonly violate the information constraint: the decision maker seldom could access the information requisite to inducing the right equilibrium.

Contract law is made by courts, the American Law Institute (in restatements), and the ALI and National Conference of Commissioners on Uniform State Laws (as in U.C.C. Article 2). The problems raised here call into question whether the latter two sets of lawmakers (called here "drafters") should attempt to create many problem-solving and equilibrium-inducing defaults. Even in the most favorable situation, when all relevant information is observable and verifiable, the generalist aspirations of contract law make the creation of acceptable problem-solving defaults difficult. Moreover, the latter three information structures frequently obtain. When they do, satisfying the acceptability and information constraints respecting problem-solving and equilibrium-inducing defaults is very hard to do.\footnote{11}

This suggests that drafters should concentrate on creating normative and transformative defaults. A fair number of contract law rules do have normative and transformative aspirations. That a default solves a contracting problem acceptably is a necessary condition to its being an effective normative default, however; parties will contract out of rules that embody unacceptable solutions. Hence, the factors that make creating acceptable problem-solving defaults difficult necessarily make creating acceptable normative defaults difficult. Finally, transformative defaults seldom would be effective. Parties are more likely to resent, and thus change, rules that contradict their preferences than they are to change their preferences. This essay thus concludes that drafters should attempt to create fewer contract law defaults than is now thought desirable.

Courts adjudicate disputes; hence, they apparently must create defaults to resolve cases of contractual incompleteness. The problems raised here affect courts as well as drafters, however. When courts do

\footnote{11. Scholars sometimes argue that a court should reconstruct the contract term that the particular parties before it would have chosen had those parties considered the issue. See, e.g., Ayres & Gertner I, \textit{supra} note 3, at 89-90 (reviewing the literature). This normative stance is not discussed here. Many default rules are in statutes or restatements. Legislators and drafters cannot adopt a contextualist approach, but rather must draft for the general case. Also, when contracting parties are sophisticated, they should be given incentives to consider problems rather than be rescued from inaction. The prevailing view holds that, when contracting parties are sophisticated, a contextualist approach is either unnecessary or unwise. For a discussion, see Charny, \textit{supra} note 5, at 1831, 1852. This essay is primarily concerned with restatement or statutory default rules and with contracts between sophisticated parties. Thus it restricts attention to noncontextualist approaches.}
face information structures (b) - (d), they respond by refusing to create problem-solving or equilibrium-inducing defaults. Rather, courts enforce a contract's verifiable terms (when this is possible) as if those terms represented the parties' complete agreement.12

D. This Essay's Scope and Purpose

Part II sets out the conventional view that default rules should solve contracting problems. This view is referred to as the "default rule paradigm." Part II then derives the acceptability constraint formally, and argues that the attempt to create normative default rules is misguided. Part III argues that it is very difficult to write problem-solving and equilibrium-inducing defaults under information structures (b) - (d) above—the "unfavorable information structures." Part III also discusses evidence relevant to this essay's thesis and concludes by stressing a consequence of contract law's inability to create many efficient default rules: most of the state-supplied problem-solving defaults that regulate contracting behavior are not contract law rules at all; rather, they are corporate law rules, partnership law rules, property law rules and so forth. Part IV argues that the state should not attempt to create transformative defaults. Part V concludes with a brief discussion of possible grounds for designing contract law rules when the default rule paradigm is inapplicable.

This essay has two goals. The first goal is to clarify important issues respecting default rules. The second goal is to move certain questions higher in the intellectual queue. For example, if drafters seldom can create good problem-solving, equilibrium-inducing, normative or transformative defaults, what are they to do? Are there considerations of justice or fairness on which contract law rules can be based when the conditions for creating helpful defaults do not obtain? These questions should receive more attention than they have been given.

II. The Default Rule Paradigm

A. The Coase Theorem and the Conventional View of Defaults

The Coase theorem holds that any allocation of legal rights is efficiency neutral if (a) the parties whom the allocation affects are

informed about relevant economic variables; (b) wealth effects are absent; (c) competitive markets exist; and (d) the cost of making transactions is zero. These four assumptions imply that if the prevailing allocation of legal rights is inefficient, affected persons would contract to the efficient allocation. The no-transaction-costs assumption underlies the default rule literature, so this essay focuses on it.

Transaction costs obviously exceed zero, but often do not prevent markets from forming. Parties in markets trade goods or services for money. They also can trade legal rights. As a consequence, the state apparently has only two relevant tasks when markets exist. First, when markets function well, the state should protect property rights and enforce trades, including trades of legal rights. Second, when markets are imperfect—that is, when some assumptions of the Coase theorem do not hold—the state should improve market performance.

Are there legitimate functions for a law of contracts in a Coase theorem world? Two noncontroversial functions are defining the contracting game and protecting parties from exploitation. Thus, contract law should contain structural and immutable rules. Contract law, however, contains a number of rules that parties are free to change. Scholars observed that many of these rules attempt to solve contracting problems. For example, parties face the contracting problem

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13. Assumption (a) in effect holds that the Coase theorem applies when potential bargainers would face information structure (a) described supra part I.B. Part III below discusses the consequences of relaxing this assumption. Wealth effects create a wedge between bid and ask prices. A large wedge can prevent trade. In that event, the allocation of legal rights will matter because private transfers of rights are precluded.

This essay ignores wealth effects for two reasons. First, as a matter of fact, they usually will be too small to matter. Two knowledgeable analysts recently summarized the prevailing view: [T]he assumption of no wealth effects is most restrictive—least likely to be valid and most likely to lead to incorrect conclusions—when the decision makers are individuals and when large cash transfers or significant changes in personal living conditions are involved. When the sizes of the cash transfers are small relative to the decision maker's financial resources, assuming that there are no wealth effects (or that they are small enough that they can safely be ignored) is more likely to be a good approximation to reality.

Paul Milgrom & John Roberts, Economics, Organization and Management 36 (1992). Default rules usually affect deals between commercial parties. These parties seldom make cash transfers when bargaining over contract terms that are large relative to their financial resources. Second, as a matter of theory, wealth effects should not affect rights allocations in the default rule context. See Richard Craswell, Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships, 49 Stan. L. Rev. 361, 385-87 (1991). The implicit assumption that parties act rationally is not discussed here; the competitive market assumption also is relaxed in Part III.

of specifying the seller’s quality obligation. The law solves this problem by requiring the seller to make a warranty when the contract is silent.\textsuperscript{15} The Coase theorem seems to suggest that solving contracting problems with legal rules should not be done. Economic actors can solve problems for themselves when well-functioning markets exist. Contract law seldom can help when well-functioning markets do not exist because courts lack the institutional competence to cure most market imperfections. Drafters and courts thus should not attempt to create problem-solving defaults.

This conclusion is unpersuasive when the no-transaction-cost assumption is relaxed. Transaction costs should be reduced whenever the costs of doing so are lower than the costs of not. Thus, the state should supply a problem-solving rule when its cost of rule creation is less than the sum that private parties would otherwise incur to create the same rule. A problem-solving rule also would be a public good if the costs to parties of solving a commercial problem would exceed the gains, so those parties would leave the problem unsolved, but the state’s cost of solving the problem would be lower than the parties’ benefit from a solution. Public good provision is a legitimate state function. In sum, the state should supply problem-solving contract law rules whenever public rule creation is efficient. These rules also should be mutable: the legal solution is enacted to solve problems for parties, so it follows that parties whose problems are not solved should be free to create their own deal.

Conventional theory also implies a criterion that should guide the state when it creates problem-solving default rules. Because a rule’s object is to reduce contracting costs, the state should enact the rules that the fewest parties would change.\textsuperscript{16} Therefore, a good problemsolving default satisfies what the Introduction called an acceptability constraint—good defaults “stick” while bad defaults do not.

B. A Derivation of the Acceptability Constraint

It is clarifying to derive the acceptability constraint functionally. To do this, assume there are \textit{n} sets of contracting parties. The set of solutions to a particular contracting problem from which a decision maker can choose is \textit{R}; the problem-solving rule she actually chooses

\textsuperscript{15} U.C.C. § 2-314 (1990).

\textsuperscript{16} A similar informal conclusion can be found in Charny, \textit{supra} note 5, at 1878: “[T]he court should choose the interpretation [of a contract] that will induce parties to expend the least effort in bargaining around the court’s interpretation.” \textit{See also id.} at 1841-42.
is \( r \in R \). A portion \( \alpha \) of the set of contracting parties \( n \) will prefer the legal default \( (0 < \alpha \leq 1) \) while another portion \( (1 - \alpha) \) will not. Assume that all parties in \( \alpha \) have the same contracting costs, as do all parties in \( (1 - \alpha) \), but the contracting costs of \( \alpha \)-type parties can differ from the costs of \( (1 - \alpha) \)-type parties.\(^{17}\) Any default rule saves each set of parties in \( \alpha \) contracting costs of \( c(r) \) because the rule substitutes for the term these parties would otherwise create. The default rule imposes on each set of parties in \( (1 - \alpha) \) contracting costs of \( c(-r) \) because they must contract for their preferred solution. An enacted default rule \( r \) saves total costs per contracting period of \( C(r) \), where \( C(r) \) is the sum (positive) of the costs avoided by the portion of contractors who accept the rule, and the sum (negative) of the costs incurred by the portion of contractors who reject the rule and create another one. The market interest rate is \( i \). Parties make contracts each period. Because contracting problems do not change rapidly, contracting cost flows can be approximated as perpetuities. Then the present value of the total cost savings from enacting a problem solving default is

\[
C^*(r) = \phi \left[ \sum_{0}^{\alpha n} c(r) - \sum_{0}^{(1-\alpha)n} c(-r) \right]
\]

where \( \phi = 1/i \). The acceptability constraint holds that the state should choose the rule \( r \) from \( R \) that maximizes \( C^*(r) \).

If parties have similar contracting costs, the acceptability constraint can be given a "democratic" interpretation: the state should choose the default rule that maximizes \( \alpha \), the portion of contracting parties who will let the rule stand.\(^{18}\) Parties in markets commonly

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\(^{17}\) The analysis is more complex, but its conclusions will not change, if more than two party types are assumed. For a model similar to the one developed here, see Ayres & Gertner I, supra note 3.

\(^{18}\) An example may clarify the analysis. Let there be \( n = 100 \) sets of contracting parties. The cost to each of creating a rule is \$1.00 per contract. The market interest rate is 7\%, so \( \phi = 14.3 \). Only three potential defaults could respond to the contracting problem at issue: rule \( r_1 \) is preferred by 42 sets of parties; \( r_2 \) by 28; \( r_3 \) by 30. Using the equation for \( C^*(r) \) derived above, \( C^*(r_1) = -$228.80; C^*(r_2) = -$629.20; C^*(r_3) = -$772.00 \). The acceptability constraint holds that a drafter should enact \( r_1 \), if she enacts any rule, because \( r_1 \) maximizes \( C^*(r) \).

To see how, realize that were there no default, the present value of the parties' total contracting costs to get the terms they prefer would be \( 100 \times $1.00 \times 14.3 = $1,430.00 \). Rule \( r_1 \) causes the parties' net contracting costs to fall to \$228.80 (what is saved by parties who like \( r_1 \) minus what is spent by parties who do not); that is, \( r_1 \) reduces total contracting costs by \$1,201.20. This is the largest possible cost savings given that only three rules are feasible. The lawmaker thus should enact \( r_1 \) if the cost of doing so is less than \$1,201.20, the maximum savings from any feasible rule. Note that choosing \( r_1 \) maximizes \( \alpha \) under \( r_1, \alpha = 42\% \); it is smaller under either of
have similar contracting costs so the advice to maximize $\alpha$ holds over a wide domain. To make this result clear, suppose that two defaults could respond to the contracting problem at issue, rule $r_1$ and rule $r_2$; $\alpha$ of contracting parties would not change $r_1$; $(1-\alpha)$ would contract to $r_2$. The costs to parties who prefer to contract to $r_2$ exceed the costs to parties who prefer retaining $r_1$ in their contracts. The total contracting costs saved under either rule are

$$C^*(r_1) = \phi \left[ \sum_{0}^{\alpha n} c(r_1) - \sum_{0}^{(1-\alpha)n} c(r_2) \right]$$

$$C^*(r_2) = \phi \left[ \sum_{0}^{(1-\alpha)n} c(r_2) - \sum_{0}^{\alpha n} c(r_1) \right].$$

The state should enact $r_2$ as the default if it generates greater cost savings—that is, if $C^*(r_2) > C^*(r_1)$. Substituting the values for these costs, the condition simplifies to

$$c(r_2) > \frac{\alpha c(r_1)}{1-\alpha}.$$

The condition becomes harder to satisfy as the parties’ contracting costs become more alike and as the majority that prefers $r_1$ increases. The number-of-rule-preferrers factor seems more significant. To see why, assume 60% of the contractors in a relevant market prefer $r_1$ ($\alpha = 0.6$). Using this value for $\alpha$ in the simplified condition, the state should enact $r_2$ only if the costs to parties who would otherwise contract for $r_2$ are more than 1.5 times as large as the costs to parties who would retain $r_1$ in their contracts. Put another way, when a relatively small majority prefer $r_1$, the state should enact it even if the contracting costs of the dissenters are 50% higher than the contracting costs of the acceptors.

Commercial parties’ contracting costs would seldom differ by this magnitude because these parties have similar expertise and similar access to the legal market. Therefore, a decision maker would seldom
go wrong if she slights contracting costs to focus on the parties’ preferences over rules.\textsuperscript{19} This analysis suggests a simple way to phrase the acceptability constraint: the state should enact the default rule that “typical contracting parties” prefer.

C. The Acceptability Constraint and Normative Defaults

Some mutable rules are enacted to bring about fair or just states of affairs. These rules are called normative defaults. It actually is unfair, Part II.C argues, to enact mutable rules on fairness grounds.\textsuperscript{20} To see why, assume regarding a set of fairness-based default rules that: (1) the state has made a prior decision to accord parties the freedom to contract; (2) a decision maker believes that possible default $r_f$ is fairer than possible default $r_e$; (3) typical contracting parties prefer $r_e$ to the fair $r_f$; (4) parties in the relevant market have similar contracting costs. Enacting $r_f$ would only waste resources. If the state did enact $r_f$, only those who prefer it would let it stand while the others would contract to $r_e$.\textsuperscript{21} Therefore, the state’s choice of a default rule cannot affect the substance of private contracts: the same number of parties would agree to contracts that contained the fair rule $r_f$ whether it was the default or not. The state’s choice of default, however, will affect total contracting costs; those costs are maximized when parties have similar contracting costs and the state chooses an undemocratic default. Increasing costs without increasing gains is unfair to the burdened parties. Therefore, it is unfair to enact defaults that violate the acceptability constraint on the ground that those defaults are fair.

There is a residual role for fairness, however. Assume that typical party preferences as between rules $r_e$ and $r_f$ are unknown; that is, it is unclear whether more parties would reject $r_f$ were it the law than $r_e$. Then, the state should adopt $r_f$ because it is fairer than $r_e$ and may not

\textsuperscript{19.} This conclusion holds for information structure (a), in which the parties have complete information. Contracting costs are more important in asymmetric-information environments. Parties may have widely differing contracting costs when they occupy different statuses, such as merchant/consumer or firm/worker. In these contexts, the possibility that a nonmajoritarian default would be efficient should be taken seriously.

\textsuperscript{20.} This argument is applicable when parties face information structure (a). The question whether the state should pursue fairness when information is asymmetric is considered briefly in Part V below.

\textsuperscript{21.} The analysis assumes that the parties’ contracting costs are less than the costs of living with rules they dislike. When this assumption does not hold, the legal rule would be immutable in fact.
violate the acceptability constraint. But if parties change $r_f$ frequently, contract law should change too; $r_e$ should become the law.\footnote{Richard Craswell has argued that moral theories may be helpful when creating what he calls "agreement rules" and what here are called structural and immutable rules. In Craswell's view, moral theories are not helpful when the task is to choose defaults. See Craswell, supra note 14, at 34-41; Richard Craswell, Contract Law, Default Rules, and the Philosophy of Promising, 88 Mich. L. Rev. 489 (1989). The analysis here is consistent with Craswell's view, for it argues that default rules should satisfy the acceptability constraint. That constraint tells a drafter or court to consider party preferences before she considers moral theories.}

D. SUMMARY: THE DEFAULT RULE PARADIGM

The Coase theorem implies what is called here "the default rule paradigm." The theorem provides that any assignment of legal rights is efficiency neutral given certain strong assumptions. Until recently, it was customary to suppose that those assumptions, except the no-transaction-costs assumption, accurately described the market transactions of sophisticated parties. On this view, the appropriate role for contract law can be summarized in three principles: the law (a) should supply structural and immutable rules when these are necessary or helpful; (b) should supply problem-solving defaults to facilitate market contracting; and (c) should not supply normative defaults except for normative defaults that also satisfy the acceptability constraint. These three principles constitute the default rule paradigm. Contract law either should not or cannot effectively pursue any other principles.

III. THE DEFAULT RULE PARADIGM AND ITS LIMITS

Part II discussed the acceptability constraint because its goal was to clarify the standard default rules theory. In that theory, the information constraint is satisfied by assumption: all information that courts and contracting parties would find relevant is supposed to be observable and verifiable. The Introduction nevertheless claimed that, even in this favorable case, contract law's generalist aspirations often prevent it from creating problem-solving defaults that satisfy the acceptability constraint. The Introduction also claimed that both constraints become difficult to satisfy when only a subset of relevant information is verifiable (information structures (b) - (d) above). These claims could be sustained with three showings: (i) parties commonly contract away from contract law defaults; (ii) problem-solving and equilibrium-inducing contract law defaults are a small subset of the legal defaults that regulate contracting behavior; and (iii) when
information structures are unfavorable, the two constraints seldom can be satisfied. This essay's goal is to clarify analysis, not to end argument. Thus it uses all three strategies of proof, but in a sketchy and preliminary way. It begins with the third showing.

A. PROBLEM-SOLVING DEFAULTS WHEN A SUBSET OF OBSERVABLE INFORMATION IS UNVERIFIABLE

The claim that problem-solving defaults are hard to create when relevant information is not verifiable is best illustrated by example.\textsuperscript{23} Consider a sale where two risk-neutral parties will exchange a product that the seller is to produce. The seller incurs a production cost \( c \) and can make a reliance investment \( s \) that will reduce \( c \); the buyer has a valuation for the product \( b \) and can make a reliance investment \( r \) that would increase that value. The parties' goal is to write a contract that induces both of them to make the investment that maximizes the gain from trade. Respecting the information structure, the seller's production cost and reliance investment and the buyer's valuation and reliance investment are assumed to be unverifiable; a court could know only the contract price and contract quantity and whether a party made a transfer that the contract specified. The seller, however, can observe the buyer's valuation and the buyer can observe the seller's production cost.

The optimal contract has a "fill in the price" feature. The parties first sign a contract that requires the buyer to pay \( T(p, x) = px + A(p) \), where \( p \) is the price, \( x \) is the quantity traded and \( A(p) \) is an adjustment to the price. After the contract is signed, the seller invests in cost reduction and the buyer invests in increasing value. Next, the seller's actual production cost and the buyer's actual valuation are observed. The seller then announces the price and the buyer decides whether to trade. If there is trade, the buyer pays the price and the adjustment \( A(p) \):

\[
A(p) = -\int_{0}^{p} \{p-c\} g(c; s^*) \ dc + t
\]

where \( t \) is a constant that divides the rents between the parties.

To see why this contract is efficient, realize first that because the seller names the price, it has monopoly power and so will set a price that equals the buyer's valuation, which it observes \( p = b \). This yields efficient trade (the buyer will pay no more than its valuation, so there will be no deal when that valuation is below seller's production cost). However, because price always equals the buyer's valuation, the buyer gets none of the realized surplus from trading; consequently, the buyer seems to have no incentive to invest optimally. The buyer actually is given the correct incentive to invest because, as the equations defining \( T(p,x) \) and \( A(p) \) show, the actual transfer the buyer makes to the seller is reduced by the expected trading surplus given the buyer's realized valuation \( b \) and the seller's optimal investment in cost reduction \( c^* \). 24 This expected trading surplus is the price (equal to the buyer's valuation) less production cost; because this surplus is deducted from the actual transfer payment, the buyer has an incentive to invest such that the expected surplus is maximized. Also, \( A(p) \) is independent of the seller's actual reliance investment and actual production cost. Hence, the seller will ignore \( A(p) \) when deciding what to do. Since the seller captures all the realized surplus by setting a price that equals the buyer's valuation (the seller then obtains \( p - c \)), the seller will invest optimally to reduce its cost \( c \). The "trick" is to award the seller the actual surplus from trade, and the buyer the expected surplus. Then each party has the correct incentive to invest optimally.

A problem-solving default rule could not replicate this contract because the default could not satisfy the information constraint. To see why, let this contract be the default and suppose that the seller breached by refusing to deliver and to name a price. The buyer then sues under the legal default for specific performance, offering to pay the price the seller should have named in the actual circumstances less the adjustment factor \( A(p) \). The court could not give this remedy because it could not name the price, which is supposed to equal the buyer's valuation, and which the court cannot recover (valuations are assumed to be unverifiable). The court also could not calculate the adjustment factor because it is a function of the buyer's valuation and the seller's optimal reliance investment; the latter too is unverifiable. Suppose instead that the buyer breached by offering the seller a transfer payment that is less than \( T(p,x) \); the seller sues for the correct transfer payment. As just shown, the court could not give this remedy.

24. The first term in the equation for \( A(p) \) is the expected surplus. \( A(p) \) also is negative, indicating that the sum it specifies is deducted from \( xp \), the amount the buyer otherwise would have had to pay.
because the factors that determine the payment are unverifiable. Thus, the efficient contract described above could not serve as a problem-solving default.

An apparent way to satisfy the information constraint would be to write a default that contained a list of sanctions linked to verifiable actions. For example, the failure to name a price at all is verifiable. The default could have the seller pay a fine of $y in this circumstance. There are two difficulties with this solution. First, the solution is partial only. To see why, let the default provide that the buyer pays a fine of $z if it offers to make a lower transfer payment than the contract required. The buyer offers the lower payment, the seller sues to collect the fine $z and the buyer defends with the claim that it offered the correct amount. The court could not adjudicate the dispute because, as just shown, it cannot calculate the appropriate payment. Second, a problem-solving default with sanctions probably would not satisfy the acceptability constraint. To see why, let the legal rule provide that the seller pays $5,000 for failing to name a price and the buyer pays $7,000 for understating the transfer payment. These general sanctions would bear little relationship to the circumstances of particular parties, so typical parties would contract out. On the other hand, contract law's generalist aspirations preclude the drafting of context-dependent sanctions.

Scholars have created a variety of solutions to the two-sided moral hazard problem just analyzed. Problem-solving defaults that attempted to replicate any of them would likely fail to satisfy the acceptability and information constraints for the reasons given here. This suggests that problem-solving defaults are hard to create when information relevant to the optimal solution is unverifiable.

B. Equilibrium-Inducing Defaults When Information is Asymmetric

An equilibrium-inducing default is unlikely to increase welfare when parties are asymmetrically informed. To see why, consider a popular problem in the literature: a firm with market power offers a

service to buyers who place different valuations on contract performance. The firm can affect the probability of its own breach by the level of precaution it takes, but the firm cannot observe the buyers’ valuations. Profit maximization implies the firm’s two goals: first, the firm would like to price discriminate, charging higher prices to buyers with higher valuations; second, it would like to condition the level of precaution it takes on buyer valuations, investing more in avoiding breach when facing buyers for whom performance is more important.

In the usual model, the seller induces buyers to reveal their valuations by offering a menu of contracts that can differ in two dimensions, the price and the liquidated damages clause. Respecting the latter, the seller optimizes its investment in precaution against the damages it must pay. Consequently, the higher the contract’s liquidated damages clause, the higher the seller’s cost, and so the higher the contract price. Contracts with high prices are less attractive to parties with low valuations.

If there are enough low-value buyers in the market to make serving them worthwhile, the seller can only induce the other buyers to reveal themselves by charging these buyers a price that is below their valuations. Thus, the high valuers earn positive surplus. Once the high-value buyers reveal themselves, however, the seller knows who the low-value buyers are. The seller then exploits them by charging prices that approach or equal the low valuations. In order to ensure that the high-value buyers do not masquerade as low-value buyers to get the low price, the seller must make the contract it offers to the low-value buyers unattractive to the high-value buyers. The seller does this by giving the high valuers liquidated damages clauses that equal their valuations while giving the low valuers liquidated damages clauses that are below their valuations. A set of contracts has been shown to exist such that (a) the contract intended for the high valuers

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gives them enough surplus and enough protection against breach to make the low valuers' contract unattractive in contrast; and (b) the low valuers prefer the relatively unfavorable contract intended for them to the contract the high valuers choose.

This solution maximizes seller profits but is inefficient. Price is above the seller's production cost, so too little of the service is purchased. Also, the seller takes insufficient precautions to prevent breach when dealing with the low-value buyers because the liquidated damages clauses they accept are below their valuations. Finally, if there are not enough low valuers to make serving them worthwhile, the seller exploits the high valuers by setting prices that approximate the high valuations; these prices exceed the low valuers' willingness to pay so they are excluded from the market. This too is inefficient because the seller could serve the low valuers at a price at least equal to cost.

The lawmaker nevertheless should consider replicating this contract solution as a problem-solving default. A rule that enacts the profit-maximizing (though inefficient) solution would satisfy the acceptability constraint because parties could not do better than the rule, and therefore would accept it. For reasons already given, however, a default could not contain contract menus; too many would be needed in a large, diverse economy. In an interesting article, Ayres and Gertner ask whether, when contracting costs are positive, a default exists that could induce better equilibria than the private solution does.\(^{27}\)

These authors assume: (a) it is costless for the seller to specify a price; (b) it costs the seller \(d\) to specify a liquidated damages clause; (c) it costs \(\lambda d\) to provide a menu, where \(1 < \lambda \leq \infty\). They then consider the effect of two defaults: (i) a rule that awards the buyer damages equal to its actual valuation in the event of breach; (ii) a rule that awards the buyer damages equal to the valuation of the lowest valuer in the market. The two defaults will induce different equilibria. Sellers have an incentive to let any default stand because contracting costs are positive, but this incentive is differentially attractive depending on the default chosen. Also, it costs a seller more to offer a menu than a

\(^{27}\) See Ayres & Gertner II, supra note 2, at 744-46, 754-60.
single liquidated damages clause, so sellers have an incentive to contract to a pooling equilibrium when they want to reject the default.\textsuperscript{28} The defaults condition differently on buyer valuations, however. Thus, a seller may be more willing to incur the relatively high contracting costs of offering a menu if it starts at one place (i.e., under one default) than if it starts at the other. A seller's incentive to contract out of the legal default also is a function of the distribution of buyer valuations the seller happens to face. For example, the seller is more concerned with causing the high valuers to reveal themselves when the difference between the high and low types is large. Ayres and Gertner calculate welfare under each of the two defaults in a number of hypothetical cases to show that an equilibrium-inducing default sometimes can improve on the unregulated market solution.

This is a valuable theoretical exercise but, as Ayres and Gertner recognize, the analysis cannot aid decision makers. The welfare-maximizing default in their model is contextual: which legal rule is best turns, among other things, on the valuations that buyers actually have. For example, their principal simulation shows that the default that awards buyers their actual valuations upon breach is best "when the value of performance for high types is either large or small, but for intermediate values" the other default is better.\textsuperscript{29} In order to know when to choose which default, the lawmaker thus would have to acquire information about parties in many markets and then solve a large number of economic problems. This procedure obviously is unworkable.

Ayres and Gertner conclude that equilibrium-inducing defaults are hard to write. This conclusion is particularly relevant here because Ayres and Gertner analyze the most favorable asymmetric information structure: their sellers cannot observe buyer valuations at contract time but those valuations are verifiable ex post. As a consequence, Ayres and Gertner can model defaults that are conditioned on buyer valuations. The assumption that courts are informed about buyer valuations but sellers are not is poorly defended, however, and seems implausible. If the assumption is dropped, the equilibrium-inducing defaults Ayres and Gertner consider would violate the information constraint; for the defaults would condition on unverifiable

\textsuperscript{28} In a pooling equilibrium, all buyers receive the same contract—here, the same price and liquidated damages clause. In a separating equilibrium, each buyer type receives a different contract.

\textsuperscript{29} Ayres & Gertner II, supra note 2, at 753.
information. The parties’ contracting costs also seem difficult to verify in court.

Current legal defaults apparently differ from the defaults Ayres and Gertner analyze: courts are said to read Hadley v. Baxendale to award a disappointed promisee the average valuation of all buyers in the market.\(^{30}\) This default also conditions on buyer valuations and so violates the information constraint. In addition, the prevailing default was chosen without regard to parties’ contracting costs; hence, it cannot induce welfare-improving equilibria. So in sum, Ayres and Gertner show that efficient equilibrium-inducing defaults are difficult to create when decision makers are assumed to have access to information that actually is hard to get. On a more plausible view of what decision makers could know, creating these defaults seems a heroic task.

Parts III.A and III.B show that problem-solving and equilibrium-inducing defaults are hard to write under the unfavorable information structures. An alternative approach to the creation of these defaults would ask whether the contracts that parties actually use in these circumstances could be copied as defaults for cases when inadvertence, lack of sophistication or high contracting costs prevent particular sets of parties from solving a problem in the customary way. This approach has not been considered and seriously evaluating it is beyond this essay’s scope.

This subpart concludes with an example that counsels against optimism.\(^{31}\) Parties to long-term contracts want to condition current trading prices on the cost and demand conditions they currently face. Thus, when the seller’s cost falls, the current trading price should also fall, and when the demand the buyer faces rises, that price should also rise. These contracts are not seen because cost and demand information often is unobservable and unverifiable. Parties instead use index clauses that condition transaction prices on verifiable information—e.g., the producer price index—that correlates with the cost and demand conditions the parties expect to face. Although index clauses are common, they cannot ameliorate the difficulty explicated here because these clauses are tailor made, with the type of index varying with the particular deal.\(^{32}\) An attempt to write a contract law default

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31. The example is drawn from Schwartz, supra note 12.
32. In long-term contracts, there is enough at stake for the parties to do this.
index would thus violate the acceptability constraint because too many parties would change it.

C. THE DYNAMIC INSTABILITY OF CONTRACT LAW

The evidence is consistent with the view that contract law has difficulty creating defaults that satisfy the acceptability and information constraints. Initially, there are numerous examples of contracting out. International sales contracts, for example, face the risk of currency fluctuations but deal with the risk in a variety of ways. All sale-of-goods contracts face the problem of specifying product quality, but solve this problem in a variety of ways.\(^\text{33}\) The analysis of equilibrium-inducing defaults implied that parties will contract away from the current consequential damages rule because that rule conditions on unverifiable information. The impressionistic evidence also supports this prediction, showing that commercial contracts routinely exclude liability for consequential damages when these are expected to be substantial.\(^\text{34}\) Other examples of contracting out are given elsewhere.\(^\text{35}\) This evidence suggests that contract law contains few defaults that satisfy the normative constraints.

Contract law's inability to create good defaults also can be supported by showing that laws that regulate contracting behavior constitute a large part of bodies of law that are not contracts. The dominant intellectual view in the corporate field holds that a corporation is best understood as a "nexus of contracts" between the various factors of production.\(^\text{36}\) The "corporation" actually is the set of contracts between the corporate entity and its suppliers of labor (employees and managers), capital (lenders, shareholders, suppliers of tools and goods), and customers. To understand the corporation is to understand the economic factors that influence these contracts.

The state supplies a large number of defaults that facilitate corporate contracting behavior. These defaults, however, are in the legal

\(^{33}\) U.C.C. § 2-314(2) (1990) is a problem-solving default: it responds to the problem of specifying the contract quality by providing that merchant sellers assume the risk of providing goods that pass without objection in the trade or are fit for the ordinary purposes for which such goods are used. As the text indicates, contracts governing the sales of complex products routinely disclaim the 2-314 warranty in favor of describing the quality obligation with particularity.


\(^{35}\) See Schwartz & Scott, supra note 4.

areas of employee relations law, corporate law and debtor-creditor law. As examples, employee relations law now regulates discharge extensively but often permits parties to write explicit contracts that vary the legal rules. In addition, states supply corporate codes that regulate important aspects of corporate behavior such as shareholder voting and director responsibilities, but many provisions in these codes are given effect unless otherwise agreed upon. Furthermore, debtor-creditor law regulates the order of payment among creditors of an insolvent firm, but that order can be varied by contract. This brief analysis of the corporate context suggests that when acceptable defaults are important to have, the state supplies them with lawmaking techniques that respond more sensitively to context than contract law can.

Finally, the analysis here predicts that contract law will continually dissolve into other legal fields. Earlier scholars remarked this process, reporting that when a commercial area becomes mature—that is, it generates many cases and much interest—the law regulating that area splits off from contracts to become insurance or corporations and so forth. An important initial contribution of law-and-economics scholarship was to identify a unity under this apparent diversity. The new scholarship claimed that, despite the labels “insurance” or “corporations,” these bodies of law actually regulated contracting

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40. See, e.g., Lawrence M. Friedman, *Contract Law in America* 24 (1965). A well-known contracts scholar of an earlier generation, Addison Mueller, attempted to accommodate this trend by teaching a contract law course primarily by focusing on particular industries such as construction. A residue of this commitment remains in the successor casebook. See Arthur Ross, *Contract Law and Its Application* xx (4th ed. 1988). This early stress on context may have derived from Llewellyn's emphasis on the relevance of transaction types and his claim that doctrine should be matched to fact situation. See, e.g., Karl N. Llewellyn, *What Price Contract?—An Essay in Perspective*, 40 Yale L.J. 704 (1931); K.N. Llewellyn, *On Our Case-Law of Contract: Offer and Acceptance* (pts. 1 & 2), 48 Yale L.J. 1, 779 (1938-1939); K.N. Llewellyn, *Across Sales on Horseback*, 52 Harv. L. Rev. 725 (1939); K.N. Llewellyn, *The First Struggle to Unhorsel Sales*, 52 Harv. L. Rev. 873 (1939). Llewellyn thought that context could be made appropriately influential by delegating decision-making authority to courts under vaguely stated legal doctrine, not by creating specific, context-sensitive defaults. Thus he neither explained, nor likely would approve of, the dissolution of contract law into other legal fields.
behavior and thus were a species of contract law. This essay shows, in sympathy with the earlier scholars, why much "contracting law" is not contract law. The Coase theorem implies that most rules that regulate contracting behavior should be defaults; the analysis here shows that a body of law that regulates over as wide a range as contract law could contain few defaults. As a consequence, when a related set of contracting problems is perceived to exist, affected parties, and sometimes decision makers, press for the creation of a new legal field. Contract law does not regulate the new field, but default rules commonly do.

IV. TRANSFORMATIVE DEFAULTS

Part II.C above argued that the law should largely ignore fairness considerations when choosing default rules because fair but unacceptable defaults raise transaction costs without affecting contract content. This argument may be thought to rest on an unduly narrow view of the role that law can play. Legal rules can have two functions, broadly speaking. The "substantive function" of a legal rule is to affect outcomes directly: rules can command, prohibit or facilitate particular actions or the occurrence of states of affairs. The "transformative function" of a legal rule is to change preferences: rules can teach what good actions or states of affairs are. This essay's argument can be criticized on the ground that it neglects the transformative function that contract law default rules can perform. This Part argues, in opposition, that decision makers should not pursue the transformative


42. A notable recent example of this trend is products liability law, which began as contracts, then became the less general sales law and ultimately coalesced into the specific field of products liability itself. Another example is the latest revision of the U.C.C., which now contains a separate article regulating leases, thereby removing many aspects of "lease law" from contracts and property.

43. Grant Gilmore claimed that contract law itself was in the process of dissolving into torts, in which he included products liability. See Grant Gilmore, The Death of Contract (1974). To dissolve contract into tort would be a less radical break than might initially appear because a similar intellectual approach should be taken to problems in both fields. See, e.g., Jules L. Coleman, Contracts and Torts, 12 Law & Phil. 71 (1993); Robert Cooter, Unity in Tort, Contract, and Property: The Model of Precaution, 73 Cal. L. Rev. 1 (1985). Professor Gilmore, however, chose the wrong field: contract law is continually in the process of dissolving, not so much into tort as into bodies of law that primarily regulate market contracting.

44. An argument that contract law necessarily plays a transformative role and should do so self-consciously is in Roberto M. Unger, The Critical Legal Studies Movement, 96 Harv. L. Rev. 561 (1983). The transformative function is discussed in connection with default rules in Charny, supra note 5, at 1857-68.
function in connection with the choice of default rules for two reasons. First, a default is unlikely to produce much transformation. Second, the task of choosing those defaults that could transform preferences is poorly understood.

It is helpful to begin by remarking that a transformative default is chosen to violate the acceptability constraint: these defaults are enacted to change preferences, not to satisfy them. Unacceptable defaults are unlikely to alter preferences, however. A rule could transform preferences in two ways: (a) a state claim, crystallized in the form of a law, that certain behavior is morally desirable may cause persons to reconsider their own views; (b) living under a rule may persuade people of the rule's moral virtues. The latter possibility is excluded for unacceptable defaults because parties will contract away from them. The former possibility, then, is just a possibility: for persons are unlikely to abandon considered views merely because the state enacts a nonbinding rule that these persons think is objectionable. People are more likely to reject the objectionable rule than to reject their own views.

Moreover, the transformative function should not be pursued in connection with defaults unless this speculation can plausibly be resisted. To see why, realize that it can be said of any legal rule that people whom the rule affects will come to see the wisdom behind it. Thus, a lawmaker could choose many defaults on transformative grounds in the hope that parties ultimately will adopt the values on which the rules rest and thus let the rules stand. If this hope is unrealistic, or unrealistic in the short run, the decision maker would have neglected contract law's commitment to facilitating private contracting for she would be enacting defaults whose immediate and possibly only effect would be to raise transaction costs.

The lawmaker thus faces a "when-to-stop problem." A strong commitment to facilitation would preclude choosing any default because of its possible transformative properties, yet a strong commitment to the transformative function could vitiate facilitation. At the least, there should be a presumption in favor of facilitation. Many substitutes for the transformative function that legal rules can play exist: moral education and education in how best to live can occur in homes, schools and religious institutions. On the other hand, there are few good substitutes for markets. Thus, it seems better to ask when transformation is sufficiently important to override the law's general commitment to facilitation.
It would be best to ignore transformation altogether. Contract law has not developed good solutions to the when to stop problem in connection with its choice of immutable rules. Immutable contract law commonly is highly abstract. For example, parties cannot contract out of the obligations to behave conscientiously and in good faith.45 Immutable rules thus delegate the "when-to-stop" question to courts, who are supposed to give content to the abstract prohibitions in the course of deciding cases.

The delegation solution cannot work for transformative defaults. These rules must preexist particular deals, for it is the prior existence of the rule that is supposed to persuade parties to prefer it. Thus, the when-to-stop problem must be solved for default rules at the level of rule choice, not at the level of the concrete case. There now are no solutions to the problem at this level. This difficult-to-fill gap and the state's general commitment to facilitating market contracting together suggest that the state should not enact transformative defaults.

V. CONCLUSION: THE NEED FOR NEW APPROACHES

The default rule paradigm has played a central role in contracts scholarship, and thus has attracted considerable criticism. Some of this criticism is similar to comment on the Coase theorem, from which the paradigm is derived. The theorem has been criticized because its showing that parties will contract to the efficient outcome when transaction costs are absent lacks practical significance; transaction costs always are present. Coase and others have replied that this criticism is beside the point; the theorem actually is meant to focus attention on the importance of transaction costs.46

In a similar vein, stating the default rule paradigm precisely is meant to focus attention on the importance of context and a contract's information structure. Respecting context, it always is possible, in theory, to write problem-solving defaults that satisfy the acceptability constraint when contract parties are symmetrically informed about relevant variables and a court also could be informed about those variables. Few problem-solving defaults are acceptable in every context, yet contract law rules are meant to apply very broadly. As a

consequence, legal default rules that can satisfy the acceptability constraint commonly are found in more context-sensitive fields than contract law. Respecting the information structure, parties often cannot observe important information about their contract partners or about relevant states of affairs, and sometimes cannot prove in court at acceptable cost the existence of facts that they know to exist. When these unfavorable information structures obtain, it is extremely difficult to write acceptable problem-solving or equilibrium-inducing defaults.

An apparently plausible response to these difficulties is to rest defaults on fairness considerations. This response is deeply problematic. Normative defaults, which attempt to encourage but not require fair outcomes, raise transaction costs without affecting contract content unless those defaults also solve contracting problems in acceptable fashion. Thus, decision makers should search for acceptable rather than fair solutions. The law perhaps could teach people to prefer contracts that are fairer than those now in use. However, altering preferences through the choice of defaults is a task that no one knows how to perform.

These conclusions raise the question what lawmakers should do apart from creating immutable and structural rules. This question seldom should, and apparently seldom does, trouble courts when every member of the set of solutions relevant to a particular contracting problem would satisfy the information constraint. Judges do not "create a contract law" but rather decide cases. Thus, a court adjudicating a contract dispute that involves computers may develop a problem-solving default rule that applies only to computer contracts. Good lawyers will recognize that this is a computer rule, not a contracts rule. When enough such cases are decided, a "computer law" will come to exist. This is how bodies of commercial law form.

Courts do have a problem, however, when potential rules relevant to a situation would fail the information constraint. As shown elsewhere, courts respond to this problem by refusing to write defaults at all.47 Rather, courts pursue the passive strategy of enforcing the verifiable terms as written. For example, when economic changes have made a contract's pricing term obsolete, courts will not write a changed circumstances default, but will instead grant specific performance or market damages based on the contract's pricing term.

47. See Schwartz, supra note 12.
Lawmakers who work at the level of the system, such as a contracts restater or a Uniform Law Commissioner, seemingly cannot avoid either the context concern or the information concern, however. The question how these drafters should choose mutable rules to govern situations when defaults are so hard to write as yet has no good answer.\(^{48}\)

A bad answer is that lawmakers should choose contract law rules to achieve distri[utional fairness. Courts lack the information to make dyadic distributional comparisons (should wealth be shifted from this defendant to this plaintiff?).\(^{49}\) Further, when parties have homogeneous preferences for contract terms, no generally applicable distributional rule could satisfy the acceptability constraint unless the rule also is efficient; the market will reject the inefficient term.\(^{50}\) Finally, when party preferences over terms are heterogeneous, it is possible in theory to benefit a favored distributional group, but drafters would require more information to do this than they are likely to have.\(^{51}\) Thus contract law should not contain “distributional defaults.”

Another unsatisfactory response to the inquiry made here is to derive problem-solving defaults from a theory of corrective justice. Any such theory would hold that defaults should protect contractual rights or sanction wrongful conduct in connection with contracts that

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\(^{48}\) In articles in this symposium, Steven Burton argues that courts should choose defaults that best prevent contractual breakdown and Jay Feinman argues similarly that defaults should preserve the parties' relationship. See Steven J. Burton, Default Principles, Legitimacy, and the Authority of a Contract, 3 S. Cal. Interdisc. L.J. 115 (1993); Jay M. Feinman, Relational Contract and Default Rules, 3 S. Cal. Interdisc. L.J. 43 (1993). These solutions do not respond to the difficulties this essay considers. When parties create contracts, they have an incentive to choose terms that will preserve their ex post relationship in circumstances when preservation would maximize their joint gains; and they have an incentive to contract away from legal rules that fail to serve this goal. Therefore, a court that chooses a default rule to prevent contractual breakdown is supplying a solution to parties who did not solve the problem of how to achieve ex post efficiency on their own. Professors Burton and Feinman's work, though not cast in economic terms, is thus in the genre of default rule scholarship that offers solutions to common contracting problems. As such, that work is subject to the criticisms made here. David Slawson argues that courts should not create defaults but rather should decide cases by making “findings of fact” that lack precedential value. See W. David Slawson, The Futility Search for Principles for Default Rules, 3 S. Cal. Interdisc. L.J. 29 (1993). Since contractual interpretation often raises issues that are not factual, in the conventional sense of the term, this approach seems unhelpful.


\(^{50}\) This is a well-established law-and-economics result. A clear statement of this result may be found in Craswell, supra note 13, at 368-70.

\(^{51}\) See id. at 376-77.
harms others. The former aspect of the theory seems unhelpful because contractual rights come from the parties’ contract, but defaults are necessary only when the contract is incomplete. Some corrective justice theorists argue that economic solutions have epistemological relevance to incomplete contract cases: the solution to a contracting problem that typical parties would adopt is the best evidence, *ceteris paribus*, of what the parties at bar would have done had they dealt with the matter. Hence, to enforce the economic solution is to protect a party’s rights. This approach is coextensive with the economic approach when the rules under consideration would satisfy the information constraint; both approaches then direct the decision maker to choose acceptable defaults. When information structures are unfavorable, however, the difficulties that derail the economic approach also would derail the corrective justice approach; there do not seem to be acceptable defaults to write. The second facet of corrective justice, which focuses on wrongful behavior, is not relevant to this essay’s concern. Wrongful conduct that interferes with contractual rights is a tort.

Moral and political philosophers, other than the corrective justice theorists, appear to have slighted the question how the state should justly resolve conflict between parties whose commercial relationship has foundered. Instead, philosophers have focused on especially dramatic cases such as abortion, or have sought to create theories that explain society’s “basic” institutions, the meaning of political liberalism or the nature of constitutional adjudication generally.

Perhaps scholars have taken this focus because the question asked here lacks philosophical interest. The inability of drafters or courts to write efficient or otherwise desirable defaults does not systematically disadvantage the poor or other groups commonly thought deserving of help. Rather, the losses from poor defaults fall unsystematically on parties who can anticipate them when deciding whether to play the commercial game. Losses of this type perhaps should be left where they fall. This is an unsatisfactory resolution of the question put here because the state should be reluctant to take on tasks


53. Some philosophers distinguish between chosen and random bad luck. A losing commercial deal illustrates the former: the loser chose to speculate. Being born in wretched circumstances illustrates the latter: the assignment of babies to parents is random, not chosen. The state is said to have a duty to mitigate the consequences of random bad luck, but considerations of autonomy and efficiency imply that the state has no duty to remedy the consequences of
that it will do badly. The issue thus is whether a contract law can contain good defaults in light of the difficulties discussed above, or whether the task of creating defaults should be assigned to legal fields other than contracts. 54

chosen bad luck. That courts will not create defaults when the information constraint cannot be satisfied disadvantages parties who choose to write contracts with unfavorable information structures. On the view discussed here, the state has no good reason to mitigate the consequences of the bad luck these parties may experience. A thorough exposition of the distinction between types of luck is in Eric Rakowski, Equal Justice (1991). For a thoughtful criticism, see William Ewald, On a New Theory of Justice, 82 Cal. L. Rev. (forthcoming Jan. 1994) (book review).

54. There has been a recent movement in the states to create specialized commercial courts, apparently in the hope that these courts will attract outside firms. A more important long-term effect may be to transform contract law. Specialized commerical courts may develop sufficient expertise and be sufficiently attentive to context to create more acceptable problem-solving defaults.