THERE ARE NO PENALTY DEFAULT RULES IN CONTRACT LAW

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ABSTRACT

In an influential article, Ian Ayres and Robert Gertner introduced the concept of the "penalty default rule," a rule that fills a gap in an incomplete contract with a term that would not be chosen by a majority of parties similarly situated to the parties to the contract in question. Ayres and Gertner argued that such a rule might be efficient in a model in which contracting parties have asymmetric information. However, Ayres and Gertner did not provide any persuasive examples of penalty default rules; their best example is the Hadley *rule, but this rule is probably not a penalty default rule. It turns out that there are no plausible examples of penalty default rules that solve the information asymmetry problem identified by Ayres and Gertner. The penalty default rule is a theoretical curiosity that has no existence in contract doctrine.*

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I. INTRODUCTION

Ayres and Gertner's influential article, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*,[1] introduced the concept of the "penalty default rule," which is a rule that fills a gap in a contract with a term that would not be chosen by a majority of parties similarly situated. The purpose of penalty default rules, Ayres and Gertner argued, is to force parties to reveal private information, which enables their counterparts to perform more efficiently than they would if left uninformed.[2]

At the time Ayres and Gertner wrote their article, many law-and-economics scholars believed that default rules should reflect the preferences of a majority of similarly situated parties.[3] Ayres and Gertner showed that this view is not necessarily correct if parties have private information when they bargain with each other prior to entering a contract. If they do, and if various other assumptions hold, then penalty rather than majoritarian default rules are optimal.[4] Establishing this normative claim was the main purpose of their article, and it is not my goal here to quarrel with it.[5]

Ayres and Gertner also made a positive claim: they argued that many default rules are, in fact, penalty default rules. Their central example was the rule of *Hadley v. Baxendale*, a case which held that a carrier was not required to pay damages for losses that were an unforeseeable consequence of his breach. They also cited the "zero quantity" default rule in U.C.C. section 2-201 and a handful of other doctrines.

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

2. *Id.* at 91.

3. Although, several scholars had identified the information-forcing benefits of non-majoritarian default rules such as *Hadley v. Baxendale*, (1854) 156 Eng. Rep. 145 (Exch. Div.), the case that was the focus of Ayres and Gertner's article. *See* Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 735 n.24 (1992). Earlier papers with this insight include Charles J. Goetz & Robert E. Scott, *Enforcing Promises: An Examination of the Basis of Contract*, 89 YALE L.J. 1261, 1299-1300 (1980), and John H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL STUD. 277 (1972).

4. A similar argument was made roughly contemporaneously by Bebchuk and Shavell. *See* Lucian Ayre Bebchuk & Steven Shavell, *Information and the Scope of Liability for Breach of Contract: The Rule of* Hadley v. Baxendale, 7 J.L. ECON. & ORG. 284 (1991).

5. Nor do I have any disagreement with those who have used the penalty default idea to investigate similar phenomena in other areas of the law such as statutory interpretation, *e.g.*, Einer Elhauge, *Preference-Eliciting Statutory Default Rules*, 102 COLUM. L. REV. 2162 (2002), or with those who have developed new justifications for penalty default rules such as paternalism. *E.g.*, Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211 (2003); Cass R. Sunstein & Richard H. Thaler, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003).

However, on closer inspection, none of the examples they provide in their original or subsequent papers turn out to be a clear penalty default rule. The *Hadley* rule is probably not a penalty default rule and, in any event, is certainly not a clear example of one. The zero-quantity default rule is not a default rule but an element of a legal formality. The other examples in the Ayres and Gertner article are not existing legal rules at all, but proposals for legal change. Rules cited by Ayres in subsequent scholarship as examples of penalty default rules are not default rules but instead are contract formation rules or interpretive presumptions. Nor have other scholars identified clear examples of a penalty default rule. And, in my own research, I have been unable to find a clear example of a penalty default rule or an example of an authoritative legal decisionmaker, such as a court or legislature endorsing a penalty default rule for reasons related to the factors identified in Ayres and Gertner's model. All of this suggests that there is no such thing as a penalty default rule; penalty default rules simply do not exist or are not a distinctive doctrinal category.

Part II of this Article recapitulates Ayres and Gertner's *Hadley* analysis. Part III looks at the doctrine. The Conclusion speculates about why there are no penalty default rules in contract law and whether it matters.

II. ANALYSIS

A. *Preliminaries*

Default rules are rules that, in Ayres' succinct formulation, "govern in the absence of contrary agreement."[6] As I will discuss presently, there is confusion in the literature about what rules count as default rules and what rules belong to other categories. To clarify these issues, I will use the following framework—Imagine that a party claims breach of contract, and seeks damages. The court must (1) determine whether contract formalities are satisfied; (2) if so, determine whether there was real consent (not fraud, duress, mistake); (3) if so, determine what the contract says; (4) if there is a gap (that is, if the contract does not address the contingency that caused the dispute), apply a default rule; and (5) if an explicit or implied term was violated, award a remedy.

The rules that are applied at each conceptual stage have different functions and effects. In step 1, courts apply contract formation rules such as the offer/acceptance doctrines, the consideration doctrine, and the statute of frauds. In step 2, courts apply rules that determine

6. Ian Ayres, *Default Rules for Incomplete Contracts*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 585, 585 (Peter Newman ed., 1998).

whether the parties consented, such as rules governing fraud, duress, and mistake. In step 3, courts apply rules of interpretation, including interpretive canons and the parol evidence rule. In step 4, courts apply default rules. In step 5, courts award damages or other remedies.[7] Thus, the focus of this Article is step 4.

Arguably, interpretive rules are analytically the same as default rules. Often contracts have a term that can be reasonably interpreted in multiple ways. One normally says that courts resolve ambiguities by applying interpretive presumptions, but one might with equal accuracy say that ambiguities exist because parties fail to anticipate that the term will have more than one possible meaning, that therefore such contracts involve a "gap" where one would otherwise find a definition that eliminates the ambiguity, and that courts fill the gap using a default rule. Although I will generally treat interpretive presumptions as their own category, in Part II.D, I address the argument that they are identical to default rules and conclude that even if they are default rules, they are not *penalty* default rules.

Because one of my arguments will be that doctrines that are frequently identified as default rules are not default rules at all, I want to emphasize here that I am not defining the category out of existence; there are many real default rules. The obvious marker is the "unless otherwise agreed" phrase, which is almost always attached to a default rule but never to other types of rules such as legal formalities and contract formation rules. Here are a few random examples from the U.C.C.: "reasonable price" if the price term is left open, "best efforts" in exclusive dealing contracts unless otherwise agreed, delivery in single lot unless otherwise agreed, delivery at seller's place of business unless otherwise agreed, reasonable time for delivery if delivery time left open, payment due at time and place of delivery unless otherwise agreed, assortment of goods is at buyer's option unless otherwise agreed, merchant sellers warrant that goods are free of claims of third parties unless otherwise agreed, implied warranty of merchantability unless excluded or modified, and implied warranty of fitness unless excluded or modified.[8] Indeed, virtually every section of part 3 of article 2 contains one or more default rules.

By contrast, legal formalities (step 1), such as the statute of frauds, cannot be avoided by agreement, nor can contract formation rules (step 2: offer/acceptance, fraud) or interpretation rules (step 3). In my schema, remedial rules (step 5) simply implement default

7. As is standard in the law-and-economics literature, I treat remedial rules like expectation damages and the *Hadley* rule as a default rule (step 4); in which case step 5 should be interpreted as the court, in essence, enjoining the defendant to carry out the implicit term (say, expectation damages) created by a default rule in step 4, if there is no explicit liquidated damages clause identified in step 3.

8. U.C.C. §§ 2-305, -306(2), -307, -308, -309, -310(a), -311(2), -312(3), -314, -315 (2005).

rules that are used to fill gaps; otherwise, they may be immutable rules (like the penalty doctrine and restrictions on injunctions).

Ayres and Gertner's model applies to step 4, the application of default rules. They say little about step 3, the stage at which courts determine whether there is a gap. I will say more about this step later. For now, let us focus on default rules and Ayres and Gertner's chief example of a penalty default rule, the rule of *Hadley v. Baxendale*.

B. Full Information

In *Hadley v. Baxendale*, a miller hired a carrier to transport a crankshaft. The carrier failed to deliver the crankshaft on time. The miller was unable to operate his mill and lost profits—that is, incurred consequential losses. The contract itself did not have a term that said what would happen if the crankshaft was delivered late—for example, whether the carrier should pay damages equal to the miller's losses, should refund the fee, or something else. Thus, the contract had a gap. The *Hadley* rule is, in essence, that the carrier does not have to pay damages for the consequential losses unless they are foreseeable or communicated in advance. However, if the parties choose, they may agree in the contract that the carrier should pay the consequential losses. Thus, the default rule is foreseeable losses, but the parties can opt out of the default—that is, fill the gap—by agreeing to liability for consequential losses at the time that they enter the contract.

To understand Ayres and Gertner's analysis of *Hadley*, one can best begin with a simpler version of the example that they analyze. Suppose that at the time that the miller and the carrier enter their contract, the miller values performance at some amount, V. The valuation can be low (V_L) or high (V_H); let us suppose that the valuation could be either with equal probability, and $E(V)$ is the mean of V_L and V_H. The carrier can deliver using normal care at low cost (C_L) or using a high level of care at high cost (C_H). When the valuation is high, the optimal contract provides for high care; when the valuation is low, the optimal contract provides for low care. I assume full information.

Let t refer to transaction costs, which increase with the complexity of the transaction. If the contract does not refer to care level, transaction costs are low; if it does, transaction costs are high.

If the default rule is that a carriage contract with a gap requires the low level of care, then the carrier will offer a simple contract (with a gap) to all low types. In the case of the high types, the carrier must choose between offering the simple contract (which will result in inefficient care but incur only low transaction costs) or the complex contract (which will result in efficient care but also incur high transaction costs).

If the default rule is that a carriage contract with a gap requires the high level of care, then the carrier will offer the simple contract to all high types. In the case of low types, the carrier must choose between offering the simple contract or the complex contract—again, depending on the transaction costs and precaution inefficiencies.

Assuming that the cost of transacting around is the same for low types and high types and that the inefficiency resulting from the failure to contract around is the same, then the optimal default rule will just be the rule that benefits a majority of the shippers. If most shippers are high types, then the default rule should be high precaution; otherwise, the default rule should be low precaution.

Note that under this reasoning the majoritarian rule is not the best rule if—for whatever reason—the transaction costs for the majority type are much less than the transaction costs for the minority type. If, for example, there are five high types and four low types, but it costs high types $10 to opt out and it costs low types $20 to opt out, then the default rule should be the low-precaution rule preferred by the low types (assuming that both types prefer opting out to inefficient precautions). When the default rule is minoritarian, the majority high types opt out at a cost of $50; when the default rule is majoritarian, the minority low types opt out at a cost of $80.

The *Hadley* rule is a slightly more complicated version of my low-precaution default rule. Rather than saying that the default is low precaution, it says that the shipper is entitled to damages that would be available to the low type. Failure to contract around the low-precaution default rule and the *Hadley* rule would lead to the same result: a low level of care. The only difference is that the carrier that engaged in the low level of care would pay nothing under my default rule, whereas it would have to pay a low level of damages under the *Hadley* rule if the low level of precaution resulted in delay.

As noted above, scholars and courts typically say that a court applies a default rule only if there is a "gap" in the contract. This has led to some confusion because no contract can mention all possible events, and so how can a court tell whether a gap exists? The answer is interpretation. A typical contract dispute is caused by some contingency—the goods are destroyed in transit, a strike causes a delay, and so forth—and courts try to ascertain from the contract whether the parties anticipated the contingency and explicitly allocated obligations in case that it occurred. If the contract mentions the contingency and explicitly allocates obligations (for example, "If the goods are destroyed in transit, then . . ."), then the court will not find a gap. If the contract is silent, then the court will find a gap. Many cases are ambiguous—the contract may mention a broad class of events in which the contingency may fall, for example—and in these cases courts apply general interpretive canons to resolve the ambiguity. Having done so, the court might decide that a gap does or does not exist.[9]

C. Asymmetric Information Between Parties

Suppose there is asymmetric information. The carrier does not know the type of any particular customer but does know the distribution of types, and thus knows *E(V)*. Again, optimally the carrier takes high care with high-type millers, and low care with low-type millers. But if the carrier does not know the type of miller, he will take average care, which is too low for high-type millers and too high for low-type millers. Too much or too little care results in inefficiency. The inefficiency results because some parties with private information do not want to reveal it. They do not want to reveal their private information because if they do, then they will have to pay a higher price, and this cost would exceed any benefit from the better level of care, because part of the cost is externalized on other parties.

The existence of such information externalities is not a *sufficient* reason to abandon majoritarian default rules. The carrier has an incentive to discover the types of the millers and an easy way to do so. The carrier has an incentive to discover the types because, if he knows the types of millers, then he can provide optimal care and the right price for optimal care, undercutting competitors who fail to do so. The carrier's easy way to discover the types is to offer a menu of contracts—a high-price, high-care package, and a low-price, low-care package. If the default rule is majoritarian, then the carrier can save transaction costs by offering simple contracts to the majority type (say, low), and the complex contract—which specifies level of care—for the high type. The default rule would specify low care because that is what a majority of the parties would want.

But conceivably the majoritarian default rule could be inferior to a penalty default rule. As in the full information case, one reason might be that it is sufficiently more expensive to write complex con-

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9. One last point concerns the difference between what Ayres and Gertner called "tailored" and "untailored" defaults. To understand this distinction, note that a court might try to fill a gap with exactly the term the two parties to the dispute would have chosen if they had anticipated the dispute—in other words, the term that would have maximized the *ex ante* value of the contract to the two parties. Alternatively, a court might try to fill a gap with the term that most parties to similar contracts would have chosen. The difference between these approaches is that the first involves applying a standard and the second involves applying a rule. The economic analysis of this difference is identical to the general economic analysis of rules versus standards, one that involves trading off the decision costs incurred by courts and the efficiency loss resulting from applying a rule, which is always under- or overinclusive. I will assume (except where I state otherwise) that courts make decisions costlessly, in which case they should always fill gaps with the efficient terms (by applying standards) rather than by applying rules. In the present analysis, the efficient term is just whatever term that would have maximized the *ex ante* value of the contract to the two parties, independent of any effect on third parties.

tracts for high types than for low types. There is no reason to think this might be likely, but it is a theoretical possibility.

Another reason—the focus of Ayres and Gertner—is that the information externality is (sufficiently) higher when the minority fails to contract around than when the majority fails to contract around. Again, there is no particular reason to think this is so, but it is possible.

However, even if these outcomes are possible, they are not plausible. Real people do not divide into majority types and minority types; there is most likely a distribution of valuations best imagined as continuous, perhaps a truncated normal curve or a uniform distribution or something similar. If this is what the world looks like, then the majoritarian default rule will usually favor parties with the mean valuation, or valuations close to the mean, and disfavor parties with valuations at both tails. But there is nothing about being at a tail in a distribution that would make it likely that the parties have idiosyncratically high transaction costs.

A further puzzle is why, as Ayres and Gertner seem to assume, majoritarian default rules and penalty default rules would coexist. The *Hadley* model is quite general and can be applied to any element of a contract—not just damages, but price, assignability, location of delivery, and so forth. There is no reason to think that information externalities pose more of a problem when parties omit a damages term than when parties omit a price or assignment term. Default rules of the kind found in the U.C.C. operate at a high level of generality and are not necessarily specific to any market.[10] If Ayres and Gertner's claim that the *Hadley* rule is a penalty default rule is correct, then one would expect all general default rules to be penalty default rules. If it is not correct, then one would expect all general default rules to be majoritarian default rules.

In sum, penalty default rules can be efficient relative to majoritarian default rules but only if one makes special assumptions. These assumptions strike me as implausible, but others may disagree. I have argued elsewhere that it would be difficult to show that these assumptions are valid, and I will not repeat that argument here.[11]

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10. As Scott and Schwartz note, the default "rules" in the U.C.C. seem a lot more like general standards than rules. They argue that such vague standards do not provide guidance and are largely unhelpful. *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 601 (2003). I am not sure I agree with them, but the point here is that the various default rules in the U.C.C. apply to settings that seem, analytically, extremely similar, so it is hard to see why some would be penalty default rules and others would be majoritarian; given the similarity of the settings, one would expect all to belong to one type or all to belong to the other type.

11. Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829 (2003). Alan Schwartz has also long expressed skepticism about the ability of judges to choose optimal penalty default rules. *See, e.g.*, Alan Schwartz,

D. Asymmetric Information Between Parties and Courts

Although the bulk of Ayres and Gertner's original article provides a model of asymmetric information as between parties, they frequently justify penalty defaults on the basis of an entirely different theory. This theory points out that courts are expensive and fallible institutions. If a contract has a gap, the courts must lumber into action and try to determine the efficient term. But this is difficult and costly, so it would be better for parties to supply the term *ex ante*. To encourage parties to fill gaps at the time of contracting, courts should use penalty defaults. To avoid the bad outcomes created by penalty defaults for the majority of parties, this majority will fill gaps, thus simplifying the task for courts in most cases. By contrast, if people know that courts enforce majoritarian rules, they will feel less urgency about specifying terms in their contracts, knowing that the courts may do a good enough (even if not perfect) job.

There are two ideas here, and they must be carefully distinguished. The first idea is that courts use legal doctrines to encourage contracting parties to provide sufficient detail in their contract, so that judicial interpretation in case of dispute will be guided by the *ex ante* intent of the parties, rather than by judicial guesswork. This idea was advanced by Lon Fuller, who argued that legal formalities serve this evidentiary function.[12]

The second idea is that penalty default rules (in addition to legal formalities) serve the function of encouraging parties to produce specific rather than vague contracts. Ayres and Gertner argue that penalty default rules encourage specificity by penalizing parties—giving them what they would not have wanted—who agree to vague contracts.

The first idea is plausible, but the second idea—that penalty default rules are the cure—is less persuasive. As to the diagnosis, there is no doubt that in a simple economic model, the parties have an incentive to externalize their costs on courts. One way of doing so may be to leave gaps in their contracts in the expectation that courts will fill them properly in case there is a dispute.

But the obvious remedy to this problem is to charge parties a fee for using the court system. They are charged modest fees already; perhaps the fees should be higher and especially for contract cases. Another obvious remedy—noted by Ayres and Gertner—is to refuse to enforce indefinite contracts. Traditionally (though less so today), courts would refuse to enforce indefinite contracts even if they were

The Default Rule Paradigm and the Limits of Contract Law, 3 S. CAL. INTERDISC. L.J. 389, 416 (1993).

12. Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799 (1941).

sufficiently definite to resolve the dispute in question.[13] Thus, when parties draft a contract, they will fear leaving a gap lest a court refuse to enforce the contract on grounds of indefiniteness—even if the gap has no bearing on the dispute before the court—so that whichever party would benefit from nonenforcement could simply fail to perform, eliminating the value of the contract.[14]

There is little reason to think that penalty default rules would be a remedy to the problem of parties leaving gaps as a way of externalizing some of the cost of contracting onto courts. Penalty default rules penalize only the majority of parties for failing to fill a gap. However, the judicial externalization problem is not caused by the majority of parties; it is caused by *all* the parties—that is, both types, not just the majority type. By contrast, the indefiniteness rule applies to all parties, just as the judicial externalization problem requires. So does the rule that requires parties to pay court costs.

The larger point is that Ayres and Gertner's analysis of penalty default rules—their use of the *Hadley* model to identify the relevant variables for determining what the optimal penalty (and/or majoritarian) rules should be—is irrelevant to the question of how parties should be discouraged from externalizing costs on courts. The *Hadley* model concerned how parties should be discouraged from concealing information from each other or, put differently, from externalizing information costs on third (contracting) parties. Thus, the variables that are important in the *Hadley* model, such as the proportion of parties that belong to the high type or the low type, are not relevant to the analysis of how to discourage externalization of costs on courts. Thus, even if Ayres and Gertner's analysis of *Hadley* is correct, there is no reason to think that limiting damages to foreseeable losses would result in the optimal amount of detail in the contract from the perspective of the judicial externalization problem.

E. Summary

Ayres and Gertner's *Hadley* model shows that under certain parameters optimal default rules would not maximize the *ex ante* value of particular contracts but would penalize parties in order to encourage them to reveal information to each other. Drawing on Fuller's discussion of legal formalities, Ayres and Gertner also argue that optimal default rules might also penalize parties so as to encourage them to write specific and complete contracts that can be easily interpreted

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13. The doctrine was overthrown by *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214 (N.Y. 1917).

14. *See* Robert E. Scott, *A Theory of Self-Enforcing Indefinite Agreements*, 103 COLUM. L. REV. 1641 (2003).

and enforced by courts. "Penalizing" parties means implying terms that would not maximize the *ex ante* value of their contracts.

It is worth noting that what distinguishes a penalty default rule and a majoritarian default rule is *not* that only penalty default rules are information-forcing. *Both* types of rule are information-forcing. A majoritarian rule is information-forcing because the minority types will contract out of it if transaction costs are low enough, revealing both their valuations and the valuations of the majority that does not opt out. The only difference between the two rules is that more parties opt out of—or would prefer to opt out of—a penalty default rule than out of a majoritarian default rule, everything else held equal. Ayres and Gertner are correct that in imaginable cases greater opting out is more socially valuable than less opting out, despite the expense. Indeed, in the simplest case one does not need information externalities to get this result: it is true in the very simple situation where, for whatever reason, it is extremely cheap for each member of the majority to opt out, whereas it is very expensive for each member of the minority to opt out. But it is hard to think of real-world examples where such differential costs hold and to believe that this is true at the general level at which default rules operate.

If I am right that penalty default rules do not promote efficiency under plausible assumptions about the world, then it is unlikely that penalty default rules would exist.[15] But everyone seems to think they exist. Do they? I now turn to this empirical question.

III. EMPIRICAL ANALYSIS

Evaluating Ayres and Gertner's claim that penalty default rules exist turns out to be harder than it might appear. The problem is that many contract rules are ambiguous. To simplify matters, I will distinguish three types of tests: (1) there are default rules that are clearly not majoritarian; (2) there are default rules that are clearly not majoritarian, and that can plausibly be understood to incorporate the factors (cost of contracting around, distribution of types, information externalities) identified by the *Hadley* model; and (3) there are default rules that are clearly not majoritarian and that have been interpreted, explained, or defended by legal decisionmakers in a manner consistent with the *Hadley* model. The first test is weakest; the third is strongest. The first test would be satisfied by a nonmajoritarian rule that was not intended to force parties to reveal information but reflected other concerns, such as fairness. As an aside, one might think that a good test would be the existence of default rules that force parties to reveal information; however, as I have already

15. I confine my analysis to general rules of contract law and ignore family law, etc.

noted, because virtually all default rules force parties to reveal information, this test would not distinguish penalty and majoritarian default rules.

I will argue that there are, at best, one or two cases that ambiguously satisfy the first test, and none that satisfies the second and third.[16]

A. Hadley

I start with the *Hadley* rule, which is Ayres and Gertner's strongest example—perhaps their only plausible example. Still, it is not clear that the *Hadley* rule is a penalty default rule. There are two other possibilities: that it is majoritarian and that it is not majoritarian but that it does not reflect the factors in Ayres and Gertner's model.

The usual reason for thinking that the *Hadley* rule is not a majoritarian rule is that it is counter to the notion of efficient breach. The efficient breach theory says that contract damages should equal actual loss, so that the party tempted to breach will breach only if the cost of performance exceeds the lost value to the potential victim. On this view, the majoritarian damages default rule would be actual loss, for it would save the parties the transaction costs of specifying the efficient amount of damages in case of nonperformance. Since the *Hadley* rule excludes the unforeseeable portion of any loss, it is not majoritarian.

The problem with this view is that it oversimplifies the analysis of optimal damages rules. The decision to breach is just one of many decisions the parties may make, and if damages for actual loss ensures that this decision is made optimally, it has more ambiguous effects on the numerous other decisions that parties must make—the decision whether to take precautions, to mitigate, and so forth.[17]

Indeed, one problem with expectation damages is that they force the breacher to provide insurance to the victim against whatever event causes the breach. It will rarely be the case that the carrier

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16. Proving a negative is difficult. For present purposes, it seems sufficient to focus on examples used by Ayres and Gertner (or Ayres, in his solely authored efforts) and a few other authors, and there may be penalty default rules lurking somewhere in the common law or the U.C.C. which I miss. I also ignore several putative examples of penalty default rules which are really proposals to change existing laws into penalty default rules; e.g., the discussion of Lefkowitz and the lost-profits puzzle. *See* Ayres & Gertner, *supra* note 1, at 104-06.

In a highly unsystematic survey of articles with the term "penalty default rule" appearing somewhere within them, I found no cases where an author claims that a general rule of contract or commercial law is a penalty default rule (aside from the examples from Ayres and Gertner). Most of the articles either contain proposals or hypothetical examples, or involve other areas of the law such as statutory interpretation, legal ethics, or patent law.

17. *See* Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach,* 61 S. CAL. L. REV. 629 (1988).

will be the cheaper insurer, and indeed, we observe that modern carriage contracts always limit liability—although the shipper may purchase insurance from the carrier for an extra fee. Perhaps this insurance is frequently purchased, but one suspects not. Carriers have no competitive advantage in the insurance market. Indeed, carrier-supplied insurance is likely in many cases to be inferior to self-insurance. If this is right, then most parties would want liability limited to foreseeable loss; the *Hadley* rule is majoritarian.[18]

This conclusion is bolstered by the rule's reference to foreseeability. The carrier will not adjust its level of care in anticipation of unforeseeable losses—whether the term "unforeseeable" is taken in its literal sense or used to refer to remote contingencies—because the expected loss is either insensitive to, or only remotely related to, the level of care. Thus, within Ayres and Gertner's *Hadley* model, there is no benefit—in terms of a higher level of precaution against higher losses—from holding the carrier liable for consequential losses. The losses covered by the *Hadley* rule are in this way the type of losses against which one might want to purchase insurance, but not the type of losses the carrier should internalize for the sake of efficient precaution. Again, there would be no reason for the parties to turn the carrier into an implicit insurance company, as would be the case if expectation damages, not limited by the *Hadley* rule, were the default.

B. Zero Quantity and Legal Formalities

Ayres and Gertner say that the U.C.C. supplies different default rules for price and quantity.[19] If the parties fail to supply a price term, the U.C.C. says that the court should imply a "reasonable price," which will usually be the market price at the time of delivery.[20] If the parties fail to supply the quantity term, the U.C.C. says that the court should not enforce the contract.[21] Ayres and Gertner interpret this provision as a "zero-quantity default."[22] The court implies that the quantity will be zero and, also, though they do not say this, that the buyer has no obligation to pay anything. For Ayres and

18. *But cf.* Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105 (1989). The ambiguity of the *Hadley* rule has been noted by many scholars, including Barry E. Adler, *The Questionable Ascent of* Hadley v. Baxendale, 51 STAN. L. REV. 1547 (1999), and Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990). Ayres and Gertner seem to agree. *See* Ayres & Gertner, *supra* note 1, at 91.

19. Ayres & Gertner, *supra* note 1, at 95-96.

20. *Id.* at 95-96 & n.42.

21. *Id.* at 96 & n.43.

22. *Id.* at 96.

Gertner, the price default is plausibly a majoritarian rule and the quantity default is a penalty default rule.[23]

The reason that the zero-quantity default is a penalty default rule, Ayres and Gertner argue, is that it is clear that most parties who enter a contract would not agree to zero quantity, which would defeat the purpose of having a contract in the first place.[24] The reason for zero quantity is that "it is cheaper for the parties to establish the quantity term beforehand than for the courts to determine after the fact what the parties would have wanted."[25]

The problem with this argument is that the zero-quantity default is not a default rule at all; it is a legal formality.[26] The U.C.C. says as much: section 2-201 is entitled "Formal Requirements; Statute of Frauds." The requirement that certain contracts be in writing is a classic formality, and all that the zero-quantity rule does is specify that quantity (as well as a signature and reference to goods) must be in the writing. According to the official comment, the drafters of the U.C.C. required a quantity term rather than a price term because market prices, catalogs, and price lists provide an objective way to prevent opportunism (for example, a claim by the seller that the price is higher than what the parties agreed to), whereas there is no similar objective check on claims that the asserted quantity is different from what the parties agreed to.[27] By contrast, section 2-305, which is entitled "Open Price Term" is located in a different part of the U.C.C., a part entitled "General Obligation and Construction of Contract." Section 2-305 is a default rule. Section 2-201 is not. And, as Ayres and Gertner agree,[28] section 2-305 is a majoritarian default rule.[29]

Putting aside the drafters' own understanding of what they were doing, we can see why section 2-201 is a legal formality by considering its purpose. Like all contract formalities, the purpose of the statute of frauds is to prevent people from fraudulently claiming that a contract exists.[30] Formalities make such fraud more difficult by forcing the fraudulent party not only to perjure himself in court but also to forge documents, which is riskier and more difficult than perjury. At the same time, formalities are not supposed to be so burdensome as to interfere with good faith contracting. Forcing parties to supply a quantity term (and, in fact, not the exact quantity, but a ceiling) would be a way of checking fraud without also inhibiting contracting

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23. *Id.* at 95-97.
24. *Id.* at 96.
25. *Id.*
26. This was pointed out in W. David Slawson, *The Futile Search for Principles for Default Rules*, 3 S. CAL. INTERDISC. L.J. 29, 37 (1993).
27. U.C.C. § 2-201 cmt. 1 (2005).
28. Albeit with some qualifications. *See* Ayres & Gertner, *supra* note 1.
29. *See id.* at 95 n.42.
30. RESTATEMENT (SECOND) OF CONTRACTS § 131 cmt. c (2005).

too much since parties will almost always have an idea of the quantity involved.

One should also observe that the logic of section 2-201, as Ayres and Gertner describe it, does not follow their model, but Fuller's older theory.[31] As they describe it, section 2-201 does not force parties to reveal information to each other by penalizing one party if he or she does not; it forces parties to reveal information to courts by penalizing both parties if they do not. Ayres and Gertner think that parties should be forced to include a quantity term because the parties can more easily reveal their optimal quantity to the court than the court can figure it out *ex post*. This might be true; but it is not related to Ayres and Gertner's model, where parties have private information about their valuations vis-à-vis each other.

Legal formalities are not default rules—one cannot opt out of them or contract around them. Either one satisfies them or one does not have a contract, and they apply regardless of whether there is a gap somewhere in the contract. Default rules come into play only if formalities are satisfied and a contract exists.

C. *Unilateral Mistake and Other Contract Formation Rules*

Ayres and Gertner have invoked formation doctrines as examples of default rules. Consider this passage from a recent article:

> For example, section 153 of the *Restatement (Second) of Contracts* allows a contractor who is unilaterally mistaken about a basic assumption to void a contract if "the other party had reason to know of the mistake." The default possibility of voidability is a penalty that the informed contractor can only avoid by revealing information. Indeed, in a *Hadley*-like fact pattern, a carrier could argue that a basic assumption of its promise to perform or pay damages was the belief that the miller would only have foreseeably low damages. Any evidence that the miller knew that it had high damages, but failed to correct the carrier's mistaken assumption, might be grounds for voiding the carrier's duty to pay damages at all. A slightly expanded reading of the common law of mistake thus can be seen as a penalty default to induce knowledgeable contractors to correct the other side's mistakes of law or fact.[32]

This is a puzzling argument. The mistake doctrine is not normally thought of as a default rule because it does not fill a gap in an otherwise valid contract; it results in the avoidance of the contract. In a classic mistake case, a contractor's bid is much lower than the bids of competing contractors. The bid reflects a mistaken calculation, and

31. *See* Fuller, *supra* note 12.

32. Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591, 1609-10 (1999) (footnotes omitted).

the party taking the bid has reason to know that the contractor's low bid results from a mistake. If the offeree accepts the bid, the resulting contract would not have a gap—the price term is filled in. The problem with the contract is not that it lacks a price or has any other gap; it is that the price is "wrong." The mistake doctrine does not fill a gap in an incomplete contract; it operates on precontractual behavior, preventing the formation of a contract in the first place.[33]

In this way, the mistake doctrine is like doctrines against fraud as well and, indeed, like legal formalities, which require parties to reveal to each other whether they want the agreement to be legally enforceable. None of these doctrines force parties to reveal the type of information analyzed in Ayres and Gertner's *Hadley* model—that is, the value that the promisee attaches to performance and the cost of performance for the promisor. Indeed, the unilateral mistake doctrine forces the promisee to reveal information to the promisor about the promisor's cost, not the promisee's valuation.

But suppose that the mistake doctrine is thought of as a default rule along the following lines. The contract does not have a term specifying the parties' obligations if the contractor's bid is based on a clerical error; courts apply a default rule that says that the parties have no obligations if such is the case. In other words, the default rule provides a certain term if a precontractual contingency—the clerical mistake—is not mentioned in the contract. It is worth emphasizing that it is not clear that this is an accurate statement because it is not clear that parties could contract out of this rule, but let us suppose that this is the case. Still, the mistake doctrine would surely be a majoritarian default rule, if it is a default rule at all. Given that clerical errors are difficult to avoid, that the party that receives the bid can easily detect a major clerical error by comparing the bidder's price with the prices offered by other bidders and that the recipient of the bid need not rely on the bid given that other bids are submitted, it would make sense for the parties to agree in advance on a term that relieves the bidder of its obligation if a clerical error results in a price that is substantially higher than the next highest price.

D. *Interpretive Presumptions*

Another kind of rule is the interpretive presumption, like the *contra proferentem* rule that a contract should be construed against its drafter. Ayres claims that this rule is a penalty default.[34] Is it?

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33. RESTATEMENT (SECOND) OF CONTRACTS § 153(b) (2005).

34. *See* Ayres, *supra* note 6, at 587; *see also* Omri Ben-Shahar, *"Agreeing To Disagree": Filling Gaps in Deliberately Incomplete Contracts*, 2004 WIS. L. REV. 389.

An initial but probably unimportant problem with the view that it is a penalty default is that the rule applies, at least formally, regardless of whether there is a gap in the contract. Interpretive presumptions operate at step 3, when the court must interpret the contract. Only if the court, applying interpretive rules, finds a gap at step 3, would it then move on to step 4 and fill the gap.

As an illustration, suppose that a contract involving a European party and an American party lists a price of "100" but does not say whether the price is in euros or in dollars. A court would (at step 3) resolve this ambiguity. It might apply the *contra proferentem* rule, the parol evidence rule, or something else. Once the ambiguity is resolved in one way or another, the court's inquiry ends. There is no gap, as there would be if the parties had not stated the price in the contract.

Or as another illustration, suppose that a contract has an ambiguous statement about whether the promisee can assign the contract. At step 3, the court might interpret the ambiguous statement as an explicit term that forbids or permits assignment, or it might interpret the ambiguous statement as meaningless or inapplicable (for example, parol evidence reveals that it applied to other kinds of assignment than the one in question in the dispute). In the latter case, the court finds a gap at step 3, so it can move on to step 4 and fill it in using the U.C.C.'s default rule which permits assignability.[35]

Nonetheless, one might plausibly argue that interpretive presumptions are analytically the same as default rules even if they are placed in a separate doctrinal category. An ambiguous term might be reinterpreted as a term that does not fully specify obligations. In the first illustration, one might say that the price term is ambiguous because the contract contains a gap—it does not say whether the price is denominated in euros or dollars. The court fills this gap by using a default rule that provides for the term that would benefit the party that did not draft the contract.

Even if this interpretation is correct, it does not establish that interpretive presumptions like *contra proferentem* are penalty default rules. In any specific application of the rule, the term chosen by the court may or may not reflect the interests of the majority of the parties. In the first illustration, there is no reason to think that a majority of American-European contract parties would prefer the price to be in euros rather than dollars. Nor is there any reason to think that the term contrary to the drafter's interests is the term that a minority (or majority) of contract parties would choose.

When we think again of Ayres and Gertner's model, their assumption was that (say) the buyer may belong to different types: a major-

35. U.C.C. § 2-210(3) cmt. 6 (2005).

ity type and a minority type. Now, stipulate that the sellers are identical. In this setting, a penalty default rule would provide the term preferred by the minority type. The *contra proferentem* rule provides the term preferred by the nondrafter. In Ayres and Gertner's setup, the *contra proferentem* rule would be a penalty default rule with the functions they assign to penalty defaults only if the majority type happens to be the party that drafts the contract. But there is no reason to believe this; more likely, the seller drafts the contract or the buyer (of either type) drafts the contract.[36] Thus, the rule does not differentiate between types, as envisioned by the Ayres and Gertner model, so the rule does not cause one type to opt out while saving the other type transaction costs. There is a mismatch between the model and the function of the interpretive presumption.

Further, if we must think of interpretive presumptions as default rules, then surely they are majoritarian. The drafter has an advantage: she can sneak in favorable language. But as a consequence, the drafter may have trouble persuading the nondrafter to consent to a contract. A natural solution to this problem is to agree that ambiguities will be construed against the drafter. Similarly, sellers may have trouble persuading consumers to agree to contracts for complex products that they do not understand unless the consumers are assured that ambiguities will be construed against the sellers. It is hard to imagine parties agreeing to the contrary rule—that ambiguities will be resolved in favor of the drafter and against consumers and insureds.

None of this is to deny that interpretive presumptions like *contra proferentem* have information-forcing effects. As I have noted, majoritarian as well as penalty default rules have these effects. The *contra proferentem* rule, for example, might encourage the drafter to be more explicit and to provide more details about obligations. This may reduce the chance that the other party will misunderstand the contract; it also may facilitate judicial interpretation of the contract. Interpretive presumptions that favor consumers and insureds encourage sellers and insurers to draft detailed and explicit contracts, which increases the chances that the less sophisticated party will understand her contractual obligations. But these effects are not the subject of Ayres and Gertner's model.

E. Section 2-210

Ayres and Gertner cite section 2-210 in a discussion of penalty default rules, though it is not clear whether they claim it is an example of a penalty default rule or not.[37] Nonetheless, I will discuss it, if only

36. Of course, if only the high type is the drafter, the information problem is solved.
37. Ayres & Gertner, *supra* note 3, at 763-64.

to show that the majoritarian interpretation of this rule and rules like it is more straightforward and plausible than the alternative interpretations.

Section 2-210(2)(a) says that a "party may perform [his] dut[y] through a delegate unless otherwise agreed or unless the other party has a substantial interest in having [his] original promisor perform or control the acts required by the contract."[38] The default thus has two parts: (1) delegation permitted if the identity of the original promisor does not matter and (2) delegation not permitted if the identity of the original promisor does matter. As is always the case with a default rule, the parties can opt out and prohibit delegation in the first case, or permit it in the second.

The majoritarian explanation for this rule is simple and intuitive. For the promisor, the power to delegate has value, and thus he or she will normally want to have it. This power is valuable because it allows the promisor to pay someone else to perform on his behalf, which he will want to do if he can find someone else who will do it for a low price or if he finds some better opportunity that conflicts with his initial promise. But delegation is undesirable for the promisee if the value of performance turns heavily on the unique abilities of the promisor and a normal damages remedy cannot fully compensate the promisee for the shortfall. Thus, one would normally expect delegation to be permitted when the performance is fungible and not when the promisee cares about the identify of the promisor.

Ayres and Gertner note that this rule may force a promisee to reveal the extent to which he values the promisor's performance, which is information the promisor may use to extract a higher price.[39] To avoid paying the higher price, the promisee might refuse to reveal his interest and, thus, consent to an inefficient contract that permits delegation.[40] But it is not clear what follows from this observation. Perhaps Ayres and Gertner's point is that section 2-210 is not a penalty rule, and for this reason may be objectionable. If so, then clearly section 2-210 must count as a majoritarian rule.

F. The Understandings of Legal Decisionmakers

I have said little about step 3, which asks whether the reasoning of legal decisionmakers reflects the considerations modeled by Ayres and Gertner. One way to apply this test is to look at the reasoning given by decisionmakers rather than at the doctrines themselves.

38. U.C.C. § 2-210(2)(a) (2005).
39. Ayres & Gertner, *supra* note 3, at 763-64.
40. *See id.* at 765.

1. *The Uniform Commercial Code*

The U.C.C., which is the source of many of Ayres and Gertner's examples, was designed by its guiding light, Karl Llewellyn, to reflect existing business norms and customs.[41] Llewellyn believed that the common law depended too heavily on formal doctrinal distinctions that did not match business practice and, thus, forced parties to engage in unnecessary rituals to ensure that their agreements were enforced properly.[42] In addition it forced courts to engage in needless gyrations in order to extract correct results from recalcitrant doctrine. Llewellyn thus used business practice as a guide, and either made the U.C.C.'s default rules reflect practice or else incorporated vague standards that would allow courts to do this *ex post*.[43]

This being so, it would be surprising if the U.C.C.'s default rules reflected nonmajoritarian preferences. They would, only if business norms and customs themselves cured the information asymmetries identified by Ayres and Gertner's *Hadley* model. But this seems implausible. Business practices become norms because, as the term suggests, they are normal—most people engage in them. Most people engage in them because they are jointly profit-maximizing. This is the standard majoritarian approach to default rules. The opposite view would hold that two parties to a contract engage in some practice in order to benefit a third party—and this behavior becomes routinized.

2. *Some Recent Cases*

Seven cases contain citations to Ayres and Gertner's original article, *Filling Gaps in Incomplete Contracts*. Four of these citations are not relevant to the current discussion,[44] but three of them are interesting.

Harnischfeger Corporation v. Harbor Insurance Company[45] involved a dispute over the meaning of a clause in an excess insurance policy. The insured argued that the excess insurer's liability would kick in when the insured (which self-insured for the primary amount) had paid out $3,000,000 in claims and legal fees.[46] The insurer argued that its liability kicked in only after the insured had paid out

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41. Gregory E. Maggs, *Karl Llewellyn's Fading Imprint on the Jurisprudence of the Uniform Commercial Code*, 71 U. COLO. L. REV. 541, 546-47 (2000).

42. *Id.*

43. *Id.* at 553.

44. *See* Am. Airlines, Inc. v. Wolens, 513 U.S. 219 (1995); Coronet Ins. Co. v. GACC Holding Co., No. 90C07129, 1991 WL 172182 (N.D. Ill. Aug. 30, 1991). Another case—*Moreau v. Harris County*, 158 F.3d 241 (5th Cir. 1998)—confuses contract law and statutory interpretation, holding that its interpretation of the Fair Labor Standards Act reflects a contract default rule. In *Duncan v. Theratx, Inc.*, 775 A.2d 1019, 1021-22 & n.4 (Del. 2001), the court uses the majoritarian approach, only noting the possibility of penalty defaults in a footnote.

45. 927 F.2d 974 (7th Cir. 1991).

46. *Id.* at 975.

$3,000,000 in claims only.[47] The court held that the clause unambiguously favored the insurer's interpretation and thus rejected the insured's invocation of the principle that ambiguities should be resolved against insurers.[48] The court noted in passing, "Perhaps the interpretive principle [that ambiguities should be resolved against insurers] could be recast as one requiring the insurer to come forth with information in its possession but unknown to the insured," citing the Ayres and Gertner article.[49] But then it said, "Wisconsin has not suggested this understanding of its approach, perhaps because it doubts judicial ability to determine how much information is optimal . . . ."[50] Thus, the court rejected the penalty default analysis.

American National Fire Insurance Company v. Kenealy[51] was another insurance dispute. The insurer had provided in a policy that changes in coverage of the insurance (for a yacht) were valid only if approved by the insurer.[52] When the insureds sought to increase the geographic coverage of the insurance policy, the broker obtained this expansion but told them that the expanded coverage would continue for one year when in fact the insurer authorized the expansion for only a few months.[53] The yacht sank after the expiration of the new coverage but before the one-year period expired.[54] The insurer sought to avoid liability on the basis of the clause limiting coverage changes, but the court held in favor of the insureds because the broker was a proper agent with apparent authority to bind the insurer.[55]

The court rejected the insurer's argument because the clause that conditioned changes on approval by the insurer did not say that the insurer could not provide such approval through its agents.[56] Thus, the contract was silent on the issue of whether an agent could bind the insurer, and the question for the court was whether the default rule should put the burden on the insurer or the insured. The court noted that in some cases the insurer is in a better position to monitor the agent, and in other cases the insured is in a better position.[57] It decided that the default should favor the insured—that is, the agent binds the insurer unless otherwise agreed—because otherwise insurers may "strategically withhold[] information as to what authority

47. *Id.*
48. *Id.* at 976.
49. *Id.*
50. *Id.*
51. 72 F.3d 264 (2d Cir. 1995).
52. *Id.* at 266.
53. *Id.*
54. *Id.*
55. *Id.* at 271.
56. *Id.* at 268.
57. *Id.*

the agent actually has, and whether the company is bound if an accident occurs."[58]

Although the court cited Ayres and Gertner's article,[59] the court did not have any concerns about the insurer having private information about its valuation. The court apparently thought that insureds would assume that the broker could bind the agent even if the law were otherwise. In effect, the court was aligning the law with the uninformed expectations of insureds—perhaps because it believed that the insurer, by using the broker in the first place, was in part responsible for generating these expectations. It feared that if the default rule placed the burden on the insured, the insured would not realize that the broker's statements were not binding until ratified by the insurer and, further, that the insurer would have no incentive to clarify the law in the contract.[60] Whatever one thinks of this reasoning, it reflects traditional consumer protection ideas and is not an application of the Ayres and Gertner model.

Finally, in *City of Burlington v. Indemnity Insurance Co. of North America*,[61] the court had to decide whether an "all risk" insurance policy provided coverage only for damage caused by external events (such as storms) and not by "intrinsic" factors such as structural defects in the property in question. Although it certified this question to a state supreme court rather than deciding it, the court argued in passing that a default rule that all risk policies covered intrinsic as well as extrinsic losses would be a penalty default rule.

> On this account, expanded coverage to the detriment of insurers in all-risk policies is justified since such expansions give insurers, who presumably have better knowledge of insurance laws than do insureds, a powerful incentive to insert explicit language into policies, thereby informing the insureds as to the precise scope of coverage.[62]

Although the court cited the Ayres and Gertner article,[63] like the *Kenealy* court, it relied on a different theory—namely, that insureds do not understand their coverage, and that default rules should reflect the expectations of the insureds rather than the jointly optimal terms.

It should also be noted that the court does not explain why a default rule that stipulated expanded coverage would not be the majoritarian default. On the one hand, insurers might be reluctant to cover

58. *Id.* at 269.
59. *Id.* at 269 n.1.
60. *See id.* at 269.
61. 332 F.3d 38 (2d Cir. 2003).
62. *Id.* at 49.
63. *Id.*

intrinsic defects because of fears of moral hazard. On the other hand, insureds are unlikely to distinguish externally and internally caused losses—a loss is a loss—and be willing to pay for both. Indeed, the distinction between external and intrinsic losses is at best a rough and ready one: when a storm damages a structure, is the cause of the loss the "external" storm or the "internal" design problems that rendered the structure unable to withstand the storm? Without knowing more about the market, one cannot say with any confidence that one version of the default rule or the other is majoritarian. But given that the *Burlington* court does not refer to private valuations, differential transaction costs by type, the proportion of types, and so forth, it could not have been applying the Ayres-Gertner model.

G. Summary

My survey of the law revealed no unambiguous penalty default rule in American contract law.[64] One might argue that many of the ambiguous default rules are actually penalty default rules—that is, they reflect the preferences of a minority rather than of a majority. But it is clear that the self-understanding of courts is otherwise: courts almost always think of themselves as choosing the rule that a majority would want. In addition, courts never take into account factors relevant to the Ayres-Gertner model. Indeed, they rarely discuss the problem of private information that is identified by that model—that individuals with high valuations will try to hide this information—in the context of choosing or justifying default rules. Thus, if some default rules are not majoritarian, the most likely explanation—putting aside the consumer protection defaults mentioned below—is that courts or the drafters of the U.C.C. simply made a mistake about what the majority prefers.

Problems of private information appear in judicial discussions mainly in cases involving consumer protection. Here, courts worry that consumers (or insureds) do not understand the law, do not understand the terms of the contract that they sign, or do not properly value the product that they purchase. A few default rules seem to be intended to give the seller an incentive to explain the law to the consumer, or to provide explicit terms in the contract, but the justification is mainly the traditional consumer protection justification, according to which consumers are easily manipulated by sellers, not the Ayres-Gertner concern with information externalities that arise

64. Nor in British law, apparently. *See* KIM LEWISON, THE INTERPRETATION OF CONTRACTS (2004). Lewison repeatedly emphasizes that the rules of interpretation are intended to help courts determine the intentions of the parties. *See, e.g.*, *id.* at 191 ("The canons of construction are no more than pointers to discovering the presumed intention of the parties to a written contract.").

because contracting parties can be classified into heterogeneous types who attach different valuations to the same product or service.

The rules of contract law that are most explicitly concerned with information asymmetries are not default rules but interpretive presumptions, contract formation rules, and—what we have not discussed so far—immutable rules such as the unconscionability doctrine. All of these rules apply regardless of whether there are gaps, no doubt reflecting courts' concern that consumers may fail to understand the transaction even when the contract is detailed, explicit, and (relatively) complete.[65]

In sum, two conclusions are worth highlighting. First, there are no penalty default rules. Second, rules that seem designed to smoke out private information—such as legal formalities, contract formation rules, and so forth—do not reflect the logic of Ayres and Gertner's *Hadley* model.

IV. CONCLUSION: WHY ARE THERE NO PENALTY DEFAULT RULES?

Let me conclude with some speculation about why penalty default rules do not exist. But initially, let me exclude one possibility—that the Ayres and Gertner model is in fact wrong. The model and their general point are correct: within the confines of the model's assumptions, there may be good reasons for penalty default rules. The question, then, is why courts and legislatures have not endorsed this reasoning and created penalty default rules.

One possible reason is that the Ayres-Gertner model has not yet been absorbed into contract theory, but at some future point, after the ideas have been taught to enough generations of students, the ideas will become a part of the general understanding of contract law. Although one cannot know what the future holds, the early judicial response suggests that this will not happen. Indeed, this response suggests that the problem with the Ayres-Gertner analysis is that it is too complicated and indeterminate for judges to use.

Alan Schwartz and Robert Scott have made a similar but more general argument about default rules.[66] They argue that courts do not create default "rules" that are specific enough to have value for the parties because the parties have adequate incentives for supplying optimal terms, even with asymmetric information, where signaling and screening mechanisms can be used which, if not perfect, are

65. Indeed, the kind of asymmetric information model used by Ayres and Gertner does not rely on contractual gaps; it could justify the refusal to enforce explicit terms. *See* Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381 (1990).

66. *See* Schwartz & Scott, *supra* note 10, at 594-609.

better than anything that courts could produce.[67] Although the U.C.C. and the common law contain many default "standards," these standards are too vague to provide guidance for parties or courts. If Schwartz and Scott are right that courts do not bother producing default rules and tend to enforce the terms that the parties supply and no more, then it would follow *a fortiori* that there are no penalty default rules.

A final reason that penalty default rules do not exist may be that contract law doctrine is not well suited for the types of information externalities identified by Ayres and Gertner's model. Contract doctrine is extremely general; it applies in diverse market settings. Information externalities may be much more of a problem in some markets—say, insurance markets—than others, and the appropriate response may be *ex ante* regulations oriented to a particular market rather than general contract law. For example, insurance markets are thought to be especially vulnerable to information externalities, and here we have massive *ex ante* regulation, including price, term, and market access regulation. Courts may feel that they should allow legislatures to identify information externalities and enact appropriate laws, and that neither common law development nor general commercial codes are appropriate for such problems.

Indeed, common law courts have been remarkably passive about solving contract externalities. Prior to the enactment of antitrust legislation, courts only occasionally interfered with restraints on trade. Occasionally citing public policy, courts strike down contracts that are not themselves illegal but might further illegal conduct, but here legislation comes first and identifies the illegal conduct. Contract formalities protect third parties from fraudulent claims that they have entered contracts. And tort rules like the fraud doctrine prevent the most obvious kind of externalizing behavior. Otherwise, contract doctrines tend to enforce freedom of contract; most mandatory rules are paternalistic or otherwise inexplicable from a conventional economic perspective. Ayres and Gertner's argument implicitly assumes that courts would use general doctrines of contract law in order to deter parties from producing subtle information externalities that were first identified by economists only thirty years ago. It is more likely that the century-old *Hadley* doctrine, like other doctrines of contract law, reflect judicial conjectures about the hypothetical bargain—the jointly value-maximizing terms that most parties would want.

67. *Id.*