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# Collapsing Illusions: Standards for Setting Efficient Contract and Other Defaults

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# Collapsing Illusions: Standards for Setting Efficient Contract and Other Defaults

STEVEN J. BURTON\*

*In this Essay, Professor Burton analyzes and evaluates four commonly used standards for setting efficient default rules and standards. Based on two theoretical insights, he shows that three of them collapse upon analysis into the fourth, a Coasian standard that turns out to be a dead end. The theoretical upshot is that the Coase Theorem often is a good reason to use defaults rather than mandatory rules or standards. But neither the theorem nor reference to a transaction-costless world sustains particular defaults. To set an efficient default, the law should guide courts toward supplying terms that parties should have adopted to generate a surplus from the term or a cluster of related clauses.*

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## INTRODUCTION

Much of contract and other fields of law consists of default rather than mandatory rules and standards. Contractual defaults, for example, generate implied terms when parties have not agreed; parties may displace a default by agreeing otherwise. Much theoretical work in law and economics seeks to identify efficient defaults. At present, this may be the most important theoretical task in several fields.<sup>1</sup>

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\* John F. Murray Professor of Law, University of Iowa. For their comments on earlier iterations of this Essay, I am grateful to Oren Bar-Gill, Omri Ben Shahaar, Julia Braun, Christopher R. Drahozal, Herbert Hovenkamp, Robert T. Miller, Maya Steinitz, Serena Stier, Lianguo Sun, and participants in the Iowa Legal Studies Workshop held on January 16, 2015.

1. Cf. Omri Ben-Shahaar, *A Bargaining Power Theory of Default Rules*, 109 COLUM. L. REV. 396, 396 (2009) (“How to fill gaps in incomplete agreements is perhaps the most important question in contract law.”).

Efficiency is a sensible goal for defaults, subject to rule-of-law constraints.<sup>2</sup> The Coase Theorem suggests that we often should use defaults.<sup>3</sup> Presumably, many parties would contract out of inefficient defaults by adopting efficient terms.<sup>4</sup> They need not incur transaction costs to do so when the default is efficient in the first place. Thus, efficient defaults facilitate efficient exchanges, which produce surplus value (gains of trade).

The Coase Theorem, however, says nothing about how to set efficient defaults. Coase indicated that the law should reduce transaction costs, but standing alone this is an indeterminate standard. The scholarly literature contains four supplementary standards in the main.<sup>5</sup> An empirical majoritarian standard favors the rule or term that the majority of relevant parties wants.<sup>6</sup> A theoretical or hypothetical majoritarian standard favors what a hypothetical majority would want.<sup>7</sup> A party-oriented standard favors what the affected parties would have wanted.<sup>8</sup> And a Coasian standard favors what rational parties would agree upon in a transaction-costless world (TCW)<sup>9</sup>—a

2. See Steven J. Burton, *Normative Legal Theories: The Case for Pluralism and Balancing*, 98 IOWA L. REV. 535, 562–65 (2013) (showing that a proposal for efficient default contract interpretation rules flounders because it fails to respect rule-of-law constraints).

3. See *infra* text accompanying note 5.

4. This probably is not true of nonsalient terms in standard form consumer contracts. See generally OREN BAR-GILL, *SEDUCTION BY CONTRACT: LAW, ECONOMICS, AND PSYCHOLOGY IN CONSUMER MARKETS* (2012).

5. Another standard supports what Ayres and Gertner call “penalty defaults.” Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 95–107 (1989) (giving a theory of penalty defaults) [hereinafter Ayres & Gertner, *Filling Gaps*]. They do not think that all defaults should impose penalties. *Id.* at 127–28 (“Our analysis does not imply that penalty defaults should be used in all contractual settings.”). Penalty defaults respond to gaps caused by strategic behavior, not transaction costs. *Id.* at 94. Penalties might be appropriate for filling such gaps as a supplement to the standard proposed herein, which then would apply to gaps resulting from transaction costs. See Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591 (1999) [hereinafter Ayres & Gertner, *Majoritarian vs. Minoritarian*] (identifying other possibly efficient nonmajoritarian standards for efficiency-minded lawmakers to consider).

6. See, e.g., Ben-Shahar, *supra* note 1, at 400–01 (asserting that “one of the most basic tenets of contract law [is] that gaps in contracts should be filled with terms . . . that most parties would have jointly chosen”); Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983) (suggesting that courts should set default rules by asking “what arrangements would *most* bargainers prefer?” (emphasis in original)); Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 549 (2003) (offering a normative theory of contract interpretation based on what firms want the state to provide).

7. See, e.g., Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353, 361 (1988) (suggesting that a default rule should be “the contract that most well-informed persons would have adopted if they were to bargain about the matter”).

8. See Ben-Shahar, *supra* note 1, at 396 (“The most broadly accepted principle of gap filling is that courts should ‘mimic the parties’ will.” (quoting Richard Craswell, *Contract Law: General Theories*, in 3 ENCYCLOPEDIA OF LAW AND ECONOMICS 1, 3–4 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000))).

9. See *Mkt. St. Assocs. Ltd. v. Frey*, 941 F.2d 588, 596 (7th Cir. 1991) (Posner, J.)

world in which all agreed terms are efficient. The first three standards are illusory because, upon analysis, they collapse into the fourth. It, however, turns out to be a dead end.

These conclusions rest on two insights. One is that *efficiency often is a feature of a cluster of related clauses, rather than a term in isolation*; consequently, defaults often must be “tailored” to fit into a cluster harmoniously. The other is that *few, if any, contract terms or clusters exist in TCW*; consequently, that world cannot serve as a reference point for setting efficient defaults. The upshot is that TCW should not play any part in setting particular defaults. We need an alternative standard, which this Essay will propose.

Part I describes the problem of setting defaults. Part II shows that the empirical majoritarian standard collapses into a hypothetical majoritarian standard. Part III shows that the hypothetical majoritarian and party-oriented standards collapse into the Coasian standard, which is a dead end. Part IV presents and defends an example of a better approach: defaults should guide courts toward supplying terms that the parties *should* have adopted to generate a surplus from the term or a cluster of related clauses. Throughout, I will emphasize contract defaults because contracts is what I know best, but the analyses are more broadly applicable.<sup>10</sup>

## I. THE PROBLEM

Parties often leave gaps in their contracts. A dispute may arise in a gap and require resolution by law. Contract law’s default rules and standards supply terms to fill gaps. In existing law, for example, a default rule provides that, unless the parties otherwise agree, the place for delivery of goods shall be the seller’s place of business or, if he has none, his residence.<sup>11</sup> A default standard provides that, unless the parties otherwise agree, the price of goods shall be a reasonable price.<sup>12</sup> The law of contract performance and enforcement consists for the most part of defaults.

For some time now, scholars have reviewed existing defaults and proposed new ones, most often a normative pursuit of economic efficiency. Their efforts begin with the Coase Theorem.<sup>13</sup> It may be stated as follows: in TCW, whatever the initial

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(quoted *infra* text accompanying note 44); see generally R. H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 12–15 (1960).

10. See, e.g., Douglas G. Baird & Thomas H. Jackson, *Fraudulent Conveyance Law and Its Proper Domain*, 38 VAND. L. REV. 829, 835–36 (1985) (arguing that debtor-creditor law, including fraudulent conveyance law, “should provide all the parties with the type of contract that they would have agreed to if they had had the time and money to bargain over all aspects of their deal”); Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1093–98 (1972) (noting that efficient laws would establish default entitlements as the parties would allocate them in a world without transaction costs); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 702 (1982) (claiming that default fiduciary duties should be derived from a hypothetical contract between investors and managers negotiating free of bargaining costs).

11. U.C.C. § 2-308(a) (2014).

12. *Id.* § 2-305(1).

13. See generally Coase, *supra* note 9.

allocation of rights to resources, parties will exchange them until the allocation is efficient.<sup>14</sup> This theorem is central to the rationale for using defaults. It highlights the fact that parties often may make contracts that provide for different rights and duties from those provided by the law, and that their contract presumably will be more efficient than the law. Real parties need not incur transaction costs to contract out of an efficient default, a term that would be agreed in TCW. This reduction of transaction costs would foster exchanges, which would create surplus value and move resources toward an efficient allocation.

But the theorem does not purport to say anything about what the defaults should be. Coase thought it obvious that efficiency counsels us to reduce transaction costs.<sup>15</sup> But he said nothing about how the law should proceed to accomplish that goal.

Scholars have supplied four main standards. (1) An empirical majoritarian standard favors the default that the majority of relevant parties wants.<sup>16</sup> Transaction costs would seem to be lessened when only a minority needs to contract out of a default to get what it wants. (2) A hypothetical majoritarian standard favors what a hypothetical majority would want. The transaction cost rationale here is the same, though it is unclear how a scholar or lawmaker should hypothesize a majoritarian preference. (3) A party-oriented (also hypothetical) standard favors what the affected parties would have wanted.<sup>17</sup> Parties who know *ex ante* that a court will employ this standard, it might be thought, need not incur full negotiation and drafting costs to get what they want. (4) A Coasian standard favors what rational parties would agree upon in TCW<sup>18</sup>—a world in which all agreed terms are efficient. Adopting defaults that satisfy this standard would aim to give the parties what they want, for no one wants to incur transaction costs.

I suggest that each of these four standards is deficient and that a better one is available. Part II analyzes the empirical majoritarian standard, which seems the most attractive of the four. Part III considers the hypothetical standards and TCW. I will argue that the first three standards collapse upon analysis into the fourth. The fourth, however, is a dead end. Part IV proposes a better standard.

## II. EMPIRICAL MAJORITARIANISM

Empirical majoritarianism is supposed to be based in fact.<sup>19</sup> However, an adequate body of factual data rarely exists.<sup>20</sup> For two reasons, there is no prospect of

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14. *See id.* at 12–15 (explaining what came to be known as the “Coase Theorem,” though Coase did not so name it).

15. *Id.* at 15.

16. *See supra* note 6.

17. *See supra* note 8; *infra* text accompanying note 44.

18. *See Mkt. St. Assocs. Ltd. v. Frey*, 941 F.2d 588, 596 (7th Cir. 1991) (Posner, J.) (quoted *infra* text accompanying note 44).

19. *See* Alan Schwartz & Robert E. Scott, *Contract Interpretation Redux*, 119 *YALE L.J.* 926, 955–57 (2010) (responding to criticism that their majoritarian theory of contract interpretation defaults lacks empirical support).

20. The most developed empirical claim probably is Schwartz and Scott’s. *Id.* A critical premise in their main argument is that the majority of firms prefers formalistic over contextual interpretation, an empirical proposition. *Id.* at 940–41, 946–47, 957; Schwartz & Scott, *supra*

developing one. First, this standard aims to identify an “untailored” rule, one that will fill gaps using the same term for all gaps within a general type. Gaps, however, often occur within clusters of clauses that vary considerably from transaction to transaction. Realistically, there is no majority preference for filling these kinds of gaps. Second, any majoritarian standard encounters a number of conceptual problems, such as the identity of “voters” and the instability of majorities as circumstances change. For these two reasons, empirical majoritarianism collapses into a hypothetical majoritarianism.

#### *A. Clusters of Related Clauses*

Ayres and Gertner helpfully distinguished “untailored” from “tailored” defaults.<sup>21</sup> An untailored default provides parties with a single, off-the-rack term that represents, for example, what the majority of contracting parties wants or would want.<sup>22</sup> The term is likely to come from a general rule that supplies the term before a case arises and, therefore, without regard to a particular contract’s expressly agreed terms. A tailored default, by contrast, provides parties with what they would or should have contracted for.<sup>23</sup> It is likely to be derived from a standard that leaves it to courts to supply the term after a dispute has arisen. A tailored default allows consideration of the entire contract before supplying the default term. Ayres and Gertner’s distinction easily can be generalized to reach beyond contract law to other fields of law.

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note 6, at 573–84. Though they later characterized their study as “theoretical,” they then offered four bits of empirical evidence: (1) quotations of two contract clauses (one of which does not concern interpretation); (2) the common practice of including merger clauses in commercial contracts (which is consistent with contextual interpretation); (3) two case studies of arbitration practices in two commodity trade associations (which cannot be easily generalized); and (4) firms’ frequent use of choice-of-law clauses to select New York law. Schwartz & Scott, *supra* note 19, at 955–57 & nn.69–71.

The fourth bit of evidence rests on an empirical study of choice-of-law clauses in 2882 contracts between large, publicly held corporations. It found that 46% of them, a strong plurality, had clauses choosing New York law. Theodore Eisenberg & Geoffrey P. Miller, *The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies’ Contracts*, 30 CARDOZO L. REV. 1475, 1478 (2009). Miller followed up with a study of the same database aimed specifically at confirming Schwartz and Scott’s prediction that firms prefer New York law, which is formalistic, over California law, which is not. He concluded that their prediction was confirmed. Geoffrey P. Miller, *Bargains Bicoastal: New Light on Contract Theory*, 31 CARDOZO L. REV. 1475, 1508–11, 1522 (2010). However, Miller’s sample, which is confined to large, publicly held corporations, does not track Schwartz and Scott’s much broader definition of “firms.” See *infra* text accompanying note 36. This casts doubt on the extent to which Miller’s study supports their prediction. Professional firms and small or privately held corporations, which outnumber large, publicly held corporations, might not choose New York law to govern their contracts. They might prefer local law. We do not know.

21. Ayres & Gertner, *Filling Gaps*, *supra* note 5, at 91 (distinguishing “untailored” and “tailored” defaults).

22. *Id.* at 91.

23. *Id.*

Empirical majoritarianism pursues untailored, acontextual default rules.<sup>24</sup> Thus, it aims to identify a rule that will fill contract gaps using the same term for all gaps within a general type, such as gaps in contracts involving price, quality, or time. It ignores variations in expressly agreed terms from contract to contract.

Contract defaults, however, often must be tailored to be efficient. Importantly, I suggest here, *efficiency often, but not always, is a feature of a cluster of related clauses rather than a single term in isolation*. Clusters, of course, vary considerably across contracts. Supplying a term regardless of the cluster into which it should fit often will not be efficient.

Consider, for example, a contract for the sale of goods. It may contain terms concerning the identity of the goods, the quantity of the goods, the quality of the goods (warranties), the times for delivery and payment, a required notice of a claim of breach, a right to cancel and other remedies for breach, time limits for bringing an action for breach, and various other matters. Assume that the terms provide for the sale of a sailboat of a certain description; to be new and of the first quality; payment on delivery; delivery within two years of concluding the contract; buyer to accept delivery regardless of any defect; buyer to give notice of any breach within seven days of delivery or be barred from any remedy; buyer to forgo any right to cancel; buyer's remedy to be limited to repair or replacement; seller's remedy to be its lost profit; and a contractual limitations period of thirty days from delivery for bringing any legal action.

Let us focus on the quality term requiring the seller to deliver a new sailboat of the first quality. In isolation, it would appear that the buyer will value the term very highly. Now look at the other terms. They do not make the quality term valueless to the buyer. But they diminish its value considerably. Assume that the seller tenders a defective sailboat. The buyer cannot reject but must accept delivery. She has only one week to discover the defect(s) and give notice of the breach or be barred from any remedy. Even if she discovers the defect and gives such notice, she cannot revoke acceptance and cancel. If the seller fails to repair or replace, the buyer is likely to know of it only after the contractual limitations period has run. In this context, surely the promise of "first quality" is worth very little to the buyer.

Now consider an alternative contract. It contains the same quality term. But, instead of protecting the seller's interests so ferociously, it provides for that which the Uniform Commercial Code provides as defaults. Thus, under appropriate circumstances, the buyer may reject delivery and cancel.<sup>25</sup> If she accepts delivery, she need not discover and give notice of the breach within one week of delivery but, instead, has a reasonable time from the time she discovers or should have discovered the breach.<sup>26</sup> If she rightfully revokes acceptance and gives notice, she may cancel.<sup>27</sup>

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24. See *id.* at 92 ("Charles Goetz and Robert Scott have proposed that courts should set untailored default rules by asking 'what arrangements would *most* bargainers prefer?'" (quoting Goetz & Scott, *supra* note 6, at 971 (emphasis in original))). Empirical majorities cannot tailor defaults to particular cases because there are too many such cases; majorities do not speak to all of them.

25. U.C.C. §§ 2-601, 2-711(1) (2014).

26. *Id.* § 2-607(3)(a).

27. *Id.* §§ 2-608, 2-711(1).

Her remedy still might be repair or replacement.<sup>28</sup> But she has at least one and possibly four years in which to file an action.<sup>29</sup> Now the term requiring a sailboat “of the first quality” looks much more valuable to the buyer.

Accordingly, parties often would not put values on individual terms in isolation (acontextually), as untailored default rules presuppose. The sailboat hypotheticals show that the *same term* (a sailboat of first quality) generates different values depending on other clauses in the contract (the agreed textual context). Asked the value of a warranty of first quality, both buyer and seller would answer, “It depends.” And, though some clauses seem to stand alone,<sup>30</sup> it depends on the agreed textual context, the cluster of expressly agreed terms in which the warranty will be embedded.

This fact, I suggest, has important implications for a normative efficiency theory of contract and other defaults. A default may come into play when a cluster is incomplete. A theory then should identify the clause (or clauses) that completes a cluster and enhances *the cluster’s* joint value to the parties. Consequently, efficiency often attaches to a cluster of clauses. A lone term need not produce a surplus at all.

Empirical majoritarianism does not seek tailored defaults, though only they can take account of clusters. Clusters are too heterogeneous for an untailored rule, adopted in advance of a dispute, to yield efficient clusters in many cases. Moreover, empirical majoritarianism cannot feasibly be adapted to support tailored defaults. Empirical studies aimed at finding majoritarian preferences would have to target preferences for clauses within clusters as well as stand-alone terms. The number of needed studies would be huge and each one costly.

It might be thought that untailored majoritarian defaults can be identified on an interim basis assuming “all else is equal” (*ceteris paribus*). Relevant clusters would indicate that the justification for a default is not final and that all else is not equal. However, this approach deprives the inquiry of its intended normative character. To be normative—to say what someone ought to do—a rule or standard should be the final step in an analysis, which should be inclusive of all relevant values. The rule or standard should say what someone should do, *all things considered*.<sup>31</sup>

The fact that efficiency may be a feature of a cluster has broad implications. It should figure in efficiency analyses of any legal text with respect to which defaults are appropriate. In these contexts, like contract, the value of one provision may vary with the other provisions in the text. Existing principles of contract interpretation implicitly recognize such relationships when they say that a document should be interpreted “as a whole.”<sup>32</sup> Similarly, the efficiency of one point of law may depend on other points. A default rule or standard of negligence law, for example, may be either efficient or inefficient depending on whether the relevant jurisdiction has a defense of contributory or, instead, comparative negligence.

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28. *Id.* § 2-719(1)(a).

29. *Id.* § 2-725(1).

30. *E.g., id.* § 2-308.

31. *See* Burton, *supra* note 2, at 539–41.

32. STEVEN J. BURTON, *ELEMENTS OF CONTRACT INTERPRETATION* 41–42 (2009).

*B. The Majoritarianism of Majoritarian Default Rules*

To probe more deeply, assume the problem of heterogeneous clusters away temporarily. It would still be necessary to design and conduct sound empirical studies. The design task is plagued by four conceptual problems and one practical problem.

First, almost all studies leave the relevant parties unspecified. As is well known, contract parties, for example, exist on many dimensions (parties who are merchants or consumers, contracts for goods, services, financing, real estate, etc.) at many levels of abstraction (all parties to all contracts, all parties to recent contracts, all parties to contracts made on the date of the contract in question, all parties everywhere, all parties in the place where the contract in question was made, etc.). Surely the majority should be a majority of fewer than all parties to all contracts ever made. But there is no defensible way to define the group a majority of which should count. In other contexts, there may be many affected parties, some of whom have not yet been born or chartered. Here, too, what is the group a majority of which should count?

Schwartz and Scott offer what is perhaps the most developed and plausible version of empirical majoritarianism in a study of contract law.<sup>33</sup> They sought to identify majoritarian defaults to fill gaps in contracts between firms.<sup>34</sup> The majority of firms would get to “vote” on the rules for filling gaps in their own contracts.<sup>35</sup> The minority could contract out. Transaction costs then would seem to be lower overall because fewer firms would incur the costs of contracting out.

Let us look more closely. Schwartz and Scott define “firms” to include corporations with five or more employees, limited partnerships, and professional partnerships such as law and accounting firms.<sup>36</sup> They would reassign contract disputes involving firms selling to individuals to consumer, real property, and securities law; individuals selling to firms to employment law; and those between individuals to family and real property law.<sup>37</sup> It is unclear, however, what justifies treating the local bakery or a two-person law firm practicing family or criminal law differently from an individual. As I suggested elsewhere,<sup>38</sup> distinctively contract law issues arise in cases within all of these categories. Arbitrariness and unequal treatment would result if the law were to treat common issues differently without further justification.

Second, assume that the relevant parties all are firms, however defined. How does a firm form a preference for one complete cluster of clauses over others? It must consider all of the contracts it enters. Some will be standardized following thorough consideration. For these, the clusters of related clauses will be steady. The firm, however, will not see that there is a gap; if it did, it would fill the gap expressly. So, the firm will not form a preference for filling a gap of which it is unaware. Others of

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33. See *supra* note 20.

34. Schwartz & Scott, *supra* note 6, at 544–46 (offering a theory of contract interpretation applicable to contracts between firms); *id.* at 569 (“The relevant question, then, is what should be the majoritarian default.”).

35. See *id.* at 546–48 (restricting the theory’s application to contracts between firms).

36. Schwartz & Scott, *supra* note 6, at 545.

37. *Id.* at 544.

38. Burton, *supra* note 2.

a firm's contracts will be nonstandard. For these, the clusters of clauses will vary from contract to contract. Preferences for filling gaps also will vary because, as the sailboat hypothetical indicates, the value of a gap filler often depends on the cluster it would complete. For these reasons, I doubt that firms would form preferences for one default or another in general. A fortiori, nonfirm actors, including private individuals, would not form such preferences.

Third, assume that some theorist solves the problems of relevant parties and preferences. A next question is: Who speaks for a firm? A corporation, in particular, is not a univocal black box. Different parts of corporations—management, directors, employees, divisions, shareholders, etc.—have different interests. Consequently, different parts of firms might well have different preferences for default rules. Each, moreover, might have a variety of preferences for different types of contracts. No one in a firm, not even the general counsel, totals up or averages different preferences or imposes a single preference for all of a firm's varied transactions.

Fourth, assume that some theorist solves the problems of relevant parties and preferences, and there is someone who speaks for each firm univocally. The next question involves the significance of each firm's "vote." The principle that applies could be "one firm, one vote." But it need not be so. Weighted voting schemes are common, as in corporate governance, where the general rule for shareholder voting is "one share, one vote." In Schwartz and Scott's theory, one might question whether the vote of a firm with five employees (say, the local bakery), or a five-person law firm doing divorce or criminal defence work, should count the same as that of General Electric. It seems safe to say that GE has a stronger interest in the default rules and standards of contract law, and a greater impact on the social allocation of resources, than the local bakery or such a law firm. Since the goal is an efficient allocation, a majoritarian might make the best case by giving each firm a number of votes equal to its number of contracts per year, gross income, dollars of profit, volume of sales, number of employees, or some other measure of its impact on efficiency. If so, however, the method for law making would be seriously undemocratic; if it is not, the "one firm, one vote" rule undermines the claim of efficiency.

Fifth, even if the problem of heterogeneous clusters and the above four conceptual problems could be solved, there may remain a practical problem of instability.<sup>39</sup> Sometimes changes in laws or market conditions are rapid and great. A majority may prefer a term only subject to unspecified changes in circumstances. For example, a majority of corporate and commercial loan contracts may provide for one accounting method today and another tomorrow due to changes in the law or accounting practices. Stock options may be common in calm bull markets but not when the market turns volatile or bearish. Contract making may be too slow for untailed defaults to keep pace.

So, we usually don't know what any empirical majority of relevant parties, by any definition, wants. And, for the future, designing and conducting empirical studies would require solving the problem of heterogeneous clusters and the five problems identified in this subsection. Even if these daunting problems could be solved, such studies would be many and too expensive.

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39. I am grateful to Robert T. Miller for suggesting this argument.

To summarize, empirical majoritarianism looks to what in fact the majority of relevant parties wants for setting untailored defaults. Defaults, however, must be tailored to achieve the efficiency goal whenever a gap arises in a cluster of related clauses. “What the majority wants,” moreover, is an empirical question. But there are few empirical studies to support particular defaults. Further, designing such studies would run into trouble. Designers would need to solve the problem of heterogeneous clusters and the five problems identified in this subsection. For these reasons, we should abandon the empirical majoritarian standard and look for a better alternative.

### III. HYPOTHETICAL CONSENT

This Part examines three alternatives to empirical majoritarianism. Though expressed in different ways, all three derive party consent to a default hypothetically. Hypothetical consent, however, is not an acceptable grounding for any kind of default.

#### *A. Hypothetical Majoritarian and Party-Oriented Standards*

In the absence of sound empirical studies, the empirical majoritarian standard functions hypothetically: it collapses into hypothetical majoritarianism whenever the empirical claim is illusory due to a lack of factual data or otherwise.<sup>40</sup> Two of the problems discussed in Part I carry over to this standard: the hypothetical mode does not solve the problems of specifying the relevant parties or of unstable majorities. But the other problems fall out. This standard is an improvement.

It would be a further improvement if the two outstanding problems were solved. This might be accomplished by dropping the majoritarianism of the first two standards. We could substitute hypothetical consent based on an *ex post* judgment on what the affected parties would have agreed upon *ex ante*.<sup>41</sup>

Both versions of hypothetical consent go awry for the same two reasons. First, they are counterfactuals. Law and economics scholars characteristically proceed by engaging in independent efficiency (cost-benefit) analyses—that is, independently of any majority or the parties. They seek to identify the default that best reduces the joint costs of a contract and thereby increases the benefit, its surplus. They *then* attribute the result to a majority or the parties. Once a sound cost-benefit analysis has been completed, however, the efficient result is as known as it can be. It adds nothing but rhetoric to attribute that result to a majority or the parties.<sup>42</sup>

The rhetoric is not inconsequential. It confuses the analysis. By relying on hypothetical consent, moreover, these standards spread a cloak of objectivity and contractual liberty over an analyst’s independent conclusions. But, simply put, hypothetical consent is neither objective nor consensual. The majoritarianism of majoritarian defaults, in addition, rhetorically invokes the virtues of democratic

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40. See *supra* note 20.

41. See *supra* note 8; *infra* text accompanying note 44.

42. See JULES L. COLEMAN, RISKS AND WRONGS 164–73 (1992) (analyzing counterfactual default rules); Richard Craswell, *Efficiency and Rational Bargaining in Contractual Settings*, 15 HARV. J.L. & PUB. POL’Y 805, 805 (1992) (agreeing with Coleman).

political theory. But democracy has nothing to do with the efficiency of defaults. It would be far more transparent to engage in cost-benefit analysis and drop the attribution.<sup>43</sup>

Second, upon analysis, the two hypothetical standards are illusory because they collapse into the Coasian standard, what rational parties in TCW would agree upon. On the surface, an ambiguity dogs the inquiry into what a majority or the parties would have agreed upon: the inquiry might include or exclude transaction costs. Most gaps appear just when transaction costs preclude express agreement. If the hypothetical inquiry includes transaction costs, the analyst often would leave the same gap as the one that the parties left. No default then is available, and a dispute would remain unresolved by law. If the inquiry excludes transaction costs, however, the illusory character of the three hypothetical standards becomes evident. Indeed, they appear to be surrogates for consulting rational parties contracting in TCW.

### *B. TCW: The Coasian Standard*

Judge Richard A. Posner made explicit that which is implicit in the standards discussed above. He thought courts should fill gaps to implement the overriding purpose of contract law, as he saw it:

[W]hether we say that a contract shall be deemed to contain such implied conditions as are necessary to make sense of the contract, or that a contract obligates the parties to cooperate in its performance in “good faith” to the extent necessary to carry out the purposes of the contract, comes to much the same thing. They are different ways of formulating the overriding purpose of contract law, which is to give the parties what they would have stipulated for expressly if at the time of making the contract they had had complete knowledge of the future and the costs of negotiating and adding provisions to the contract had been zero.<sup>44</sup>

This hypothetical standard looks to a different reference point—the term that rational parties would agree upon in TCW. I suggest here that few, if any, efficient defaults can be set with reference to contracts in that world.

TCW stems from Coase’s *The Problem of Social Cost*.<sup>45</sup> In a 1988 reflection on that article and its reception, however, Coase insisted that his purpose in discussing TCW was very limited.<sup>46</sup> As relevant here, he sought to show that exchanges in TCW would move resources to highest valued uses, regardless of the initial assignment of

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43. See *infra* Part IV.

44. *Mkt. St. Assocs. Ltd. v. Frey*, 941 F.2d 588, 596 (7th Cir. 1991) (Posner, J.). I do not take Judge Posner’s reference to “complete knowledge of the future” literally. All that is needed is complete knowledge of the opportunities made available by the price system over time.

45. Coase, *supra* note 9.

46. See R. H. COASE, *THE FIRM, THE MARKET, AND THE LAW* 174 (1988) (indicating that he had wanted to persuade economists to leave the world of zero transaction costs, which represented the world of modern economic theory).

legal rights.<sup>47</sup> He has said little about the features of that world; in particular, he has said nothing about the features of contracts there. He wrote:

In [*The Problem of Social Cost*], I examined what would happen in a world in which transaction costs were assumed to be zero. My aim in so doing was not to describe what life would be like in such a world . . . .<sup>48</sup>

. . . .  
It would not seem worthwhile to spend much time investigating the properties of [a world of zero transaction costs].<sup>49</sup>

In light of TCW's central role in the standard under discussion, however, we should do what Coase did not do. This standard looks to TCW for agreed terms that point the way to efficient defaults in our world. It is crucial to ask whether such terms would exist there. If they would not, TCW would be an analytical dead end.

In 1988, Coase wrote: "Another consequence of the assumption of zero transaction costs, not usually noticed, is that, when there are no costs of making transactions, it costs nothing to speed them up, so that eternity can be experienced in a split second."<sup>50</sup> If Coase is right that "eternity can be experienced in a split second," there are no contracts in TCW. A contract is an exchange projected by promise(s) into the future.<sup>51</sup> Speed in such a world collapses the present and future. Parties would not enter *contracts* in the first place. Hence, there would be no contract terms.

It is doubtful, however, that Coase is right about this. The absence of transaction costs speeds up contract making but not contract performance. We should distinguish transaction costs from production costs. The former include the costs of entering transactions. The latter include the time it takes to produce a good or service. Thus, parties in TCW may make a contract in a split second to build a bridge. But it still takes time to build it. Contracting parties in TCW may make promises about the bridge's design, progress payments, completion dates, and so forth.

It does not follow that TCW contains contracts with useful terms for setting defaults, whether the terms are to stand alone or to complete incomplete clusters. Without information, search, and other transaction costs, rights snap directly to a highest valued user. Assume that Able has a 1965 Ford Mustang convertible that he no longer likes much. Baker values it more than Able, and Charlie values it more than Baker or Able. In our world, Able might well sell the car to Baker, a classic car dealer, who in turn would sell it to Charlie, a collector. The information and search costs for Able to find Charlie could be prohibitive. In TCW, by contrast, Able would never sell the car to Baker. Since information and search costs are zero, Able would sell directly to Charlie. Indeed, there are no middlemen like Baker in TCW.

47. Coase, *supra* note 9, at 2–15 (explaining what came to be known as the "Coase Theorem").

48. COASE, *supra* note 46, at 13.

49. *Id.* at 15.

50. *Id.*

51. RESTATEMENT (SECOND) OF CONTRACTS §§ 1, 2 (1981) (defining a contract as a promise and a promise as a manifestation of intention to act or refrain from acting); Ian R. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691, 696 (1974) (expanding the definition to encompass exchanges projected into the future).

Consequently, there would not be contracts with middlemen's terms in TCW. In our world, by contrast, middleman contracts for the sale of goods are common. They routinely include, for example, terms about inventories, returns, servicing warranty claims, sales quotas, consignments, risk of loss, etc. Building and construction routinely involve general contracts and subcontracts between general contractors and subcontractors, and subcontractors with labor and materials suppliers. When a gap in a middleman's contract is in issue, there are no counterpart terms in TCW. Indeed, there would be no counterparts to most contracts in our world, only Able-Charlie contracts.

Absent negotiating and drafting costs, it might be that Able and Charlie would conclude a fully specified (complete) contract. In that case, TCW would include counterpart terms and clusters for the few Able-Charlie contracts in our world. Perhaps, however, contracts in TCW would be very thin. There are no information costs, so Able and Charlie know all there is to know about the car, the market, and each other. They might agree on a price and the identity of the car, but little else. They might bank on the probabilities of gains and losses instead of contract terms and clusters.

The upshot of the foregoing analysis is that, in TCW, contract terms and clusters do not exist or, at best, are scarce. Hence, recourse to TCW to set defaults is incoherent, the actual analysis is not transparent, and the efficiency goal is not well served. Such recourse presupposes that terms and clusters are there. But this presupposition is almost always false. It might be thought that recourse to TCW nonetheless is a useful heuristic or thought experiment. But, like the other standards discussed thus far, it is a poor one: to adapt Gertrude Stein's comment about Oakland, "there is no there there."<sup>52</sup> Recourse to TCW invites unsound conclusions because it is a dead end.

This insight has important, potentially disruptive implications far beyond contract scholarship. Leading economic analyses of defaults look to contracts in TCW when analyzing the laws of negligence, debtor-creditor relations, corporations, and many other matters.<sup>53</sup> For the reasons given above, such inquiries are misguided. The next Part presents a better way to pursue efficient contract defaults, one that probably underlies recourse to TCW in many cases. It, too, has broad implications for many analyses of efficient defaults.

#### IV. A PREFERRED STANDARD FOR CHOOSING EFFICIENT DEFAULTS

In this Part, I propose and defend a coherent, transparent, and likely more efficacious standard for setting efficient contract performance and enforcement defaults. I here confine the proposal to contract defaults only because contract law is what I know. I believe the proposed standard is generalizable to other fields of law with little, if any amendment. I leave it to those with other specializations to do the generalizing.

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52. GERTRUDE STEIN, *EVERYBODY'S AUTOBIOGRAPHY* 289 (Cooper Square Publishers 1971) (1937).

53. *See supra* note 10.

As with any legal proposal, an efficiency claim depends on two dimensions. One concerns the efficiency of a law's *content*. The other concerns the efficiency of a law's *form* as rule or standard.<sup>54</sup> Ideally, efficient laws are justified by a confluence of efficient content and form. The proposal here takes the form of a presumptive standard that is justified in efficiency terms in both ways.

*A. The Content of Efficient Defaults*

Here is my proposal: *Presumptively, default standards should guide courts toward supplying the term that the parties should have adopted to generate a surplus from the term or a cluster of related clauses.* This standard would function in two substantive ways. First, only a standard or a highly tailored rule can guide courts to fill gaps to achieve efficiency when the gap is in a cluster of related clauses. Efficiency then is a feature of the cluster.<sup>55</sup> Lawmakers cannot feasibly know the contours of heterogeneous clusters in advance of a dispute. So, they cannot supply an efficient default term to complete a cluster. Second, a court should find that the parties *should* agree on a term or cluster if it would benefit one of them more than it costs the other, transaction costs aside. This would generate—perhaps maximize—a surplus. The parties thus should agree when agreeing would be Kaldor-Hicks efficient. *Coase's TCW drops out!*

This standard differs from those criticized above because, for one thing, it is explicitly normative and, therefore, more transparent. Make no mistake: the others are just as normative. Behind their facades lies a utilitarian normative theory. I have no quarrel with that theory when it comes to filling gaps in contracts.<sup>56</sup> My quarrel is with attributing the results of an efficiency analysis to the hypothetical consent of counterfactual parties. Such attributions confuse and hide the analytical action. An analyst should “own” the analysis and make it readily available for others to evaluate.

The proposed standard also differs because it makes explicit reference to “the term or a cluster of related terms.” Three of the four standards criticized above aim at untailed default rules. Consequently, they purport to supply a single term to fill a type of gap regardless of the expressly agreed terms in a contract, which often contains clusters into which the default should fit, rendering the cluster efficient. Untailed defaults cannot fit in a way that generally achieves efficiency. (Similarly, efficiency analyses of a term in any legal document, such as a contract, statute, or corporate charter, should consider clusters of related terms.)

Consider, for example, *Loudenback Fertilizer Co. v. Tennessee Phosphate Co.*<sup>57</sup> A buyer contracted to take its entire phosphate rock requirements, up to a maximum quantity, from the seller at a fixed price for five years. Three terms form a cluster

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54. See generally Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1 (1993); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

55. See *supra* Part II.A.

56. This statement represents a change from the position I took over twenty years ago. See Steven J. Burton, *Default Principles, Legitimacy, and the Authority of a Contract*, 3 S. CAL. INTERDISC. L.J. 115 (1993).

57. 121 F. 298 (6th Cir. 1903).

here: a floating quantity term that varies with the buyer's requirements, a maximum quantity term set in the contract, and a fixed-price term set in the contract. The buyer made "acid phosphate" with the rock and sold it as a fertilizer. For more than a year during the term, the buyer ordered no rock but purchased acid phosphate from other manufacturers because, the buyer testified, this was more profitable. When the market price of rock and, therefore, acid phosphate rose, the buyer ordered the maximum quantity of rock from the seller. The seller refused to deliver. In an action by the buyer, the court held that the buyer had materially breached by performing in bad faith, thereby entitling the seller to cancel.<sup>58</sup>

The proposed standard would guide a court toward deciding whether to complete the cluster by supplying a term that prohibits the buyer's gambit. The question should turn on whether the parties should have agreed on one so that the cluster likely produces a surplus, transaction costs aside.

With a prohibition, the seller can rely on its knowledge of the buyer's manufacturing business to produce an appropriate quantity of phosphate rock up to the fixed maximum. The seller probably would not have foreseen the contingency of a manufacturer transforming its business into one of arbitraging fertilizer.<sup>59</sup> Ex ante, the seller gains predictability from a cluster of clauses containing a prohibition.

The buyer, on the other hand, would lose the opportunity to arbitrage. This cost, however, probably is less than the benefit to the seller (though this judgment would be more confident if the case had been litigated on this basis). Ex ante, the buyer has better information about its own future desire to buy acid phosphate instead of phosphate rock. Thus, the opportunity cost to the buyer is the cost of disclosing its contingent future desire and gaining agreement to a clause establishing a floor price. Because the buyer did not make such a disclosure, and the contract contained a fixed price, the parties should have completed the cluster by agreeing on a prohibition.<sup>60</sup>

It might be objected that the proposed standard calls for just the sort of imposition that contract law should never countenance: it calls for courts to impose upon the parties rights and duties the parties did not choose. However, *all* defaults do this. Defaults operate *only* when the parties did not choose. There is no need to refer to majorities, the parties, or rational parties in TCW in order to justify a contract default. Referring to "what the parties would have wanted," in any of its versions, is a

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58. *See id.* at 302–03.

59. *Accord*, *Orange & Rockland Utils., Inc. v. Amerada Hess Corp.*, 397 N.Y.S.2d 814 (App. Div. 1977).

60. This analysis supplements the one I advanced in earlier writings. Steven J. Burton, *Breach of Contract and the Common Law Duty To Perform in Good Faith*, 94 HARV. L. REV. 369, 395–96 (1980). The difference is that I then suggested that the buyer performed in bad faith because it used its performance discretion to pursue an opportunity that it forwent upon entering into the contract in question—the opportunity to buy acid phosphate should the market price for phosphate rock rise. The standard proposed here differs in that it would find the buyer in bad faith because it used its discretion to pursue an opportunity that it *should* have forwent when entering the contract. The earlier analysis remains sound when the requisite finding of fact can be made; in that case, the factual implication should take priority over the normative. The result is a three-tiered analysis based on the priority of express terms (as interpreted) over any implication and the priority of factual implication over normative gap filling.

rhetorical illusion with untoward consequences for efficiency. Whether or not we make such a reference, the cost-benefit analysis is doing all of the work.

It also might be objected that the proposed standard would not lead to different results from those supported by studies employing some version of “what the parties would have wanted.” Though this outcome is possible, it is by no means inevitable. Once the standard for setting defaults is coherent and transparent, a different analysis and scholarly discussion should ensue, one that is explicitly normative. The analysis and discussion might well lead to different results. Each issue must be taken up individually and evaluated to find out. The limited goal of this Essay is to shift the premises of default standards analyses and restart the conversation.

### *B. The Form of Efficient Defaults*

The proposal employs an abstract standard presumptively, allowing for concrete default rules when justified. Standards often have considerable efficiency advantages over rules<sup>61</sup>: the chief one in this context is that they allow courts to supply tailored defaults. A general review of gap-filling cases surely would show that they are markedly heterogeneous.<sup>62</sup> Defaults often supply terms that complete incomplete clusters of expressly agreed clauses. Filling a price gap to divide a contract’s surplus obviously depends on the expressly agreed clauses, which generate the surplus.<sup>63</sup> Thus, the price in a contract for a sale of goods typically varies with the strength of

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61. Kaplow, *supra* note 54, at 621 (concluding that standards are preferable to rules when behavior varies greatly or is infrequent).

62. I have done a thorough review for years with respect to the implied covenant of good faith and fair dealing. See STEVEN J. BURTON & ERIC G. ANDERSEN, *CONTRACTUAL GOOD FAITH: FORMATION, PERFORMANCE, BREACH, ENFORCEMENT* (1995); Steven J. Burton, *Good Faith in Articles 1 and 2 of the U.C.C.: The Practice View*, 35 WM. & MARY L. REV. 1533 (1994); Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984); Steven J. Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA L. REV. 1 (1981); Steven J. Burton, *Breach of Contract and the Common Law Duty To Perform in Good Faith*, 94 HARV. L. REV. 369 (1980); see also Robert S. Summers “Good Faith” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 201–07 (1968) (instances of bad faith are heterogeneous); Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 819 (1982) (same). Though the implied covenant is a mandatory term of every contract, it operates as a default. See U.C.C. § 1-302(b) (2014).

63. Ben-Shahar helpfully distinguishes surplus-enhancing terms, which increase the size of a pie, from surplus-dividing terms (such as price), which share the pie out. Ben-Shahar, *supra* note 1, at 401; see Schwartz & Scott, *supra* note 6, at 554 (“Parties jointly choose the contract terms so as to maximize the surplus, which the price may then divide unequally.”). This Essay concerns surplus-enhancing terms or clusters of related clauses. The problem of supplying a distributive term is outstanding. For Ben-Shahar’s view, see *supra* note 1 at 407 (suggesting that filling distributive gaps might reflect “the division of bargaining power [between the parties], and consequently the deal, that these particular parties would have come to”). I am inclined to think that courts should fill distributive gaps with fair prices, taking into account the entire contract and the market.

the warrantees. Similarly, filling gaps in surplus-generating clauses may depend on related, expressly agreed terms.

Abstract standards allow parties to leave a clause open for courts to fill it in concretely after a dispute arises in the gap. At that time, the expressly agreed terms of a particular contract can be known. Courts then can tailor gap fillers in light of the agreed textual context into which they should fit. Legislatures cannot do that because they make rules *ex ante*. Because efficiency often is a feature of a cluster, this timing is critically important.

Standards also have advantages over tailored default rules. The cost of designing, drafting, enacting, and applying tailored rules often is high. Such rules must be subcategorized *ex ante* to the point where the rule will fill gaps of various kinds, often including gaps in various clusters. When subcategorized enough to achieve this goal, rules are likely to be highly complex, making it costly for parties who consider opting out to figure out which part of the rule applies to which disputes. This prospect substantially undermines the chief general advantage of untailed default rules—their relative predictability when drafters decide whether to opt out. The prospect also increases the risk of error and unequal treatment.

Contract defaults should take the form of standards presumptively. This presumption might be overcome when a rule can be designed, drafted, enacted, and applied at little cost while clusters are irrelevant. In existing law, a few defaults are rules. When the parties to a contract for the sale of goods do not agree on a place for delivery, for example, Article 2 provides in part that delivery shall be at “the seller’s place of business or if he has none his residence.”<sup>64</sup> This rule has an appropriate form due to the high frequency of occasions for applying it, the similarity of those occasions, the need for predictability, and the low cost of enacting and applying it due to its simplicity. No doubt there are other defaults that should be rules, especially when it matters less what the law is than that it be predictable.

#### CONCLUSION

The standard for setting defaults should guide courts toward filling gaps with the term that affected parties *should* have adopted to generate a surplus from the term or a cluster of related clauses in which the term fits. This standard has three main advantages over its competitors. It is more transparent because it is explicitly normative. Its competitors, by contrast, hide their normativity under a rhetorical cloak of objectivity, liberty, and democracy. The proposed standard thus invites others to evaluate the analysis while its competitors mislead. It also is more coherent because it carries its normativity on its face rather than attributing defaults to the consent of counterfactual parties. Its competitors, by contrast, confusingly attribute the analyst’s normative conclusions to an empirical or hypothetical majority, the parties, or rational parties in a transaction-costless world (TCW). And it is better designed to identify efficient defaults, especially when a default should fit into a cluster of related clauses. Untailed default rules often will miss their marks, for they cannot feasibly take account of heterogeneous clusters.

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64. U.C.C. § 2-308(a) (2014).

These conclusions flow from two general theoretical insights. One is that efficiency often is a feature of a cluster of clauses rather than a term in isolation. The other is that there are few, if any, contract terms or clusters in TCW. The latter has a surprising consequence: neither the Coase Theorem nor Coase's TCW are relevant when setting efficient defaults. The Coase Theorem often sustains using defaults rather than mandatory rules or standards. But this justification for using defaults does not justify choosing any particular default.