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Status Quo Bias and Contract Default Rules

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THE STATUS QUO BIAS AND CONTRACT DEFAULT RULES

Russell Korobkin†

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INTRODUCTION

In an ideal world, contracts would explicitly allocate rights and responsibilities between contracting parties for all possible contingencies that might arise over the life of the contract. In reality, of course, contracting parties cannot foresee all possible contingencies that might bear on the operation of the contract. Furthermore, preparing for all foreseeable contingencies, no matter how remote, can be both difficult and costly. Consequently, all but the simplest contracts are, to some extent, obligationally incomplete[1]—there are gaps in the contract's explicit and implicit provisions that leave the parties' obligations unspecified under certain contingencies.[2] It falls to public

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1 *See* Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729, 730 (1992):

> Legal scholars use the term "incomplete contracting" to refer to contracts in which the obligations are not fully specified. . . . A contract that failed to specify the seller's obligations in the event of a flood or the buyer's breach would thus be obligationally incomplete. . . .
>
> Economics scholars, on the other hand, use the term "incomplete contracting" to refer to contracts that fail to fully realize the potential gains from trade in all states of the world.

2 I use the term "incomplete" to refer to situations in which the parties have left an issue unaddressed, as distinguished from instances in which the parties have attempted to address an issue but have done so with terms that are ambiguous or that are subject to more than one meaning. *See* Dennis Patterson, *The Pseudo-Debate Over Default Rules in Contract Law*, 3 S. CAL. INTERDISC. L.J. 235, 236-37 (1993) (distinguishing "substantive" incompleteness from "interpretive" incompleteness). The latter is a problem of interpreting parties' language rather than of creating legal rules to fill gaps in contracts which the parties have left. *See generally* Lawrence A. Cunningham, *Hermeneutics and Contract Default*

institutions—courts and legislatures—to create background, or "default," rules to govern private relationships when such unaddressed contingencies arise and private ordering, thus, has failed. The process by which lawmakers should determine the substance of such default rules has been a subject of much discussion in the contract-theory literature, especially over the last decade.[3]

With a few exceptions,[4] law-and-economics theorists concerned with selecting efficient legal rules have shaped and dominated the debate. The centrality of efficiency concerns in this debate is both predictable and justifiable. Default rules, by their nature, are not instruments well-suited to protecting third parties from deleterious effects of contracts, or to protecting the parties from each other. For example, it would make little sense for lawmakers to enact *default* rules prohibiting fraud in contract negotiations in order to protect contracting parties, or prohibiting contracts for illegal services in order to protect nonparties, rather than enacting substantively identical *mandatory*, or "immutable," rules which private parties are not free to change.[5] Default rules enacted for such purposes would likely fail to

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Rules: An Essay on Lieber and Corbin, 16 CARDOZO L. REV. 2225, 2235 (1995) (explaining the distinction drawn by Lieber and Corbin between the judge's first step in resolving a contract dispute, interpreting the expressions of the parties, and the second step, invoked when the first fails to resolve the case, of "supply[ing] terms to fill the gap discovered by interpretation"). This Article is concerned only with gap-filling, not with interpretation.

[3] For a particularly good dialogue on the subject, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989) (applying game theory to the question of how lawmakers should create contract default rules to facilitate efficient contracts); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990) (employing game theory, but challenging Ayres and Gertner's conclusions); Ayres & Gertner, *supra* note 1 (responding to Johnston); *see also Symposium on Default Rules and Contractual Consent*, 3 S. CAL. INTERDISC. L.J. 1 (1993) (featuring 17 pieces on theoretical perspectives on contract default rules); Randy E. Barnett, *The Sound of Silence: Default Rules and Contractual Consent*, 78 VA. L. REV. 821 (1992) (discussing the default rule approach to gap-filling); Jnles L. Coleman et al., *A Bargaining Theory Approach to Default Provisions and Disclosure Rules in Contract Law*, 12 HARV. J.L. & PUB. POL'Y 639 (1989) (applying an economic analysis to default rules); Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391 (1992) (reviewing FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991)) (considering default contract rules in the arena of corporate law).

[4] *See, e.g.*, Barnett, *supra* note 3, at 880 (arguing that consent is the fundamental value that contract law should uphold, and that this value is best insured through default rules that "reflect the commonsense or conventional expectations that likely are part of the tacit assumptions of particular parties"). *But see* Steven J. Burton, *Default Principles, Legitimacy, and the Authority of a Contract*, 3 S. CAL. INTERDISC. L.J. 115, 118 (1993) (arguing that the principle of consent is inferior to the coordination principle in creating default rules because default terms become operable only when the parties have failed to consent to any particular allocation of rights and responsibilities).

[5] *See* Burton, *supra* note 4, at 139-40 (suggesting that if lawmakers wish to enforce communitarian norms, a mandatory—not default—rule is appropriate, and that if lawmakers decide to create only a defanlt rule, there is no authority for pushing parties in one direction based on normative principles). This does not stop some theorists from

achieve their desired purpose and instead, would merely increase transaction costs.

By enacting a default rule to govern a contingency, then, lawmakers implicitly render a determination that the desires of the parties to a transaction will be permitted to take precedence over other policy concerns.[6] When the parties leave contractual gaps, default rules can best approximate the parties' desires by maximizing their joint wealth or utility. Defaults that achieve this purpose can be characterized as efficient under a Pareto standard[7] because, by dividing the joint gains, both parties may be better off than they would be under any other default rule.

But while efficiency is a proper goal of contract default rules, contracts scholars concerned with selecting efficient default rules uniformly base their analyses upon a dubious assumption about the behavior of contracting parties: that the contracting parties' preferences for the substantive terms of their contracts remain the same regardless of the choice of default rules. For example, some buyers might prefer the delivery of goods on Tuesdays and others on Wednesdays, but whether lawmakers determine that the default delivery day for contracts is to be Tuesdays or Wednesdays will not affect which day any individual buyer would prefer. This Article considers this assumption—which I will call the "preference exogeneity assumption"—and its implications.

This Article has two primary purposes. First, it argues that the preference exogeneity assumption is false. My thesis is that when lawmakers anoint a contract term the default, the substantive preferences of contracting parties shift—that term becomes more desirable, and other competing terms becoming less desirable. Put another way,

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proposing that even default rules, rather than just mandatory rules, be used to promote socially desired values. *See, e.g.*, Clare Dalton, *An Essay in the Deconstruction of Contract Doctrine*, 94 YALE L.J. 997, 1002 (1985) ("In its manifold guises, contract doctrine promises that the source of our deepest anxiety, the cbasm between self and other, could be bridged."); Jay M. Feinman, *Critical Approaches to Contract Law*, 30 UCLA L. REV. 829, 857 (1983) ("Contract law, as part of the sphere in which we as legal people operate can be a vehicle for revolutionary intellectual activity at two levels: the utopian and the immediate."); Jay M. Feinman, *The Last Promissory Estoppel Article*, 61 FORDHAM L. REV. 303, 311-15 (1992) (favoring "relational contracts," which "emphasize the interdependence of individuals in social and economic relationships").

6 The drafters of contract code provisions bave made such a determination in the vast majority of circumstances. *See, e.g.*, U.C.C. § 1-102(3) (1995) (stating that "[t]he effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement"); Edith Resnick Warkentine, *Article 2 Revisions: An Opportunity to Protect Consumers and "Merchant/Consumers" Through Default Provisions*, 30 J. MARSHALL L. REV. 39, 44 (1996) ("Freedom of contract is a guiding principle of the U.C.C. This means that the contracting parties are free to reach any agreement.") (footnote omitted).

7 For a definition of Pareto efficiency, see *infra* note 52.

contracting parties view default terms as part of the status quo, and they prefer the status quo to alternative states, all other things equal. This Article supports this contention with the first thorough series of controlled experiments designed to test the preference exogeneity assumption in the context of contract default rules. Second, this Article describes why the falsity of the preference exogeneity assumption matters. It explores the implications of this "status quo bias" that contract default terms create and provides a theory of how lawmakers should select contract default rules to neutralize the status quo bias. I suggest that the proper approach to the problem is to create default rules "tailored" to the circumstances of particular contracting parties or to impose "non-enforcement" defaults, in which courts refuse to enforce a contract unless the parties explicitly provide for certain contingencies.

Part I of the Article provides context by reviewing the debate within the law-and-economics community over whether "majoritarian" or "penalty" defaults are more efficient and explains how the preference exogeneity assumption is embedded in both of the competing theories. Part II reviews the literature from psychology and experimental economics on the status quo bias (also known as the endowment effect), which describes the tendency of individuals to prefer the status quo to alternatives, all other things equal. It then explains how evidence of the status quo bias in other contexts is potentially—but not necessarily—relevant to the question of how lawmakers can best create efficient contract default rules.

Part III describes and reports the results of a series of controlled laboratory experiments designed to test thoroughly for the first time whether the status quo bias renders false the preference exogeneity assumption of economic approaches to contract default rules. Although no single set of experiments can provide incontrovertible evidence in support of a point, the experimental results strongly suggest that the preference exogeneity assumption is inaccurate in many circumstances. Part III also considers what motivational theories best explain the existence of the status quo bias in the default rules context.

Part IV analyzes the implications of the status quo bias for default-rules theory and public policy, arguing that, to a far greater degree than previously believed, (1) the content of default rules is important; (2) majoritarian default rules are more desirable and penalty default rules less desirable; and (3) default terms tailored by courts to the circumstances of specific contracting parties or non-enforcement defaults are more desirable, and generic default terms applicable to all contracting parties less desirable.

I
THE ECONOMIC ANALYSIS OF DEFAULT RULES

A. The Problem of Transaction Costs

The Coase theorem[8] is generally understood to predict that contracting parties will bargain to the efficient allocation of rights and responsibilities, irrespective of initial entitlements if and only if transaction costs are low.[9] Consequently, in a Coasean world, parties will agree on efficient contract terms if transaction costs are low, irrespective of the substance of default rules.[10] The corollary to this application of the Coase theorem is that when transaction costs are high, contracting parties will not contract around inefficient defaults.[11]

Given the centrality of the Coase theorem to the law-and-economics movement,[12] it is not surprising that the traditional law-and-economics analysis of contract default rules focuses on problems created by transaction costs in private contracting. The traditional analysis concludes that default contract terms should mimic[13] those terms that

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8 For the original version of this analysis, see R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

9 *See, e.g.*, ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 81-82 (2d ed. 1997). Although the theorem is often stated as requiring zero transaction costs, it logically requires only that the difference in valuation of a legal right between two parties exceed the costs of reallocating the right through bargaining. *See, e.g.*, Stewart J. Schwab, *Collective Bargaining and the Coase Theorem*, 72 CORNELL L. REV. 245, 266-67 (1987). Schwab notes:

> Obviously the Coasean assumption of *zero* transaction costs is stylized, but the Coasean prediction will often remain accurate with a less extreme assumption. Specifically, transaction costs will not impede efficient bargaining whenever the difference in values that the [parties] place on an item exceeds the costs of bargaining over the item.

Id.

10 *See* ROBERT A. HILLMAN, THE RICHNESS OF CONTRACT LAW: AN ANALYSIS AND CRITIQUE OF CONTEMPORARY THEORIES OF CONTRACT LAW 225 (1997) (discussing the assumption of neoclassical legal economists that if parties could bargain without cost and with perfect information, they would agree on contract terms that are efficient because they would allocate risk to the superior risk bearer or superior risk avoider); *cf.* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 557 (1990) (concluding that default rules in corporate law "aren't very important" because lawyers can draft standard form contracts that opt out of the defanlt terms, thus minimizing transaction costs).

11 *See, e.g.*, Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466, 468 (1980) ("[B]ecause of the costs involved in enumerating and bargaining over contractual obligations under the full range of relevant contingencies, it is normally impractical to make contracts which approach completeness.").

12 Coase's article, Coase, *supra* note 8, establishing what has come to be known as the Coase theorem, is one of the most frequently cited articles in law reviews and perhaps the most frequently cited article in economics journals. For a brief description of its impact, see Daniel A. Farber, *Parody Lost/Pragmatism Regained: The Ironic History of the Coase Theorem*, 83 VA. L. REV. 397, 398-404 (1997).

13 Coase himself suggested that lawmakers could respond to the problem of transaction costs by assigning rights so as to mimic transactions that would take place in a market free of transaction costs or to reduce transaction costs so as to facilitate the efficient transfer of rights. Coase, *supra* note 8, at 17-18. Law-and-economics scholars have since debated

the majority of contracting parties would agree upon if negotiating and drafting a relevant provision were cost-free.[14] Default rules created according to this process, often referred to as "majoritarian" defaults,[15] minimize the number of occasions in which parties will need to contract around default rules in order to arrive at an efficient outcome.[16] This approach minimizes the two forms of inefficiency that transaction costs can create: inefficient contract terms and the transaction costs themselves.

When transaction costs are high, majoritarian defaults minimize the number of inefficient contracts that result from the failure of par-

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which of these approaches is preferable in different circumstances. *See, e.g.*, MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 123-24 (1987) (weighing the benefits and disadvantages of both systems).

14 *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 15 (1991) ("[C]orporate law should contain the terms people would have negotiated, were the costs of negotiating at arm's length for every contingency sufficiently low."); *id.* at 250 ("The right inquiry is always what the parties would have contracted for had transaction costs been nil . . . ."); HILLMAN, *supra* note 10, at 225 ("[I]n theory the efficient gap-filling or 'default' rule is what most parties would want."); RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 396 (4th ed. 1992) (stating that default rules should "supply[ ] standard contract terms that the parties would otherwise have to adopt by express agreement"); Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983) (stating that lawmakers should create default terms by asking, "[W]hat arrangements would *most* bargainers prefer?"); Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353, 361 (1988) (positing that default rules should provide "the contract that most well-informed persons would have adopted if they were to bargain about the matter"). This traditional economic analysis has worked its way into the body of case law, like so many other basic economic analyses of law, via Judge Posner's pen. *See* Market Street Assocs. Ltd. Partnership v. Frey, 941 F.2d 588, 596 (7th Cir. 1991) (Posner, J.) ("[T]he overriding purpose of contract law . . . 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.").

15 *See* Ian Ayres, *Preliminary Thoughts on Optimal Tailoring of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1, 5 (1993).

16 *See* HILLMAN, *supra* note 10, at 226 (noting that majoritarian default terms "decrease[ ] the overall cost of contracting because [they] save[ ] most future parties the expense ('transaction costs') of bargaining to supplant a different gap-filling rule"); *see also* David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1841 (1991); Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 399 (1993). Determining which default is efficient for the majority of parties is often quite difficult in practice. *See* HILLMAN, *supra* note 10, at 226-27 (providing examples of this difficulty). Some theorists have recommended that policymakers observe whatever term most parties reach privately. *See, e.g.*, Richard A. Epstein, *In Defense of the Contract at Will*, 51 U. CHI. L. REV. 947, 951 (1984) ("A rule of construction is often chosen because it reflects the dominant practice in a given class of cases and because that practice is itself regarded as making good sense for the standard transactions it governs."); Schwab, *supra* note 9, at 286-87 ("One way [to] decide which party values the entitlement most highly[,] and thus would have obtained the entitlement in a costless market[,] is to look to actual contracts."). However, in a mature legal system, there is usually a default, which means that parties that explicitly address an issue by contract will likely be those for whom the default is inefficient, even if they do not represent a majority of all affected parties. *See* Ayres & Gertner, *supra* note 3, at 115-16.

ties to contract around the default rules. When transaction costs are low (and, therefore, parties are expected to negotiate efficient contracts regardless of the default terms), majoritarian defaults minimize the number of parties that must incur costs by negotiating explicit contract terms rather than taking the cheaper route of leaving a "gap" in the contract for a default term to fill. Commentators have argued, for example, that the "off-the-rack" provisions of the Uniform Commercial Code ("UCC") are majoritarian defaults that save most parties the expense of specifying such terms as time of delivery, place of delivery, or even price in their agreements.[17]

The efficiency argument for majoritarian default rules implicitly assumes that the costs of contracting around a default rule are the same, on average, for the majority of parties for whom the default term is efficient and the minority who would prefer a different term. If transaction costs are systematically higher for those in the "minority" than those in the "majority," strictly majoritarian defaults may not be efficient, even assuming transaction costs are the primary cause of contractual inefficiency.[18] Thus, in some instances, total transaction costs might be minimized by requiring a "low cost" majority of parties to contract around a default rule so that the "high cost" minority of parties do not have to do so.[19] Consequently, a variation on the basic majoritarian approach would require lawmakers to account for any differential between costs of contracting for parties in the majority and those in the minority.

Two examples, to which I will return throughout this Article, are useful in understanding the theoretical concepts described thus far. The default rule concerning consequential damages for breach of contract created in *Hadley v. Baxendale*,[20] an example much used by

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17 *See* Ayres, *supra* note 3, at 1397; *cf.* EASTERBROOK & FISCHEL, *supra* note 14, at 34 ("[C]orporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting.").

18 *See* Ayres & Gertner, *supra* note 3, at 93 ("[T]he majoritarian approach fails to account for the possibly disparate costs of contracting and of failing to contract around different defaults."); Charny, *supra* note 16, at 1842 (recognizing that "minimizing the number of transactions in which parties bargain around the [default] rule will not always minimize the cost of transacting").

19 Ian Ayres has drawn on this insight to argue for the possible efficiency of "muddy" rather than clear default rules in the context of corporate contracting. Ayres, *supra* note 3, at 1403-08. Ayres hypothesizes that some parties would prefer situation-specific (i.e., "muddy") default rules, such as a rule requiring a court to select the substantive rule that is most "reasonable" given the parties' unique circumstances, while other parties would prefer generic rules, applicable to all contracting parties regardless of circumstances, but clear ex ante. *Id.* at 1405-06. Asserting (although offering no proof) that it might be more expensive for a corporation to contract around a clear but generic default provision into a muddy term than vice versa, Ayres contends that transaction costs could be minimized and overall efficiency achieved in a regime of tailored "party-specific" defaults, even if a clear term would be efficient for the majority of contracting parties. *Id.*

20 156 Eng. Rep. 145 (1854).

default rule theorists,[21] is that a party breaching a contract is liable only for damages that were reasonably foreseeable at the time of contracting.[22] An obvious alternative rule would be to impose liability on the breaching party for *all* damages proximately caused by the breach, regardless of foreseeability. A majoritarian approach to default-rule creation would ask whether, in a world with no transaction costs, most contracting parties—or perhaps most contracting parties in a given industry—would contract for full liability or limited liability (that is, liability only for foreseeable damages) and then create the default rule accordingly. If it is more costly for parties to contract for limited liability than full liability (or vice versa), however, selecting the most efficient rule would require taking into account that cost differential in addition to the percentage of parties that would prefer each term.

The doctrine of impossibility presents another context for contrasting these two approaches. Under both the *Restatement (Second) of Contracts* and the UCC, the default contract term excuses from performance a party who does not perform a contractual obligation because doing so would be commercially impracticable, or unreasonable under the circumstances.[23] A contrary rule would hold the

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21 Perhaps the most famous case in all of contract law, *Hadley* has become the example that default rule theorists most often employ to illustrate their conceptual arguments. *See, e.g.*, Ayres & Gertner, *supra* note 1 (using *Hadley* as a starting point for testing their model of default rules); Ayres & Gertner, *supra* note 3, at 101-04, 108-18 (same); Lucian Arye 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) (studying the desirability of an unlimited-liability rule); William Bishop, *The Contract-Tort Boundary and the Economics of Insurance*, 12 J. LEGAL STUD. 241, 252-60 (1983) (applying a "remoteness in damage" doctrine to insurance theory); Johnston, *supra* note 3, at 615 (questioning the "established economic analysis" of *Hadley*).

22 *Hadley*, 156 Eng. Rep. at 151. The *Hadley* decision has been cited with approval by the highest court in 43 states. *See* Thomas A. Diamond & Howard Foss, *Consequential Damages for Commercial Loss: An Alternative to* Hadley v. Baxendale, 63 FORDHAM L. REV. 665, 665 n.3 (1994). There is considerable debate as to how the rule of *Hadley* is, and should be, interpreted. *Compare* RESTATEMENT (SECOND) OF CONTRACTS § 351(1) (1981) (limiting damages to those that the breaching party had "reason to foresee as a *probable* result of the breach when the contract was made") (emphasis added) *with* Melvin Aron Eisenberg, *The Principle of* Hadley v. Baxendale, 80 CAL. L. REV. 563, 609-11 (1992) (noting with approval that the trend in the United States and the United Kingdom is to relax the foreseeability standard). For the purposes of this Article, it is only important that the rule of *Hadley* is a rule of limited liability to some degree.

23 RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981). According to § 261,

> Where, after a contract is made, a party's performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.

Id.

Section 2-615(a) of the UCC explains that:

> Delay in delivery or non-delivery in whole or in part by a seller . . . is not a breach of his duty under a contract for sale if performance as agreed has been made impracticable by the occurrence of a contingency the non-oc-

nonperforming party in breach of contract and, thus, liable for damages regardless of what circumstances led to the failure to perform. The traditional majoritarian approach to default rule creation would select the default rule that most parties would otherwise bargain for absent transaction costs; a more subtle variation would also consider whether it is more costly to contract into or out of an impossibility excuse.

A determination of whether the traditional majoritarian approach or its variant will be superior for selecting efficient defaults depends on the distribution of transaction costs among the parties subject to the default rule. What is important for our purposes is to recognize that the economic efficiency claims of *both* approaches rely on the implicit assumptions that transaction costs are the primary cause of contractual inefficiency, and that lawmakers' goal in setting default rules for private contracts should be to minimize the efficiency losses caused by transaction costs.

B. Strategic Bargaining

In the last decade, legal economists concerned with the effects of strategic behavior on private contracting, have challenged the assumption that the primary cause of inefficient contracts is transaction costs.[24] Ian Ayres and Robert Gertner have argned that, even when transaction costs are low, parties might not bargain around an inefficient default rule if one or both parties possess private information.[25] Their critical insight is that one party might prefer an inefficient contractual provision if contracting around that provision would require that party to reveal private information that the other party could ex-

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> currence of which was a basic assumption on which the contract was made
> . . . .

U.C.C. § 2-615(a) (1995). The current state of the impossibility excuse is briefly explored in Gerhard Wagner, *In Defense of the Impossibility Defense*, 27 LOY. U. CHI. L.J. 55, 58-60 (1995).

24 For an excellent review, synthesis, and critique of this literature as it applies to the Rule of *Hadley v. Baxendale*, see Eric A. Posner, *Contract Remedies, Precaution, Causation, and Mitigation*, ENCYCLOPEDIA OF LAW AND ECONOMICS 3-11 (Edward Elson ed., forthcoming 1998).

25 Because their conclusions depend on the existence of imperfect information, Ayres and Gertner's argument can be seen as an application of the Coase theorem. Their position is similar to the traditionalist argument, if the Coase theorem is understood broadly as requiring perfect information, as well as no friction in bargaining, in order to guarantee an efficient allocation of resources by the market. *See* Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089, 1095 (1972) (defining the Coase theorem's no-transaction-costs requirement "as involving both perfect knowledge and the absence of any impediments or costs of negotiating"); Elizabeth Hoffman & Matthew L. Spitzer, *The Coase Theorem: Some Experimental Tests*, 25 J.L. & ECON. 73, 73 (1982) (stating that perfect knowledge of the other party's utility function is an assumption of the Coase theorem).

ploit to capture a larger share of the gains in trade from contracting.[26] In the language of bargaining theory, each party to a bargain must consider both how to create value for the parties jointly and claim that value for himself.[27] When the act of creating value permits the other party to claim all of that value plus more, the rational bargainer will prefer to do nothing.[28]

A contracting party may have an incentive to accept an inefficient default term rather than attempt to contract around it if that party possesses private information about its own unique characteristics that could impose costs on the other party and that would be revealed if that party attempted to bargain around the default term. An example best illustrates this possibility. Consider the parties in *Hadley v. Baxendale*: a mill owner shipping a broken crankshaft and a common carrier paid to deliver the crankshaft to the manufacturer for repair.[29] If the shipper (i.e., the mill owner) knows it will suffer unusually high damages if delivery is untimely, it might be socially optimal for the carrier to take special precautions, which are best assured if the parties adopt a contract term making the carrier liable for all damages resulting from nondelivery.[30] The "reasonably foreseeable damages" default rule of *Hadley* forces the shipper to bargain for the alternative "full damages" contract term, and, by doing so, reveal that it would suffer unusually high damages in the case of breach. It is efficient for the shipper to reveal this information to the carrier because the information allows the carrier to take added precaution.[31] But the shipper may not otherwise reveal the information because, if the carrier has market power,[32] the carrier can use its knowledge of the high value the shipper places on prompt delivery to charge the shipper a higher price for the delivery service.[33] If the default rule placed liability for all damages on the carrier, the shipper would have an incentive to hide the private information about its potential damages in order to

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26 *See* Ayres & Gertner, *supra* note 3, at 99-100.

27 *See* DAVID A. LAX & JAMES K. SEBENIUS, THE MANAGER AS NEGOTIATOR: BARGAINING FOR COOPERATION AND COMPETITIVE GAIN 29-45 (1986) (explaining the "negotiator's dilemma" of balancing the need to create value with the need to claim value).

28 *See* Ayres & Gertner, *supra* note 3, at 99 ("[R]evealing information might simultaneously increase the total size of the pie and decrease the share of the pie that the relatively informed party receives. If the 'share-of-the-pie effect' dominates the 'size-of-the-pie effect,' informed parties might rationally choose to withhold relevant information.").

29 156 Eng. Rep. 145, 151 (1854).

30 If the shipper can purchase third-party insurance for the unique damages it will suffer in the event of nondelivery more cheaply than the carrier can avoid the usual risk of nondelivery, the socially optimal action might be for the shipper to purchase insurance, which is best assured by the use of a limited liability contract term.

31 *See* Ayres & Gertner, *supra* note 3, at 101.

32 If the carrier is a price taker in a competitive market for shipping services, a different analysis of the situation is required. *See* Johnston, *supra* note 3, at 625-31.

33 *See* Ayres & Gertner, *supra* note 3, at 101-02.

convince the carrier that it has a low value for the service, which could aid the shipper in negotiating a lower price. Ignorant that the shipper placed an unusually high value on timely delivery, however, the carrier would not take the socially optimal level of heightened precaution to ensure delivery.

A similarly inefficient contract could result when the party favored by the default term has knowledge of the default rule while the other party does not. Assume, for example, that: (1) the default rule limits carriers' liability to foreseeable damages, (2) the carrier knows this but the shipper (likely to be a less frequent participant in delivery transactions) does not, and (3) the carrier is a better cost avoider (i.e., is in a better position to minimize damages caused by a breach of contract) than the shipper. It would be efficient for the parties to allocate the risk of all damages caused by breach to the carrier, but the carrier might be better off taking advantage of the shipper's ignorance and charging the "full liability" price for its services while not revealing that the shipper retains some of the risk under the applicable default term.

To promote efficiency, Ayres and Gertner propose consciously setting default rules to the disadvantage of the party likely to possess important private information in an effort to induce that party to bargain around the default term and, in so doing, reveal that private information.[34] They call rules determined in this way "penalty default[s]."[35] If the strategic problem in the *Hadley* example is that shippers often have private information about their potential damages, a penalty default can be created by making the carrier liable only for reasonably foreseeable damages. This should force a high-value shipper to contract around the default rule by requesting that the carrier assume more liability, which implicitly reveals that the shipper risks greater than average damages and should induce the carrier to take the optimal level of precaution.[36] If the strategic problem in *Hadley* is that shippers are often uninformed about default terms in shipping contracts, a penalty default can be created by assigning all liability to the carriers. A full-liability rule would force carriers to bargain for limited-liability terms when doing so would be efficient and

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34 *Id.* at 94, 97-100; *see also* Ayres, *supra* note 3, at 1398 ("Hypothetical defaults are designed to allow [parties] to avoid explicit contracting, while penalty defaults are designed to induce explicit contracting."); Bebchuk & Shavell, *supra* note 21 (comparing the impact of both limited-liability and unlimited-liability rules on communication equilibria).

35 Ayres & Gertner, *supra* note 3, at 91.

36 *See* Doug Carleton, Note, *Averting the New Business' Battle to Prove Lost Profits: A Reintroduction of the Traditional Reasonable Certainty Rule as Penalty Default*, 67 S. CAL. L. REV. 1573, 1591-92 (1994) (suggesting a default rule that nonbreaching parties to a contract not be entitled to lost profits as damages, thus forcing parties to reveal ex ante information about their likely losses in an effort to bargain for a lost profits term).

would educate the shipper about the default terms.[37] In contrast to majoritarian defaults, which *mimic* the terms that parties would contract for in a world without transaction costs, penalty defaults exemplify the other common law-and-economics approach to overcoming market imperfections: assigning rights so as to *facilitate* the efficient allocation of rights by private parties.[38]

The concept of penalty default rules has received much attention because it forces lawmakers to consider a different cause of inefficient contracting than the conventional wisdom assumes. If left to their own devices, parties might fail to contract around inefficient default rules not only because of high transaction costs, but also because strategic incentives pit the collective interests of the parties against the interests of each individual party. Assuming that the costs of default rules are limited to the transaction costs of parties bargaining around the default and the inefficiencies created when strategic concerns cause parties not to contract around otherwise inefficient default rules, penalty defaults are more efficient than majoritarian defaults when the costs of the latter exceed those of the former.[39]

The argument for penalty defaults assumes that parties with private information might not contract around inefficient default terms because suggesting an alternative term could weaken their bargaining positions by revealing either the content of the default term or how important an alternative term is to them. But the possibility that strategic behavior could cause parties to accept inefficient default terms is still broader; a party also may not wish to bargain around certain default terms when doing so might be seen as a signal of an undesirable characteristic not directly related to the proposed alternative term.[40] For example, the carrier in *Hadley* might not attempt to bargain around a full-liability default term even when the shipper is the more efficient risk-bearer because the shipper might see the carrier's action as a signal that it is unreliable and may therefore negligently fail to deliver on time more often than the shipper previously assumed.[41] In

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37 *See* Ayres & Gertner, *supra* note 3, at 98 (arguing that when one party is relatively uninformed about the default rule, the default should be set against the informed party).

38 *See supra* notes 24-26 and accompanying text.

39 *See* Ayres & Gertner, *supra* note 3, at 112-15.

40 *See generally* Johnston, *supra* note 3, at 616 (arguing that the majority rule in *Hadley* is at odds with the normal strategic incentives of average parties).

41 Johnston uses a contrary example: given certain assumptions, subjects might have more difficulty bargaining around a limited-liability default term than an unlimited-liability default term. Johnston, *supra* note 3, at 630-31. He claims that his example suggests expansive default rules which are superior to narrow ones, *id.*, but, as my example indicates, that conclusion is not necessarily correct—everything depends on the particular facts. Johnston's more general point, though, that the desire to send certain signals can cause parties to decide that it is strategically sensible to accede to inefficient default terms rather than to attempt to contract around them, *id.* at 617, is certainly correct.

such a situation, a party must balance the desire to create a more efficient contract with the risk that an attempt to do so could cost it the deal.

Even the very act of bargaining around contract default rules—irrespective of the substance of the default term—might send the signal that the party is a contentious trading partner who is excessively concerned with the legal rights delineated in the contract and is likely to be litigious in the event of a dispute.[42] This implication could cause the other party to demand concessions in return for the perceived higher risk of conflict or to shy away from the contract altogether. If the contract at issue involves a long-term relationship, such a signal could be even more detrimental to the party seeking to contract around the default term.[43] All of these possibilities exemplify the basic point that contracting parties might strategically decide to accept inefficient default terms rather than contract around them, even when the transaction costs of contracting around the default terms are very low.

C. The Limited Importance of Default Rules

Both the transaction-cost and strategic-behavior based theories of contract default rules imply that, regardless of how important the content of default rules might be, there are certain circumstances in which the choice of default rules does not matter at all. Under any of the analytical approaches described above, if transaction costs are low and neither party possesses private information, the choice of default rule has little to no practical significance.[44] In such circumstances, economic analysis suggests that the parties should arrive at the same contractual risk allocations, either explicitly (by contracting around the default rules) or implicitly, (by choosing not to contract around the defaults) regardless of the content of the default terms.

If relational considerations are incorporated into any of the law-and-economics approaches, the choice of default rules might matter in even fewer circumstances; that is, even when parties fail to contract around an inefficient default rule because of high transaction costs or

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42 *See* Lisa Bernstein, Comment, *Social Norms and Default Rules Analysis*, 3 S. CAL. INTERDISC. L.J. 59, 70-71 (1993). Bernstein refers to these problems as the "relational costs of contracting around default rules." *Id.* at 72-73.

43 Bernstein observes that some industries set their own transactional default rules that include provisions for mandatory arbitration. *Id.* at 84-87. In such industries, attempting to contract out of mandatory arbitration might send a loud signal of likely intransigence in the event of conflict, which would, in turn, provide a strong incentive to parties to avoid contracting around the arbitration default, no matter how inefficient.

44 Easterbrook and Fischel's discussion of whether the choice between a limited and full liability rule for corporations matters if corporations are free to contract around the rule suggests that: "[t]he answer is yes, but probably not much." Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89, 102 (1985).

strategic behavior, *and* a contingency arises that invokes the default term, the substance of the default rule still will not govern the parties' relationship in many instances. This is because parties that have a mutually beneficial ongoing relationship may choose to ignore the default rule when they allocate losses after contingencies arise in order to preserve the relationship.

Suppose, for example, that: (1) the applicable default rule would hold the carrier in *Hadley* liable only for reasonably foreseeable damages in the event of breach, (2) the carrier negligently fails to deliver the crankshaft on time, and (3) the shipper then reveals that he consequently suffered considerable damages, the magnitude of which were unforeseeable by the carrier at the time of contracting. If the shipper seeks compensation for its full damages, the carrier is legally entitled to refuse and to compensate the shipper only for the foreseeable damages. But if the carrier values its continuing relationship with the shipper, it might be inclined to pay the shipper its full damages, effectively waiving its right to the limited liability it enjoyed under the default rule.[45] Of course, the likelihood that the carrier would waive its default right following the occurrence of an unexpected contingency is a function of the severity of the shipper's damages and the value to the carrier of the ongoing relationship. The important point, though, is that in many cases the default rule is likely to be irrelevant even when one of the parties could invoke the rule to its benefit. The analysis is essentially identical in a scenario in which the default term is contrary to the *Hadley* rule. If the shipper reveals unforeseen substantial damages following a breach, the carrier might choose to negotiate an allocation of these damages with the shipper rather than litigate, even if the default rule provides it with a right to full compensation. In ongoing or repeat relationships, then, parties might often ignore default rules in an effort to reach a mutually satisfactory accommodation.

This analysis can extend even to single transactions in which parties have no history of past dealings and are unlikely to desire future dealings. To the extent that the *Hadley* carrier values its reputation with other shippers, or that the shipper values its reputation with other carriers, the parties might choose to negotiate a mutually-agree-

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45 *Cf.* Robert C. Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 STAN. L. REV. 623 (1986) (documenting how rural neighbors with ongoing relationships ignore formal legal rules and resolve disputes based on community norms); Mark P. Gergen, *The Use of Open Terms in Contract*, 92 COLUM. L. REV. 997, 1080 (1992) ("Norms of sharing and cooperation . . . turn out to make good economic sense.").

able allocation of losses rather than enforce the legal rights provided by default rules.[46]

Economic analysis thus suggests that default rules matter in only a subset of the total number of contractual relationships. If transaction costs are low and information is distributed symmetrically between the parties, they will negotiate efficient contracts regardless of the content of default rules. Even when these assumptions do not hold and parties fail to contract around inefficient defaults ex ante, if a contingency arises that invokes the substance of the default rule, the parties might well choose to ignore that substance if preserving the relationship with the other party or protecting their reputation with similarly situated parties is more important than the advantage that can be obtained by invoking the rights that the default rule provides.

D. The Implicit Preference-Exogeneity Assumption

Despite their differences, all of the economic theories of contract default rules share an implicit but fundamental assumption: contracting parties' preferences for contract terms are exogenous to the content of the default terms that will govern the parties by operation of law if the parties do not contract around them. According to economic analysis, many factors might affect how much the *Hadley* shipper would prefer a full-liability contractual provision to a limited-liability provision: the damages it would suffer if the carrier failed to make a timely delivery, the cost of purchasing third-party insurance to cover future losses, the amount of precaution the carrier customarily takes, and so forth. One factor that will not affect the strength of its preference, however, is the content of the default liability term.[47] Obviously, the shipper will prefer full liability over limited liability, but it will not value a full-liability term any more or less if the default term is full-liability than if it is limited liability. The carrier will prefer limited

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46 *Cf.* HILLMAN, *supra* note 10, at 235 (pointing out that some theorists argue that the desire to maintain a good reputation and avoid contract breakdown matter more to business parties than contract law).

47 At least one commentator has suggested that the content of contract default rules can change the preferences of contracting parties over time by stamping the imprimatur of the legal system on certain substantive rules. *See* Charny, *supra* note 16, at 1879 ("[I]n some instances, application of the rule will persuade parties that it is correct . . . ."). This argument is a specific application of the broader contention that the *content* of the law can change preferences over time. *See, e.g.*, Mark Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. CAL. L. REV. 669, 695 (1979) (noting that "[p]erhaps society learns what to value in part through the legal system's descriptions of our protected spheres"); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 933-39 (1996) (noting that choices are affected by social norms). Although they bear similarities, these arguments differ from the argument advanced in this Article: that contract default rules affect preferences, not because the law places its imprimatur on certain contract terms, but because people prefer the status quo to alternative states, all other things being equal.

liability, but the strength of its preference will similarly be unaffected by the substance of the default term.

It is easy to see why economic theories of default rules need the preference-exogeneity assumption. If the selection of a default term can cause parties' preferences for substantive contract provisions to shift, the question of which possible default rule is optimal takes on an additional dimension of complexity: lawmakers must anticipate the effect of such preference shifts on the bargaining dynamics between the contracting parties as well as the effects of transaction costs and strategic behavior.

Why theorists make the implicit assumption of preference exogeneity is somewhat less obvious—they do not offer any empirical evidence to support the proposition. The reason is embedded deeply in the behavioral model of rational-choice theory, which underlies economic analysis of law.[48] Rational-choice theory presumes parties will act to maximize their expected utility. To effect this maximization, parties must compare end states that might result from alternative behaviors discounted by their likelihood of not occurring.[49] The economic analysis of law usually simplifies this calculation by assuming that parties will act to maximize their expected wealth.[50] Under the standard application of this theory, we would expect the shipper in *Hadley* to compare its expected costs of the carrier's negligent failure to deliver the crankshaft in a timely fashion under both allocations of liability, and to value a full-liability contractual regime over a limited-liability rule at the difference between those two costs.[51] The carrier should make the opposite calculation, computing the value it places on a world in which the carrier assumes limited liability and comparing this to the value of a world of full liability. Absent transaction costs and strategic behavior, both parties are better off adopting the rule

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48 *Cf.* Thomas S. Ulen, *Rational Choice and the Economic Analysis of Law*, L. & SOC. INQUIRY 487, 487-91 (1994) (book review) (discussing the reasons for the law-and-economics movement's devotion to rational choice theory).

49 The focus on end states gives rise to the "invariance" principle, which holds that an individual given a choice of options should prefer the same option regardless of the form in which the choice is presented. *See, e.g.*, Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251, S253 (1986) (stating that invariance is "[a]n essential condition for a theory of choice that claims normative status"). The preference-exogeneity assumption follows from the invariance principle: a costless choice between two options should not be affected by which of the options is the default.

50 *See, e.g.*, KELMAN, *supra* note 13, at 118 (noting that "wealth maximization is the preferred collective goal for the legal economists"); POSNER, *supra* note 14, at 12 (stating that value is measured by willingness to pay); *cf.* DONALD P. GREEN & IAN SHAPIRO, PATHOLOGIES OF RATIONAL CHOICE THEORY: A CRITIQUE OF APPLICATIONS IN POLITICAL SCIENCE 95-99 (1994) (criticizing law-and-economics for its rationality assumptions).

51 *Cf.* Jay M. Feinman, *Relational Contract and Default Rules*, 3 S. CAL. INTERDISC. L.J. 43, 50-51 (1993) (criticizing the standard default rules paradigm for assuming that rational, self-interested parties only engage in cost-benefit analysis).

favored by the party with the stronger preference, with the parties sharing the surplus value that results by means of a side payment of money or other favors.[52] Whether the default term provides for full or limited liability, however, has no impact on which party is the better risk-avoider or risk-bearer and thus can more efficiently bear the risk of losses, thereby creating a cooperative surplus for the parties to divide. Accordingly, the paradigm of rational choice suggests that the content of the applicable default rule should be irrelevant to determining whether, or to what extent, a contracting party prefers a contract term.

II
THE THEORETICAL CRITIQUE

A. Evidence of the Status Quo Bias

The analytical power of rational-choice theory makes the preference-exogeneity assumption attractive, but there is a significant body of empirical and experimental data that, while not precisely on point, at least suggests that the assumption might be false. Two closely-related sets of empirical findings are relevant. The first, known alternatively as the "endowment effect"[53] or the "offer-asking" gap,[54] is that individuals will often place a higher value on an entitlement if they own it than if they do not.[55] The second, referred to as the status quo bias, is that people systematically favor maintaining a state of affairs that they perceive as being the status quo rather than switching to an alternative state, all else being equal.[56] This Section will review the

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52 By adopting the contract term preferred by the party with the stronger preference, and with the benefiting party making a side payment to the nonbenefiting party, the adopted term becomes "Pareto efficient," meaning that at least one party is made better off and neither are worse off than they would have been under the possible alternative term. ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 12 (1988).

53 *See, e.g.*, Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 44 (1980) (coining the term "endowment effect").

54 *See, e.g.*, Duncan Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387, 401 (1981) (referring to the "offer-asking problem"); Russell Korobkin, Note, *Policymaking and the Offer/Asking Price Gap: Toward a Theory of Efficient Entitlement Allocation*, 46 STAN. L. REV. 663, 664-65 (1994) (calling the gap between "what someone is willing to pay (WTP) for an entitlement she does not own and what she is willing to accept (WTA) in return for giving up the same entitlement if she owns it" the "offer/asking price gap").

55 Most demonstrations of the endowment effect use consumer goods as entitlements. *See* sources cited *infra* notes 71-81 and accompanying text. Some experiments have demonstrated the endowment effect using legal property rights, usually rights to environmental commodities or preservation, as entitlements. *See, e.g.*, *infra* notes 82-88 and accompanying text.

56 *See, e.g.*, William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7, 8 (1988) ("Faced with new options, decisionmakers often stick with the status quo alternative, for example, to follow customary company policy, to

relevant literature,[57] and the following Section will consider the similarities and differences between the content of experiments that have demonstrated the status quo bias and endowment effects, and the unique and unexplored relationship between the status quo and contract default rules.[58]

A series of controlled questionnaire experiments by William Samuelson and Richard Zeckhauser using undergraduate and graduate students as subjects illustrates the positive relationship between the status quo and individual preferences.[59] In each experiment, the authors provided subjects with several options, asking each subject to select one.[60] The subjects were randomly subdivided into smaller groups, each of which received a different description of the state of the world that either revealed that one of the options represented the "status quo" position or that none of the options represented the status quo.[61] As they hypothesized, the authors found that the subjects generally preferred a given choice most often when it represented the status quo and least often when another choice represented the status quo, with preferences for the choice falling somewhere in between when none of the options given would preserve the status quo.[62]

In one test, the authors presented subjects with four investment options, each with a different risk profile—a high-risk stock, a moderate-risk stock, a treasury bill, and a municipal bond—from which they

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elect an incumbent to still another term in office, to purchase the same product brands, or to stay in the same job.").

57 The literature is reviewed in substantially more detail in Elizabeth Hoffman & Matthew L. Spitzer, *Willingness to Pay vs. Willingness to Accept: Legal and Economic Implications*, 71 WASH. U. L.Q. 59 (1993).

58 Unfortunately for the sake of clarity, neither the behavioral decision theory literature nor the legal literature applying it differentiates in any consistent way the various terms used to describe the basic phenomenon. Most of the research on the phenomenon uses "endowment effect" and "status quo bias" interchangeably. *See, e.g.*, Maya Bar-Hillel & Efrat Neter, *Why Are People Reluctant to Exchange Lottery Tickets?*, 70 J. PERSONALITY & SOC. PSYCHOL. 17, 17 (1996) ("Reluctance to trade has previously been studied under the label of the *endowment effect*, [and] the *status quo bias*. . . .") (citations omitted); *see also* Edward J. McCaffery et al., *Framing the Jury: Cognitive Perspectives on Pain and Suffering Awards*, 81 VA. L. REV. 1341, 1351 (1995) ("The central relevant body of cognitive decision theory research . . . has been variously termed the 'endowment effect[ ]' [or] the 'status quo bias' . . . ."). *But see* Cass R. Sunstein, *Endogenous Preferences, Environmental Law*, 22 J. LEGAL STUD. 217, 230 (1993) (calling the endowment effect a "narrower phenomenon" than the status quo bias). I have chosen to emphasize status quo bias in this Article because contract default rules do not create endowments, at least as the term is conventionally understood, *see infra* notes 90-92 and accompanying text, although they do engender a bias in favor of the term perceived as the status quo.

59 Samuelson & Zeckhauser, *supra* note 56. The 486 subjects were MBA students and senior business majors at Boston University and public policy students at the Harvard University's Kennedy School of Government. *See id.* at 14.

60 *See id.* at 12-13.

61 *See id.* at 12-14.

62 *See id.* at 14.

had to choose one in which to invest a sum of money.[63] Subjects in one subgroup were told only that they had recently inherited money that they now needed to invest—the neutral frame.[64] The others were told that they had inherited a portfolio, most of which was invested in one of the four choices, and they had to decide whether to leave it there or switch to one of the other choices (with zero transaction costs of switching).[65] Subjects selected each of the options most often when it was the status quo investment and least often when one of the other choices was the status quo investment.[66] Daniel Kahneman and Amos Tversky demonstrated the same effect when they asked students to imagine that they held one of two hypothetical jobs, the first with a higher salary and the second with better working conditions, and to decide whether they would prefer to stay in their current position or switch.[67] Regardless of the job to which they were hypothetically assigned, most subjects chose to remain at that job rather than trade employment opportunities.[68]

Experimenters have observed similar results in contexts more personally relevant to the experimental subjects. One survey asked customers of the Pacific Gas & Electric Company who had experienced different levels of service reliability to describe how much money they would be willing to pay ("WTP" value) for increased reliability and what amount of money they would be willing to accept ("WTA" value) for reductions in reliability.[69] The authors found that for any given service level, customers' WTA values exceeded their WTP values by a magnitude of four to one, signifying an extreme bias in favor of the status quo level of service reliability, regardless of the level of reliability.[70]

Scholars have empirically demonstrated the powerful pull of the status quo not only in hypothetical choice situations, but also in circumstances where subjects are forced to place monetary values on goods and receive compensation on the basis of their valuations. In a now famous series of studies conducted by Daniel Kahneman, Jack Knetsch, and Richard Thaler, the experimenters randomly endowed subjects with either a coffee mug or six dollars.[71] "Mug owners" were

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63 *See id.* at 12-13.

64 *See id.* at 12.

65 *See id.* at 12-13.

66 *See id.* at 17 tbl.1c.

67 Daniel Kahneman & Amos Tversky, *Choices, Values, and Frames*, 39 AM. PSYCHOLOGIST 341, 348 (1984).

68 *See id.*

69 *See* Raymond S. Hartman et al., *Consumer Rationality and the Status Quo*, 106 Q.J. ECON. 141, 143 (1991).

70 *See id.* at 144.

71 Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325, 1330 (1990).

asked to reveal the minimum amount they would be willing to accept to sell the mug ("WTA" value), while the cash holders were asked to reveal the maximum amount they would be willing to pay for one of the mugs ("WTP" value).[72] Subjects were told that the experimenters would calculate the market-clearing price for the mugs based on the WTA and WTP data elicited and execute trades between the mug holders who preferred the cash market value of the mugs and cash holders who preferred the mug to dollars at that price.[73] If initial ownership (or initial endowments) did not affect preferences for the mugs, approximately fifty percent of the mugs would trade hands in this setting because there was no reason to think that subjects in one group were more fond of mugs than were subjects in the other group. The experimenters found, however, that mug owners valued the mugs roughly twice as high as cash holders and very few trades took place.[74] Results did not change substantially when subjects participated in multiple iterations of the experiment to permit them to benefit from learning about how the market operated.[75]

In a similar set of experiments, Jack Knetsch and J.A. Sinden gave some subjects a ticket for a lottery with a fifty dollar cash prize and others three dollars in cash, and then offered to buy the ticket holders' tickets for three dollars and to sell tickets to the cash holders for three dollars.[76] Eighty-two percent of the ticket holders kept their tickets while only thirty-eight percent of the cash holders purchased a ticket, implying that those endowed with tickets placed a higher value on the tickets than those endowed with cash.[77]

Experimenters have replicated these results in numerous other studies using relatively inexpensive consumer goods,[78] and they have observed similar results in real-world quasi-experiments where individuals had more personal wealth at risk. In one notable example, New Jersey and Pennsylvania both passed laws in the 1980s giving consumers the choice of a cheaper automobile insurance policy with limited rights to sue, or a more expensive policy with more expansive legal

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72 *See id.* at 1330-31.

73 *See id.* at 1331.

74 Mug holders revealed a median WTA value of $5.25, while cash holders revealed WTP values of $2.25-2.75 in different trials. *See id.* at 1332 tbl.2.

75 *See id.* at 1332. In a trial with 44 subjects playing 4 iterations of the game, the number of trades executed in each successive iteration were 4, 1, 2, and 2. *See id.* at 1332 tbl.2.

76 Jack L. Knetsch & J.A. Sinden, *Willingness to Pay and Compensation Demanded: Experimental Evidence of an Unexpected Disparity in Measures of Value*, 99 Q.J. ECON. 507, 512 (1984).

77 *See id.* at 513.

78 For a comprehensive view of the literature, see Hoffman & Spitzer, *supra* note 25, at 77-82.

rights.[79] In New Jersey, the default policy is the limited-rights policy—drivers must specifically request an expanded-rights policy—while the opposite is true in Pennsylvania.[80] Various reports at different times have concluded that a large majority of New Jersey drivers own limited-rights policies, while a large majority of Pennsylvania drivers own expanded-rights policies,[81] despite the absence of any obvious reason why residents of the two states would have substantially different tastes in insurance.

Although most of the experimental work documents the status quo bias in the context of consumer goods or other individually-owned entitlements, many of which can be physically held in the owner's hand, studies also provide evidence that individuals value less tangible property rights in a similar way. These studies often base their findings on survey data and usually focus on environmental resources.[82] In one study, for example, residents of the four-corners region of the southwestern United States were asked to value an entitlement to air quality.[83] Approximately one-half of the subjects were told that a factory had the legal right to emit pollution into the atmosphere that would decrease average visibility in the area from seventy-five miles to fifty miles.[84] The experimenters told the other one-half of the subjects that the factory wanted to emit the pollution, but that the residents had the legal right to block its operation.[85] The first group of subjects reported that it was willing to pay an average of $4.75 per family per month to keep the factory from opening, whereas the second group demanded an average of $24.47 per family per month before it would permit the factory to begin operation.[86] If possession of the legal right did not affect the residents' valuations of clean air, the monetary valuations expressed by both groups should have been identical—it should not have mattered that subjects in one condition were asked for their WTP values while subjects in the other condition were asked for their WTA values.[87] Similar studies have

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79 The story is told in, among other places, David Cohen & Jack L. Knetsch, *Judicial Choice and Disparities Between Measures of Economic Values*, 30 OSGOODE HALL L.J. 737, 747 (1992).

80 *See id.*

81 *See id.*

82 *See, e.g., id.* at 743-44 (reporting data from various studies of subjects' valuations of environmental resources).

83 *See* Robert D. Rowe et al., *An Experiment on the Economic Value of Visibility*, 7 J. ENVTL. ECON. & MGMT. 1 (1980).

84 *See id.* at 8-9.

85 *See id.*

86 *See id.* at 10 tbl.2.

87 It bears mentioning that evidence of an endowment effect for environmental rights is sometimes questioned on methodological grounds. In such survey experiments, subjects might have believed that they had strategic incentives to understate their WTP values and overstate their WTA values while believing, conversely, that they had no incentive to reveal

demonstrated that the value that environmentalists and hunters place on keeping their favorite pristine areas undeveloped can vary by orders of magnitude depending on whether the respondents have the right to prohibit development or developers have the right to build.[88] In many circumstances, it seems that "whether people have a preference for a good, a right, or anything else is often in part a function of whether the government, or the law, has allocated it to them in the first instance."[89]

B. Is the Status Quo Bias Applicable to Contract Default Rules?

The body of behavioral science literature discussed above powerfully demonstrates that, in at least some contexts, preferences can depend on how a decisionmaker perceives options relative to the status quo. This insight suggests that the preference exogeneity assumption of the law-and-economics literature on contract default

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their true valuations. Residents of the four-corners region, for example, might have believed that their valuations could be used to determine the price taxpayers would pay the factory not to operate or, alternatively, would be paid by the factory to operate. If so, they could effectively "game" the survey by artificially deflating their WTP values and inflating their WTA values. Some subjects may have also misunderstood that they were to reveal their *maximum* WTP or their *minimum* WTA. Those asked for their WTP might have responded to the surveys like "buyers" of goods normally do—by starting low and increasing their bids only after negotiations. For the same reason, those asked for their WTA values might have started high, as "sellers" are conditioned to do.

88 *See, e.g.*, JUDD HAMMACK & GARDNER MALLARD BROWN, JR., WATERFOWL AND WETLANDS: TOWARD BIOECONOMIC ANALYSIS 24-40 (1974) (discussing waterfowl hunters' valuation of a wetland); WILLIAM F. SINCLAIR, 5 KEMANO II ENVIRONMENTAL STUDIES: THE ECONOMIC AND SOCIAL IMPACT OF THE KEMANO II HYDROELECTRIC PROJECT ON BRITISH COLUMBIA'S FISHERIES RESOURCES (1976) (discussing fishermen's valuation of a fishing area); Nancy D. Banford et al., *Feasibility Judgements and Alternative Measures of Benefits and Costs*, 11 J. BUS. ADMIN. 25, 29-32 (1980) (studying the valuation of fishing pier); Rebecca R. Boyce et al., *An Experimental Examination of Intrinsic Values as a Source of the WTA-WTP Disparity*, 82 AM. ECON. REV. 1366, 1366 (1992) (reporting that WTA values exceed WTP values for environmental commodities by anywhere from two to more than ten times, depending on the study); David S. Brookshire et al., *Valuing Increments and Decrements in Natural Resource Service Flows*, 62 AM. J. AGRIC. ECON. 478, 482-87 (1980) (discussing valuation of the opportunity to hunt elk); William D. Schulze et al., *Valuing Environmental Commodities: Some Recent Experiments*, 57 LAND ECON. 151, 165-67 (1981) (noting hunters' and wildlife observers' valuation of "wildlife experiences").

89 Sunstein, *supra* note 58, at 273-24. The endowment effect has been demonstrated even when individuals are given counterfactuals that ask them to imagine a different allocation of rights, rather than merely learning there is a different allocation of rights. In a recent study, Edward McCaffery, Daniel Kahneman, and Matthew Spitzer found that experimental subjects playing the role of jurors in hypothetical lawsuits awarded plaintiffs higher "pain and suffering" damages when they were instructed to determine the award by considering the amount a plaintiff should be paid *pre-accident* to consent to the accident than when they were instructed to determine how much the plaintiff should be paid *post-accident* to be "made whole." McCaffery et al., *supra* note 58, at 1354-72. This difference suggests not only that a higher value is placed on physical well-being when it is enjoyed than when it is not enjoyed, but that a higher value might be placed on physical well-being even when it is not enjoyed if decisionmakers consider its value from a counterfactual perspective.

rules might be empirically false. Just as individuals appear to place a higher value on investment instruments, mugs, and lottery tickets when they possess those items than when they do not, contracting parties might place a higher value on the contract term governing consequential damages for breach, or the existence of an impossibility excuse, if they perceive the rule to represent the status quo than if they perceive it to represent a change from the status quo. Thus, the default term that governs the parties *might appear to parties to represent the status quo allocation of rights and responsibilities.*

Whether the content of contract default rules might affect preferences in the same way ownership of a mug might is a question the contracts literature has raised,[90] but it has never been subject to thorough empirical testing.[91] Although this fact alone suggests a need for more research, there is a solid theoretical reason to believe that preferences for contract terms might not be affected by default rules, despite the wealth of experimental data demonstrating the status quo bias in other contexts. The reason is that contract default rules do not provide contracting parties with vested entitlements in the way that allocations of mugs, jobs, financial instruments, or property rights in environmental resources do. Rather, the benefit that one party might derive from a contract default rule hinges on an independent party agreeing both to enter into a contract and to accept the default term. The highly contingent nature of contract default rules means that such rules do not provide actual endowments, but only what might be termed "illusory endowments." Their illusory nature might prevent parties from viewing such "endowments" as part of the status quo when negotiating contracts.[92] For example, although common carri-

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90 *See* Richard Craswell, *Passing On the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361, 390 (1991):

> Even if the framing hypothesis is valid, substantial questions remain concerning what point of reference consumers would choose . . . if they are influenced by framing effects at all. For example, if the law says that all contracts will include an implied warranty unless explicitly disclaimed, would consumers treat the implied warranty as something they already own and consequently place a higher value on it? Or would they treat it as something they have not yet acquired and never will acquire unless they choose to buy the underlying product, thereby giving it the lower value appropriate to things that are not yet theirs?

Id.; *see also* Charny, *supra* note 16, at 1867-68 (noting "suggestive evidence" for the claim that parties' preferences "are influenced by the rule that the court adopts").

91 The question has been tested once, as part of a series of experiments. *See* Stewart Schwab, *A Coasean Experiment on Contract Presumptions*, 17 J. LEGAL STUD. 237 (1988). For a detailed discussion of this experiment, see *infra* notes 94-99 and accompanying text.

92 *Cf.* CASS R. SUNSTEIN, BEHAVIORAL ANALYSIS OF LAW (Chicago John M. Olin Working Paper in Law and Economics No. 46, 2d series 1997). Sunstein notes that:

> People are averse to losses, but whether an event "codes" as a loss or a gain depends not on simple facts but on a range of contextual factors, including how the event is framed. The status quo is usually the reference point. . . .

ers stand to benefit from the *Hadley* rule that limits liability for consequential damages resulting from breach, carriers might not view a limited-liability term as part of the status quo at the time of contract negotiations because the potential benefits of the default rule cannot vest prior to contract formation. If a carrier cannot reach an agreement with a shipper, then the limited-liability default rule is of no use to it.

Because no party can capture any benefit from a contract-default rule unless and until the other party agrees to a contract that does not override the default term, benefits that flow to one party from the substantive content of a contract rule are a type of cooperative surplus created by the parties' acting in concert. If it is more efficient for parties to contract around a default term than to accept it, they can create a larger joint surplus by doing so than by not doing so. Regardless of whether the default term or an alternative is more efficient, how parties divide the joint surplus created by the contract logically should depend on their bargaining leverage and skill, not the content of the default rule. Consequently, a plausible hypothesis is that contracting parties will agree to the same contract term (the most efficient one) regardless of the default rule.[93] If this hypothesis is correct, then preferences for contract terms might be exogenous to the substance of the applicable default rules, as economic analysts of default rules implicitly assume.

The argument that the status quo bias might not operate in the realm of contract default rules is buttressed by the only experiment of which I am aware that bears on the question. A decade ago, Stewart Schwab conducted a bargaining experiment in which teams of students negotiated a collective bargaining agreement, one-half representing management and one-half representing a labor union.[94] Among the contract provisions at issue in the negotiation was whether management would have the right to unilaterally relocate work to its

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> The most important source of reference point is the law—where has the legal system placed the initial entitlement?

Id. at 6-7.

93 Some law-and-economics scholars have predicted that, for this reason, the choice of default rules will not only have no effect on which term is ultimately agreed upon, but it will also have no effect on how the joint surplus is divided. *See* Schwab, *supra* note 91, at 240; *cf.* Harold Demsetz, *When Does the Rule of Liability Matter?*, 1 J. LEGAL STUD. 13, 22 (1972) (arguing that "when there is no restriction on contracting, a change in the rule of liability need not be accompanied by wealth redistribution"). Because the experimental scenarios described in this Article are designed to measure only the absolute preferences of contracting parties, not how they would divide a cooperative surplus through bargaining, they do not address this issue.

94 Schwab, *supra* note 91, at 246-64. Schwab noted that experimental tests of whether the initial allocation of property rights in a world without transaction costs had efficiency implications do not necessarily bear on the question of whether the allocation of contract presumptions (i.e., default terms) has efficiency implications. *Id.* at 238.

nonunion plants.[95] Each negotiator was provided a "preference sheet" explicitly stating the number of "points" a negotiator would receive if certain terms were included in or excluded from the contract.[96] For one-half of the negotiating teams, the union negotiator would receive three hundred points for including a clause prohibiting relocation in the contract, while the management negotiator would receive only two hundred points for keeping such a clause out of the contract; the other half of the teams faced the opposite preference distribution.[97] Within each group, one-half of the negotiating teams learned that the default rule was that management could relocate work, while the other half learned that the default rule was that management could not.[98]

If the preference exogeneity assumption is correct, then the ultimate resolution of the relocation issue reached by Schwab's subjects in their contracts should not have differed depending on the default rule to which they were exposed. His results provide modest support for this prediction. Negotiating teams included a relocation clause in their contracts slightly more often when the default rule favored (rather than opposed) relocation, suggesting a potential weakness in the preference-exogeneity assumption, but the difference was not statistically significant.[99] It is possible, though, that the failure of Schwab's experiment to detect a significant status quo bias is an artifact of his experimental design—the experiment, unlike real life, left no uncertainty as to the ex post consequences to the negotiating parties of agreeing to or rejecting a relocation clause.[100] This Article considers in detail below why this might have affected Schwab's results.[101]

III
THE EXPERIMENTAL INQUIRY

A. The Experimental Design and Controls

In spite of the strong evidence that a status quo bias does exist in some contexts, then, the question of whether the preference-ex-

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95 *See id.* at 249.

96 *See id.* at 247. The points were then factored into the grade which students earned for class participation. *See id.*

97 *See id.* at 249.

98 *See id.*

99 *See id.* at 252-54. 57.4% of teams facing a prorelocation default negotiated for a relocation clause, while 51.9% of teams facing an antirelocation default negotiated for a relocation clause. $\chi^2 = .149$. *See id.* at 253 tbl.3.

100 In a different article, Schwab apparently concedes the artificiality of the ex post certainty of payoffs to subjects engaged in this negotiation simulation. Schwab, *supra* note 9, at 278 (explaining that a relocation clause is "essentially an insurance clause" and that "[b]ecause insurance clauses are predicated on future uncertainty, bargaining with perfect information is impossible").

101 *See infra* text accompanying notes 207-13.

ogeneity assumption of default rule analysis is warranted remains unresolved. Moreover, because this question implicates how lawmakers should approach the question of default rule creation, the resolution of this question is fairly important. To address this issue, I conducted a series of three controlled experiments designed to test the hypothesis that preferences for contract terms depend on the substance of the relevant default terms. The results strongly support the hypothesis.

Subjects for the experiments were 151 students at the University of Illinois College of Law nearing completion of their first year of law school, all of whom had completed a basic course in contract law the previous fall semester.[102] The students were recruited from each of the three sections of the first-year class and received no compensation for their participation. Students were requested to spend approximately fifteen minutes completing a survey for a research study in which they would be asked to play the role of a lawyer and provide advice to a client on the negotiation of a commercial contract.[103] Although the students were told their participation was not required, the participation rate in each section approached one hundred percent of those students present on the days when the experiment was conducted.

Each subject was provided the following background information about their client, the content of the contract negotiation, and their objectives:

> You represent a company called "NextDay" that specializes in overnight delivery of packages (similar to Federal Express). NextDay has reached an agreement in principle to provide shipping services for a company called "Gifts, Inc." (which markets gifts by catalog and ships orders overnight around the country) for a fixed per-package charge, regardless of the size, value, or destination of the package. The company that handled Gifts, Inc.'s shipping last year charged it $20 per package; the price that Gifts, Inc. will pay NextDay has not yet been finalized.
>
> You are currently engaged in negotiations with Gifts, Inc. over certain provisions of the contract. NextDay's management has asked you to provide recommendations concerning certain issues that have arisen and will almost certainly rely on your advice. At the end of the year, NextDay will review how it fared under the contract you negotiate and decide whether to retain you as their attorney in future dealings, so you have a strong personal stake in making sure that the contract serves the needs of NextDay *and* reflects well on your judgment and ability.[104]

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102 At the University of Illinois, Contracts is a one semester course taught in the fall. Students participated in the experiments in April of their first year of law school.

103 For the complete survey instructions, see *infra* Appendix A1.

104 *See infra* Appendix A2.

Subjects were then presented with three self-contained factual scenarios, each describing a different issue in the contract negotiations between NextDay and Gifts, Inc., followed by a series of questions designed to measure the subject's preference for a particular contract term.[105] There were three to six different conditions for each scenario, with differences between conditions designed to test whether the applicable default rule affected subjects' preferences for the contract term at issue.[106] The order in which the scenarios were presented to the subjects was alternated to minimize any interaction effects between scenarios. The version of each scenario a subject received was determined independently of the version of other scenarios that the subject received. All comparisons were "between-subjects," meaning that conclusions were drawn by comparing the responses of subjects who responded to different conditions of the same scenario.[107]

The primary difference between conditions of each scenario was what default term would govern the relationship between NextDay and Gifts, Inc. unless the parties agreed explicitly to an alternative term. Because the experiments sought to test the effect of different default provisions on preferences for substantive contract terms, it was important that the subjects accepted, for the purposes of the experiment, the description of the substantive default term provided in their version of the scenario. Two steps were taken to ensure that subjects did not ignore these descriptions of default rules and rely on their a priori understanding of the content of contract default rules. First, subjects were explicitly directed to "*rely only on the law as it is described to you in the survey for purposes of answering the questions.* Do not rely on your prior understanding of contract law."[108] Second, at the close of each scenario, subjects were asked to indicate whether (1) the default rule as described in the scenario was consistent with their knowledge of contract law, (2) the default rule was inconsistent with their knowledge of contract law, or (3) they were not sure.[109] The substantive responses to survey questions provided by subjects who indicated that their scenario's description of the default rule was inconsistent with

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105 *See infra* Appendices B-D.

106 This Article does not report every condition of each scenario. Thus, the total number of responses reported for each scenario does not necessarily equal 151 (the total number of subjects). The Attorneys' Fees scenario, *see infra* Part III.B.3, was alternated with another scenario that is not reported in this Article. Consequently, the total number of subjects responding to that scenario is also less than 151, although all three of the tested conditions are reported.

107 *See generally* IRWIN P. LEVIN & JAMES V. HINRICHS, EXPERIMENTAL PSYCHOLOGY: CONTEMPORARY METHODS AND APPLICATIONS 29 (1995) (describing the differences between "within-subject" and "between-subjects" experimental manipulations).

108 *See infra* Appendix A1.

109 *See infra* Appendices B-D.

their own understanding of contract law were compared to answers provided by the remainder of the subjects responding to the same experimental conditions. There were no significant differences in substantive responses based on the response to this control question, and no significant results would have lost their significance if the subjects who believed the experiment inaccurately represented the law were removed from the data set. Consequently, these tests are not reported in the results section below.

In two of the three scenarios reported below, subjects were asked to express the strength of their preferences for contract terms that varied from the default term by stating the maximum amount of money they would be willing to pay ("WTP") to include such a term in the contract when the term would favor their client, or the minimum amount they would be willing to accept ("WTA") to contract for such a term when the term would favor the other party.[110]

Soliciting WTP and WTA values carries a risk that subjects will respond to the inquiry strategically, understating their true WTP value and overstating their true WTA value.[111] If this behavior occurs, the data could appear to reveal a strong status quo bias where none actually exists. To guard against this potentiality, experimental conditions that asked subjects to reveal their WTP value explicitly instructed that this value should be the *maximum* the subject would be willing to pay Gifts, Inc. to add a specific provision to a contract, but that they would attempt to negotiate a smaller payment than their WTP value.[112] Subjects asked to reveal their WTA values were instructed that their responses should be the *minimum* they would accept to add an unfavorable term to the contract, but that they would attempt to negotiate a higher payment.[113] To ensure that subjects understood the distinction between revealing their true WTP or WTA values and understating or overstating that value for strategic purposes, in one of the scenarios subjects were not only asked to reveal their WTP or WTA values, they were also instructed to reveal the amount of money they would *initially* offer or demand in negotiations with Gifts, Inc.[114] For subjects in WTP conditions, initial offers should have been equal to or less than WTP values. For subjects in WTA conditions, initial demands should have been equal to or greater than WTA values. Most subjects' responses corresponded to this prediction, demonstrating that the subjects understood what information their WTA or WTP values were supposed to reveal. Only 4 subjects out of 151 failed this

110 *See infra* Appendices B-C.
111 *See* Hoffman & Spitzer, *supra* note 25, at 77-82.
112 *See infra* Appendices B2, C2.
113 *See infra* Appendices B1, C1.
114 *See infra* Appendices C1-2.

manipulation check by providing initial offer or initial demand values that were logically inconsistent with their WTA or WTP values. The responses of these four were dropped from the data set and not considered in the analysis reported below.

B. Results

1. *The Consequential Damages Scenario*

The first scenario ("Consequential Damages"), modeled on *Hadley v. Baxendale*, tested whether the strength of subjects' preferences for a favorable consequential damages term in NextDay's contract with Gifts, Inc. depended on the substance of the default rule that would govern in the absence of an agreement between the parties. The scenario explained that Gifts, Inc. "will be sending many packages with NextDay of various values and various levels of urgency for its corporate clients and that, depending on the circumstances, a failure to make delivery could be very costly to it even if this is not obvious from looking at the package itself."[115] Consequently, Gifts, Inc. would prefer that NextDay be liable for all damages caused by its failure to meet its delivery obligations.[116] NextDay, in contrast, would prefer the more limited liability provided by a rule making it responsible only for damages resulting from its breach of contract that were reasonably foreseeable at the time it took possession of the package.[117]

The scenario also provided all subjects with an analysis of the differential liability costs NextDay could expect under a "reasonably foreseeable damages" rule and a full-damages rule.[118] The description of such costs created a bounded but uncertain range of possible outcomes intended to reflect the uncertainties often faced by business executives and attorneys making risk-allocation decisions. Subjects were told that NextDay's accountants had estimated that there was a 95% chance that a full damages term would saddle NextDay with between $0 and $10 of additional liability per package handled (with a 5% possibility of either no additional liability or additional liability of greater than $10 per package) compared to a foreseeable damages term. This calculation took into account that few packages would be mishandled, but those that were would subject NextDay to considerably more liability under the full-liability term than the limited-liability term.[119] The accountants based their estimate "on the value of Gifts, Inc.'s shipments with other companies over the last several years . . .

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115 *See infra* Appendices B1-2.
116 *See infra* Appendix B1.
117 *See infra* Appendix B1.
118 *See infra* Appendices B1-2.
119 *See infra* Appendices B1-2.

and NextDay's history of occasionally failing to make deliveries on time."[120]

Subjects receiving condition 1 of the Consequential Damages scenario were told that:

> The law in your state, which will govern the contractual relationship between the parties, follows the traditional legal rule that delivery companies like NextDay that negligently lose a package or fail to deliver it on time—which happens occasionally—are generally liable only for damages that were "*reasonably foreseeable*" at the time the delivery company takes possession of the package from the shipper.[121]

Gifts, Inc. has proposed that the parties contract around this rule by adding the following enforceable term to the contract:

> "NextDay will be liable for all damages proximately caused by NextDay's negligent failure to deliver Gifts, Inc.'s merchandise on time, whether or not such damages were reasonably foreseeable when NextDay accepted merchandise from Gifts, Inc."[122]

Subjects were informed that Gifts, Inc. realized it would have to pay NextDay a higher per-package delivery rate than it would otherwise pay to convince NextDay to include the full liability term in the contract. They were then asked to recommend the minimum price that NextDay should accept in return for including the term (i.e., reveal their WTA value), such that if Gifts, Inc. did not offer at least that much over and above what the per-package price would otherwise be, NextDay would refuse to agree to the term. The answer choices provided allowed subjects to set their WTA value at $1 increments between $1 and $10, or to recommend that NextDay refuse to consent to the full-damages term at any price.[123]

Subjects assigned to condition 2 of the scenario were told the default rule was the opposite of what condition 1 subjects were told:

> The law in your state, which will govern the contractual relationship between the parties, specifies that delivery companies like NextDay are liable for "*all damages proximately caused by the delivery company's negligent failure to deliver a shipper's merchandise on time.*"[124]

NextDay would like to add a limited-liability provision to the contract, which would read:

> "In the event that NextDay fails to deliver Gifts, Inc.'s merchandise on time, its liability will be limited to damages that were reasonably

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120 *See infra* Appendices B1-2.

121 *See infra* Appendix B1.

122 *See infra* Appendix B1 (italics omitted).

123 *See infra* Appendix B1.

124 *See infra* Appendix B2.

foreseeable when NextDay accepted merchandise from Gifts, Inc."[125]

Condition 2 subjects were advised that in order to convince Gifts, Inc. to accept the limited-liability provision, NextDay would have to offer a per-package discount vis-a-vis what would otherwise be the contract delivery price between the companies.[126] They were asked to state the maximum per-package discount that they would recommend that NextDay offer (i.e., their WTP value), such that if Gifts, Inc. would not accept that discount, NextDay should prefer to have the contract without the proposed term included.[127] Similar to condition 1, the answer choices provided in condition 2 permitted subjects to select a WTP value in $1 increments from $1 to $10, or to recommend that NextDay refuse to offer any discount for the inclusion of the proposed provision in the delivery contract.[128]

If preferences for contract terms are exogenous to contract default rules, subjects in conditions 1 and 2 should have responded identically, on average, because the monetary scale that both used to register their preferences represented the difference in value between the two consequential damages terms. In fact, the subjects exhibited a large and statistically significant bias in favor of the term embedded in the default rule—the status quo term. Condition 1 subjects (N=26), facing a limited-liability default rule, were reluctant to advise NextDay to contract around that default term. They recommended, on average, that NextDay demand a *minimum* of $6.96 per package to do so. Subjects in condition 2 (N=28), on the other hand, confronting a full-liability default rule, valued a limited-liability term much less. They recommended, on average, that NextDay pay a *maximum* of $4.46 per package to add the limitation.[129] Even this large difference probably understates the strength of the status quo bias. Responses to condition 1 that indicated a subject would not recommend that NextDay accept the full liability term at any price ("refusers") were coded as providing a response of $10 for the purposes of creating a mean WTA value, even though none of these respondents would have accepted $10 for the inclusion of the liability term. Even if the refusers are omitted from the data set entirely—that is, the subjects apparently most affected by the status quo bias are ignored—the difference between the resulting WTA of $6.57 for condition 1 subjects (N=23) and the $4.46 WTP for condition 2 subjects is highly significant.[130]

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125 *See infra* Appendix B2.
126 *See infra* Appendix B2.
127 *See infra* Appendix B2.
128 *See infra* Appendix B2.
129 $t\ (52) = 3.89,\ p < .001$.
130 $t\ (49) = 3.23,\ p < .005$.

Comparing the average responses of subjects in the two conditions does not adequately illuminate the extent of the impact that the status quo bias would have on actual bargaining outcomes, because "outlier" responses could make the difference in mean responses seem large even if the bias would have exerted a minimal effect on actual bargaining outcomes. To understand the full implications of the data, conduct the following thought experiment: assume a series of negotiations were to take place between each experimental subject representing NextDay and each of a set of attorneys representing Gifts, Inc., where Gifts, Inc. faces the same expected cost differential between full- and limited-liability terms and the Gifts, Inc. attorneys display a status quo bias of the same magnitude that the experimental subjects displayed. That is, each condition 1 subject (who revealed his/her WTA value) negotiates under a limited-liability default against each set of Gifts, Inc. attorneys who have WTP values for contracting around the limited-liability default that are identical to the WTP values of the condition 2 subjects. Similarly, each condition 2 subject (who revealed his/her WTP value) negotiates under a full-liability default against a series of Gifts, Inc. attorneys who have a range of WTA values for contracting around the default term identical to the WTA values of the condition 1 subjects.

If there were no status quo bias, both parties in each of the resulting hypothetical negotiating pairs—1456 pairs in all—should have the same expected value, on average, of the difference between the two possible liability rules. It follows that WTP values would exceed WTA values for approximately 50% of the hypothetical negotiating pairs and, therefore, parties would reach agreements to add the proposed terms to the contract in 50% of the negotiations. In contrast, in the hypothetical scenario with the observed status quo bias, there would have been only 432 agreements to contract around the default term, or a transaction rate of just under 30% (432 out of 1456).[131] Put a different way, the status quo bias in the Consequential Damages scena-

131 These statistics are derived from the following distribution of subjects' responses:

Condition 1		Condition 2	
Response	*N*	*Response*	*N*
"Refusers"	3	$9	1
$10	5	$8	1
$9	1	$7	3
$8	3	$6	2
$7	2	$5	8
$6	1	$4	4
$5	7	$3	3
$4	2	$2	5
$3	1	$0	1
$2	1		

rio reduced the number of successful hypothetical transactions by 40% from the total that would be expected if the preference-exogeneity assumption were an accurate empirical description.

A brief digression is in order to note that the results from the Consequential Damages scenario cannot be explained by possible deviations from risk neutrality on the part of the experimental subjects flowing predictably from the condition to which they were assigned. Risk-neutral subjects should have valued the difference between limited- and full-liability terms at approximately $5 (recall that the costs of the full liability provision were between $0-$10 per package, with an unknown distribution in that range), regardless of the default rule. Risk-averse subjects in condition 1 might have preferred the security of the limited-liability term, thus providing high WTA values. However, risk aversion would also cause the subjects in condition 2 to provide a high WTP value for the less risky limited-liability provision. Similarly, a risk-seeking profile could cause subjects to place a low value on the limited-liability provision. Although this would explain the low WTP values provided by condition 2 subjects, however, it is inconsistent with the observed high WTA values of the condition 1 subjects. Risk-seekers should be willing to accept a relatively small amount of money to add the risky full-liability term to the contract.

If an individual faces a declining marginal utility for money, he should be risk-averse if he is poor, but close to risk-neutral if he is extremely wealthy.[132] If condition 1 subjects perceive NextDay as wealthier (because the default rule favors it) than condition 2 subjects do, it is possible that condition 2 subjects could assume a slightly more risk-averse attitude when advising NextDay. The difference in responses between subjects in the two conditions, though, cannot be explained by such a difference in risk preference arising from perceptions of wealth. A full-damages term is riskier for NextDay than a limited-liability term. If differences in risk preference caused the differences in subject responses, then we would expect condition 2 subjects (the "poorer" subjects) to place a greater premium on the limited-liability term, thus reducing the risk. This trend would be reflected by condition 2 subjects expressing a willingness to pay more for a limited-liability provision than condition 1 subjects would demand to relinquish a limited-liability provision in favor of the riskier full liability. The experimental results, of course, are just the opposite: condition 2 subjects express a willingness to pay far less than the asking price of condition 1 subjects.

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132 For a mathematical demonstration of why this is so, see Jeffrey J. Rachlinski, *Gains, Losses, and the Psychology of Litigation*, 70 S. CAL. L. REV. 113, 117 n.13 (1996).

2. *The Impossibility Excuse Scenario*

The status quo bias evident in the Consequential Damages scenario was replicated in a similar scenario that considered the allocation of risk of damages caused by unforeseen circumstances that would make it impossible or commercially impracticable for NextDay to meet its delivery obligations. In condition 1 of this "Impossibility Excuse" scenario, subjects were told that their state's law provides that:

> [T]he occurrence of a contingency that is both unforeseen and beyond the control of the delivery company that makes it physically impossible or commercially impractical within reason for it to meet its delivery obligation constitutes a valid excuse for non-performance of the delivery obligation. In such a situation the delivery company must refund the money it charged its customer for the delivery but is not responsible for any additional damages.[133]

Notwithstanding this default rule, subjects were informed that Gifts, Inc. had proposed the following, fully enforceable, contract term that would shift the risk of damages to NextDay:

> "NextDay will be liable for applicable contract damages should it fail to deliver a package on the next day, as promised under the contract, regardless of the occurrence of any contingency, whether or not it is unforeseen or beyond NextDay's control."[134]

Subjects were then told that Gifts, Inc. planned to offer a lump-sum side payment to NextDay if NextDay would consent to this provision. These subjects were then asked to recommend to NextDay the minimum amount it should be willing to accept for incurring additional liability under the provision.[135] No information concerning the possible costs of the added exposure was provided but, as a benchmark, the survey informed subjects that the contract with Gifts, Inc. would earn NextDay revenues of approximately $2 million per year, of which 20% would be profit.[136]

In condition 2 of the Impossibility Excuse scenario, subjects were provided with a default rule opposite of the one described in condition 1:

> Occasionally, an unexpected contingency arises that makes it impossible or commercially unreasonable for NextDay to meet its obligation of providing "next day" delivery, as promised. Under the law of your state, as in most others, the occurrence of such a contingency is no defense to a breach of contract claim—that is, NextDay

133 *See infra* Appendix C1.

134 *See infra* Appendix C1 (italics omitted).

135 *See infra* Appendix C1.

136 *See infra* Appendix C1.

is still held liable for damages despite occurrences beyond its control.[137]

Subjects were then told that NextDay would like to propose that the following, enforceable provision be added to the contract:

> "If a contingency that is both unforeseen and beyond NextDay's control occurs making it physically impossible or commercially impractical within reason for NextDay to meet its 'next day' delivery obligation, NextDay will refund the money paid for the shipment of the package but Gifts, Inc. will not be entitled to any additional contract damages."[138]

Subjects were then informed that NextDay understands that in order to convince Gifts, Inc. to accept the additional risk that this provision entails, it will have to offer a side payment. To maintain symmetry with condition 1, subjects were also informed that NextDay's expected annual revenue from its relationship with Gifts, Inc. was $2 million, of which 20% would be profit.[139]

As was true in the Consequential Damages scenario, the preference-exogeneity assumption implicitly carries with it the prediction that the responses offered by condition 1 subjects would not differ, on average, from those offered by condition 2 subjects. In effect, subjects in both conditions were asked to perform the same task: place a value on the difference between a contract in which impossibility is a valid excuse for nondelivery and one in which it is not.[140] Once again, though, the content of the default term did have a large and statistically significant effect on the strength of subjects' preference for incorporating the impossibility excuse into the contract with Gifts, Inc. Condition 1 subjects (N=22) recommended, on average, that NextDay demand a minimum side payment of $302,000 in order to accept a term that would eliminate NextDay's ability to invoke the impossibility excuse. Condition 2 subjects (N=25), in contrast, recommended, on average, that NextDay pay no more than $78,000 to add an impossibility excuse provision to the contract. The difference between the two means is highly significant whether the actual responses are com-

137 *See infra* Appendix C2.

138 *See infra* Appendix C2 (italics omitted).

139 *See infra* Appendix C2.

140 Unlike the Consequential Damages scenario, the Impossibility Excuse scenario does not provide subjects with a certain range of the additional costs NextDay would incur under a contract in which it assumed more liability rather than less liability. This difference, however, provides no reason to think that subjects in conditions 1 and 2 of the Impossibility Excuse scenario would respond differently to each other, on average, than condition 1 and 2 subjects in the Consequential Damages scenario. If anything, the lack of a certain range of outcomes would lead to a prediction that there would be greater noise in subjects' responses to the Impossibility Excuse scenario than the Consequential Damages scenario, and thus a lesser likelihood of statistically significant differences between the subjects in different conditions.

pared,[141] the natural logarithms of the actual responses are compared (to smooth out a highly skewed distribution),[142] or even if the higher condition 1 outlier valuations (those greater than $400,000) are removed from the data set entirely, thus reducing the mean response of condition 1 subjects and bringing the two means closer together.[143]

In terms of impact on bargaining activity, the status quo bias was even stronger in the Impossibility Excuse context than in the Consequential Damages scenario. Matching each subject's response with each of an identical number of hypothetical Gifts, Inc. lawyers facing the same information and endowed with the same preferences would create transactions in only 22% of the resulting hypothetical negotiations (242 transactions in 1100 negotiations),[144] less than half of the 50% that would be expected if the subjects' substantive preferences were exogenous to the content of the default rule. Put another way, for the experimental subjects, after negotiations, the default term would govern the parties' relationship more than 75% of the time. In contrast, the preference-exogeneity assumption would lead to the prediction that the default term would govern the parties' relationship only 50% of the time, assuming no transaction costs.[145]

3. *The Attorneys' Fees Scenario*

The results of both the Consequential Damages and Impossibility Excuse scenarios suggest that in situations where the defanlt contract term systematically favors either buyers or sellers of goods or services and where the disfavored party seeks to add a term to the contract to gain an advantage, the strength of the parties' preferences and,

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141 $t\,(48) = 3.37,\ p < .001$.

142 $t\,(48) = 8.80,\ p < .001$.

143 $t\,(45) = 3.57,\ p < .001$.

144 These statistics are derived from the following distribution of subjects' responses:

Condition 1		Condition 2	
Response	*N*	*Response*	*N*
> $200k	9	$200k	3
$200k	5	$150k	2
$150k	1	$100k	5
$100k	3	$75k	2
$75k	1	> $75k ≥ $50k	3
$50k	1	> $50k ≥ $25k	4
$25k	1	> $25k ≥ $10k	6
$10k	1		

145 As was true in the case of the Consequential Damages scenario, differences in risk preference among subjects could not explain the results. Risk-averse subjects are likely to have a stronger preference than risk-neutral subjects for a contract providing an impossibility-excuse term because this would limit the unknown risk of liability, which should lead to high WTP responses from condition 2 subjects and high WTA values from condition 1 subjects.

hence, the substantive term that ultimately governs their relationship, will depend on the content of the default term. But not every default term obviously favors either buyers or sellers ex ante, such that the parties would necessarily adjust the contract price to compensate the disadvantaged party for agreeing to contract around the default. Does a status quo bias created by the content of a default term affect *whether* parties favor or oppose certain substantive terms in the same way that it appears to affect the *strength* of a preference for or against a term? The "Attorneys' Fees" scenario explicitly explored this question.[146]

In the Attorneys' Fees scenario, subjects were asked to recommend to NextDay whether it should favor a contractual agreement with Gifts, Inc. requiring that each party pay its own attorneys' fees in the event of any litigation between the parties, or one requiring that the losing party in any litigation pay the attorneys' fees of the prevailing party. Each subject was advised of a few of the pros and cons of each alternative fee allocation approach: A "loser pays" rule might discourage lawsuits that lack merit and encourage the prompt settlement of clearly meritorious suits (because the defendant will want to limit the plaintiff's attorneys' fees). On the other hand, a pay-your-own-fees rule might encourage more meritorious suits to be filed (because the plaintiff will not risk being saddled with the defendant's fees) and could encourage more out-of-court settlements of suits when both parties believe they will win (because neither side could hope to recoup its attorneys' fees by litigating).[147]

Subjects assigned to condition 1 of the Attorneys' Fees Scenario were given the following information about the applicable default rule in their jurisdiction:

> When private parties litigate a legal dispute between them, each generally must pay its own attorneys' fees. However, if the parties wish to specify by contract that in any future litigation the losing

146 *See infra* Appendix D.

147 There is an exhaustive literature analyzing the differential effects on litigation volume and settlement activity of a "loser pays" regime, also known as the "British Rule," and a pay-your-own-fees regime, also known as the "American Rule." *See generally* POSNER, *supra* note 14, at 570-76 (discussing the American and British regimes); *Symposium on Fee Shifting*, 71 CHI.-KENT L. REV. 415 (1995) (considering the optimal fee-shifting regime); John J. Donohue III, *Opting for the British Rule, or If Posner and Shavell Can't Remember the Coase Theorem, Who Will?*, 104 HARV. L. REV. 1093 (1991) (arguing that no difference exists between the two rules under Coasean models); Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55 (1982) (examining the effects of risk aversion and informational assymmetries); Symposium, *Attorney Fee Shifting*, LAW & CONTEMP. PROBS., Winter 1984, at 1 (studying fee-shifting); John J. Donohue III, *The Effects of Fee Shifting on the Settlement Rate: Theoretical Observations on Costs, Conflicts, and Contingency Fees*, LAW & CONTEMP. PROBS., Summer 1991, at 195 (examining the effects of different fee regimes on the decision whether to litigate or settle).

> party must pay the attorneys' fees of the prevailing party, such a provision is fully enforceable.[148]

They were then asked whether they would favor or oppose adding such a "loser pays" provision to NextDay's contract with Gifts, Inc.[149]

Subjects assigned to condition 2 of the scenario were presented with the following, opposite statement of the governing default rule:

> Under the law of your state, in litigation arising from disputes between merchants, the losing party generally must pay the attorneys' fees of the prevailing party. However, if the parties wish to specify by contract that in any future litigation each party must pay its own attorneys' fees, such a provision would be fully enforceable.[150]

They were then asked whether they would favor or oppose adding such a pay-your-own-fees provision to the contract.[151]

Finally, a third version of the scenario—condition 3—attempted to present the choice neutrally, that is, without identifying either term as part of the status quo. Condition 3 subjects were told:

> Under the law of your state, for either party to seek court adjudication of a dispute between merchants, arising out of a contract, the contract in question must include one of the following two provisions. . . . :
>
> (1) In the case of litigation between the parties to this contract, each party will pay its own attorneys' fees.
>
> . . . .
>
> (2) In the case of litigation between the parties to this contract, the losing party will pay the attorneys' fees of the prevailing party.[152]

Subjects were then asked whether they would favor including provision (1) or provision (2) in NextDay's contract with Gifts, Inc.[153]

The results support the claim that the status quo bias can affect *whether* a party prefers a particular contract term in addition to the magnitude of the value it places on a term it favors.[154] Of condition 3 subjects (N=17), 65% favored the pay-your-own-fees term, while 35% favored the loser pays term. This distribution can be viewed as the expected distribution of all subjects assuming that substantive preferences are exogenous to the default rule. Fifty-nine percent of condition 1 subjects (N=17) opposed including a "loser pays" term in the

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148 *See infra* Appendix D1.
149 *See infra* Appendix D1.
150 *See infra* Appendix D2.
151 *See infra* Appendix D2.
152 *See infra* Appendix D3 (italics omitted).
153 *See infra* Appendix D3.
154 *See infra* Table 1.

contract, effectively preferring the default pay-your-own-fees rule. In contrast, 72% of the condition 2 subjects (N=18) opposed adding a pay-your-own-fees term, effectively favoring the default "loser pays" rule. In other words, the majority of subjects preferred whichever term was the default. The responses of the condition 1 and 2 subjects *collectively* differed significantly from the expected distribution, demonstrating that the content of the default rule affected subjects' preferences.[155] Additionally, the responses of subjects in condition 2 *alone* significantly differed from the expected distribution.[156]

TABLE 1. ATTORNEYS' FEES SCENARIO RESULTS

Condition	*N*	*Default Rule*	*Prefer "Pay-Your-Own"*	*Prefer "Loser-Pays"*
1	17	"Pay-Your-Own"	59%	41%
2	18	"Loser-Pays"	28%	72%
3	17	None	65%	35%

The responses provided by subjects in condition 1 did not differ significantly from those provided by condition 3 subjects,[157] a result that is not surprising. All law students know that the default rule in the United States generally is that each party pays its own attorneys' fees. Because condition 3 did not identify either pay-your-own-fees or loser pays as the default rule in the particular case, it would be natural for subjects assigned to that condition to code the pay-your-own-fees provision as the status quo option and to respond accordingly, just as would condition 1 subjects who were explicitly informed that pay-your-own-fees was the default rule.

C. Motivational Hypotheses

Before evidence of the status quo bias can be useful to lawmakers, a motivational theory must be developed to explain the effect. Without understanding why contract default rules can create a status quo bias, it is difficult to determine both whether lawmakers should be concerned with the bias and, if so, how they might act to minimize its effects.

1. *Explanations Consistent with Preference Exogeneity*

Before questioning why lawmakers' choices of default terms can affect contracting parties' preferences for the content of those terms, explanations for the data consistent with the preference-exogeneity assumption must be ruled out. Defenders of the assumption could argue that the data might be explained as evidence of transaction

155 $\chi^2 = 7.31$, $p < .01$.
156 $\chi^2 = 10.74$, $p = .001$.
157 $\chi^2 = .26$, $p = .6$.

costs or the signaling of private information but, as the following two subsections will explain, neither is a plausible explanation for the experimental results.

a. *Merely Evidence of Transaction Costs?*

Taken alone, the existence of a bias in favor of the status quo is not sufficient evidence of inefficient contracting behavior. For example, the status quo bias might simply be an indication that parties face non-zero transaction costs, and that incurring high costs of analyzing and negotiating alternatives to the status quo might lead to theoretically optimal rules that are not worth the candle.[158] To demonstrate, assume the following facts: (1) the jurisdiction follows the *Hadley* rule that carriers are responsible only for reasonably foreseeable damages,[159] (2) Gifts, Inc. would be willing to pay slightly more for a full-liability term than the costs NextDay would incur by taking necessary additional precautions to minimize its liability under a full-liability term, but (3) the costs of incorporating a full-liability term into the contract are extremely high. Under these facts, a full-liability provision is optimal in theory, but high transaction costs make it more efficient for NextDay and Gifts, Inc. to accede to the suboptimal default term than to contract around it.

This same analysis is appropriate when search costs for alternatives to the default term are high.[160] Consider a default rule that renders the impossibility excuse invalid. Assume that some form of an impossibility excuse might be preferable to the no-excuse default term, but that the cost associated with analyzing all possible permutations of an impossibility term and the effects of each on the parties' expected profits from the contract are greater than the expected benefit of replacing the default rule with such a term. Yet, accepting the default rule is efficient behavior for the parties, although the default term itself is suboptimal. Accordingly, the status quo, as represented by the default term, will affect the content of contracts, but only because, as traditional law-and-economics theorists have hypothe-

158 *See* Samuelson & Zeckhauser, *supra* note 56, at 34 (pointing out that "transaction costs may make any switch from the status quo costly in itself"); *cf.* Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 214-15 (1995) (arguing that searching for and processing information is costly and that, as a result, individuals often "satisfice" rather than optimize).

159 *See supra* notes 20-22 and accompanying text.

160 *See, e.g.*, Samuelson & Zeckhauser, *supra* note 56, at 34 ("An individual may well stick to a low-paying job if the process of searching for a better one is slow, uncertain, and/or costly."); *cf.* Richard Schmalensee, *Product Differentiation Advantages of Pioneering Brands*, 72 AM. ECON. REV. 349 (1982) (identifying the advantage pioneering brands have over subsequent entrants into a market because of the costs to consumers of considering untested brands).

sized,[161] the parties wish to avoid transaction costs, not because the embodiment of a term in a default rule increases parties' desire for its content.

Although plausible in some instances, these "transaction cost" accounts of the status quo bias are easily dismissed as explanations for the results of the default-rule experiments presented in this Article. The experiments involved only two parties, suggesting the physical costs of negotiating would likely be low under any circumstances.[162] More importantly, in these three scenarios specifically, the parties' negotiation costs were identical whether they accepted the default term at issue or contracted around it. In the Consequential Damages and Impossibility Excuse scenarios, the fact patterns were constructed so that the parties were already immersed in negotiations over the contract terms, and the only issue was their reservation prices—the applicable transaction costs were sunk[163] and were no greater if parties were enthusiastic about contracting around the default rule than if they were equivocal or downright opposed to contracting around it.[164] In the Attorneys' Fees scenario, subjects were asked merely to indicate whether they favored or opposed a fee-allocation term inconsistent with the default term, not the extent to which they would take affirmative efforts to shepherd it through the bargaining process.[165] Again, no choice of responses implied the subject or her client would incur

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161 *See supra* notes 8-16 and accompanying text.

162 *See, e.g.*, John J. Donohue III, *Diverting The Coasean River: Incentive Schemes To Reduce Unemployment Spells*, 99 YALE L.J. 549, 556 (1989) ("The number of actors involved in a potential Coasean bargaining situation has been deemed critical to the emergence of an efficient outcome. . . . Two is the optimal number of parties from the perspective of reducing the costs of coordination."); *cf.* Schwab, *supra* note 9, at 267-68 (noting that "[b]argaining costs are likely to be lower in labor negotiations" because there are only two parties to the negotiations and the parties are likely to be engaged in negotiations on other points anyway, making the marginal cost of adding an additional item small). Donohue also notes that "if the parties are locked in a bilateral monopoly, where neither party has alternatives to dealing with the other, transaction costs will be sharply elevated" because the parties could have difficulty agreeing on how to divide the surplus. Donohue, *supra*, at 556. Although the default-rules experiments were designed as bilateral monopoly situations, the potential costs of competitive bargaining were avoided by requiring the subjects to state their reservation prices rather than to actually reach an agreement on contract terms.

163 Sunk costs should not affect the decisions of parties seeking to maximize their wealth through contract. *See generally* RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 115 (5th ed. 1996) ("Sunk costs are like spilled milk: They are past and irreversible outflows."); Richard H. Thaler, *The Psychology and Economics Conference Handbook: Comments on Simon, on Einhorn and Hogarth, and on Tversky and Kahneman*, *in* RATIONAL CHOICE: THE CONTRAST BETWEEN ECONOMICS AND PSYCHOLOGY 95, 98 (Robin M. Hogarth & Melvin W. Reder eds., 1987) ("Historical or sunk costs should be irrelevant."); Samuelson & Zeckhauser, *supra* note 56, at 37 ("One of the earliest lessons in economics is that decisions should be based on incremental benefits and costs.").

164 *See infra* Appendices B1-2, C1-2.

165 *See infra* Appendices D1-3.

higher transaction costs involved with negotiating or drafting the final contract than any other response.

Similarly, the design of the scenarios ruled out search and analysis costs as the cause of the status quo bias. In each, decision choices were binary: "reasonably foreseeable damages" versus "all damages," an "impossibility excuse" versus "no excuse," "pay your own fees" versus "loser pays"[166]—and considering the costs and benefits of the alternative to the default term required no more time or attention than considering the costs and benefits of the default term. Although the scenarios in no sense provided subjects with all the information about the likely impact of the alternative term that a lawyer might like to have at her disposal before providing advice to a client, neither did they provide all desirable information about the likely impact of the default term. Furthermore, because the content of all default terms was determined by lawmakers and bore no relationship to the subjects' hypothetical prior choices or actions, the subjects had no reason to assume that the default terms must reflect their prior considered and thoughtful analysis. Consequently, it seems reasonable to conclude that the transaction costs associated with contracting around the default term did not cause the demonstrated status quo bias.

b. *Private Information?*

When bargaining over a contract term, information learned in the bargaining process can affect a party's preference for a given term. As the literature on the implications of strategic bargaining for the content of default rules points out, the mere fact that a party proposes contracting around a default term can implicitly communicate information about that party that affects the other party's evaluation of the term.[167] For example, as noted above, in an industry with a default rule requiring mandatory arbitration of commercial disputes, a proposal to contract around the default and provide access to courts might signal that the proposing party would have an advantage in court relative to the receiving party or be at a disadvantage in arbitration.[168] This information about the proposing party could strengthen the receiving party's preference for arbitration.

In the Consequential Damages scenario, condition 1 subjects received a proposal from Gifts, Inc. to contract for full liability, rather than the default of limited liability, while condition 2 subjects, told that NextDay wanted to contract around the default of full liability,

166 *See infra* Appendices B1-2, C1-2, D1-3.

167 *See generally* Ayres & Gertner, *supra* note 3, at 97-100 (discussing how penalty default rules encourage the production of information).

168 *See supra* notes 42-43 and accompanying text.

did not receive the same information about Gifts, Inc.'s preference.[169] Similarly, in the Impossibility Excuse scenario, condition 1 subjects received a proposal from Gifts, Inc. to contract around the default rule that recognized the impossibility excuse, whereas condition 2 subjects were informed that NextDay desired to contract around the opposite default.[170] Gifts, Inc.'s proposals should not have affected the preferences of condition 1 subjects in either scenario, however, because those proposals conveyed no previously unknown information.

With respect to the Consequential Damages scenario, Gifts, Inc.'s proposal of a full-liability term was hardly revealing because *any* shipper would prefer a full-liability term to a limited-liability term. Furthermore, subjects were also told that NextDay's accountants evaluated the expected marginal cost of full liability based on the historical value of Gifts, Inc.'s deliveries and NextDay's historical misdelivery rate at between $1 and $10 per package,[171] indicating, independent of both Gifts, Inc.'s proposal and common sense, that a full-liability term would benefit Gifts, Inc. significantly enough to make it worthwhile for Gifts, Inc. to propose such a term. Of course, if Gifts, Inc. had expressed a willingness to pay a high amount for the term (for example, more than $5), that could have been viewed as an indication that Gifts, Inc. had reason to expect higher unforeseeable losses than NextDay anticipated, possibly because it had information unavailable to NextDay. This could, in turn, have reasonably caused subjects representing NextDay to reevaluate the strength of their preference for a limited-liability term and to demand a higher price to agree to full liability. However, the scenario was carefully designed to avoid such a potential signal. Gifts, Inc. did not reveal any information about *how much* it might be willing to pay for a full-liability term, only that it preferred such a term over a limited-liability term.

Likewise, in condition 1 of the Impossibility Excuse scenario, Gifts, Inc.'s proposal to contract around the default term indicated only the obvious fact that it would prefer a contract that did not recognize an impossibility excuse to one that did. The proposal revealed no information about the strength of Gifts, Inc.'s preference, which might have been relevant to the subjects' analysis. In the unlikely event that condition 1 subjects mistook Gifts, Inc.'s proposed no-excuse term as a signal that Gifts, Inc. had an unusually strong preference for such a term (thus causing subjects to increase their WTA values above what they would have otherwise been), this bias should have been equalized by the opposite instruction given to condition 2

169 *See infra* Appendices B1-2.
170 *See infra* Appendices C1-2.
171 *See infra* Appendices B1-2.

subjects—that NextDay wished to propose an excuse term to the contract (thus causing subjects to increase their WTP values above what they would have otherwise been).[172]

It was conceivable, although unlikely, that the condition 1 subjects in these two scenarios familiar with Gifts, Inc.'s proposal to contract around the default rule would have provided higher reservation prices than condition 2 subjects if they wanted to prevent their "adversary" from getting something that it proposed. In other words, the information revealed to condition 1, but not condition 2, subjects was not that Gifts, Inc. would *benefit* from a full-liability or a no-excuse contract term, but that Gifts, Inc. *proposed* such a term. This hypothesis, though, would require that subjects view Gifts, Inc. negatively, to provide the motivation for the spiteful act of inflating NextDay's reservation price above what it would otherwise be, solely to prevent Gifts, Inc. from obtaining its proposed term.[173] Although the scenarios were carefully created to avoid portraying Gifts, Inc. in a bad light, it is conceivable that some subjects could have ascribed negative attributes to NextDay's customer. To ensure that a spiteful response to Gifts, Inc.'s proposals did not create the observed status quo bias, all subjects were asked at the end of their participation in the experiment whether their feelings toward Gifts, Inc. were positive, negative, or neutral. Answers provided to that question revealed no significant effect on subjects' responses to the Consequential Damages and Impossibility Excuse scenarios. Consequently, it seems fair to eliminate spite as an explanation for the status quo bias in these experiments.

In the Attorneys' Fees scenario, which measured the subjects' preference for a "loser pays" or a pay-your-own-fees rule,[174] a proposal to contract around a default rule by Gifts, Inc. could have signaled relevant information, because it was unclear which party, if either, stood a better chance of ultimately benefitting from either term. None of the conditions of that scenario, though, provided any information about which fee-allocation term Gifts, Inc. preferred—subjects were merely asked whether they would favor or oppose contracting around the default.[175] Consequently, there is no possibility that the status quo bias demonstrated by the results of that scenario could have been caused by the signaling of private information about Gifts, Inc.

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172 *Compare infra* Appendix C1, *with infra* Appendix C2.

173 *Cf.* Russell Korobkin & Chris Guthrie, *Psychological Barriers to Litigation Settlement: An Experimental Approach*, 93 MICH. L. REV. 107, 155-60 (1994) (finding that experimental subjects were less likely to accept a litigation settlement offer from an adversary than they were to accept the same settlement if proposed by a mediator, even when there was no possibility that the adversary possessed private information, so long as the adversary had treated the subject poorly in the past).

174 *See infra* Appendices D1-3.

175 *See infra* Appendices D1-3.

2. *Wealth Effects*

One explanation for why individuals are often willing to pay far less for an item to which they have no entitlement than they are willing to accept for the same item if they do have an entitlement to it is that WTP values are constrained by wealth in a way that WTA values are not.[176] A person with limited funds who places a high value on an entitlement might demand an extremely high price to sell it while, because of those limited funds, offering a relatively modest amount of money to buy it.[177]

Whatever the merits of this explanation in other contexts,[178] it is not a plausible description of subjects' motivation in the contract default rules experiments for at least three reasons. First, NextDay was presented implicitly as a major corporation with only a small part of its wealth at stake in its dealings with Gifts, Inc.[179] Although subjects might have viewed NextDay operating under a default rule of liability for only foreseeable damages or under a rule that permitted the impossibility excuse as somewhat wealthier than NextDay operating under the opposite defaults, nothing in the facts implied that this difference would have any more than a trivial effect on the company's overall wealth. Moreover, in the Consequential Damages scenario, any payment offered by NextDay for the adoption of a limited-liability term would come in the form of a discount on future services, not in cash, suggesting that any presumed constraints on cash-in-hand should not affect expressed WTP values. In any event, the results of the Attorneys' Fees scenario effectively exclude resource constraints as a significant motivating cause of the status quo bias in the set of experiments as a whole, just as it excludes signaling as an explanatory factor. Because a preference for either choice of fee allocation rules

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176 Herbert Hovenkamp argues that this is the source of the endowment effect. Herbert Hovenkamp, *Legal Policy and the Endowment Effect*, 20 J. LEGAL STUD. 225, 225 (1991). *But see* RICHARD H. THALER, QUASI RATIONAL ECONOMICS xi-xii (1991) (relating an informal survey in which subjects would pay only $200 to reduce a risk of immediate death by 1 in 1000 but would demand $50,000 to allow a 1 in 1000 increase in the risk of immediate death, despite being told that they could pay off their bids over 30 years interest free).

177 *See* Hovenkamp, *supra* note 176, at 231; *see also* KELMAN, *supra* note 13, at 143 (arguing that Native Americans stripped of their land by European settlers could never afford to buy it back, but that it is unclear whether the Europeans could have offered enough to induce the Native Americans to sell the land if they had recognized the natives as rightful owners).

178 *See* Korobkin, *supra* note 54, at 680-82 (criticizing Hovenkamp's explanation on the grounds that resource constraints should reduce what an individual is willing to accept for an entitlement, just as it reduces what she is willing to pay for that entitlement, because the proceeds of a sale of the entitlement can be used to purchase other items that the cash-constrained party is likely to lack).

179 *See infra* Appendix A2 (describing NextDay as similar to "Federal Express").

would not have entailed the transfer of money, resource constraints cannot explain the observed status quo bias.[180]

3. *Decommodification*

The law-and-economics assumption that actors subject to the legal system seek to maximize their utility or wealth presumes that all entitlements are commensurable—individuals can compare the value they place on one entitlement to other entitlements or to money.[181] One theory of the motivational basis of the status quo bias posits that, to the contrary, people think that some values are incommensurable and should not be monetized or otherwise traded off against other values.[182] Jonathan Baron and Mark Spranca have called these "protected values."[183] Variants of this theory predict that individuals will refuse to accept cash payments or barter in exchange for sacrificing protected values,[184] or, at least, will demand a premium for doing so to compensate for the disutility caused by sacrificing a protected value.[185] In either case, these apparent high valuations will not be reflected in what the same individuals are willing to pay for the protected value.

Many people are likely to see rights to environmental resources as protected goods which are inappropriate to sacrifice for a payment.[186] This contention finds support in a set of experiments by Rebecca

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180 The results of the Consequential Damages and Impossibility Excuse scenarios are inconsistent with the different, yet related, hypothesis that subjects led to think of NextDay as relatively wealthier because the default rule favors it will be more risk averse than subjects led to think NextDay is relatively poorer because the default rule favors Gifts, Inc. For evidence disconfirming this hypothesis, see *supra* notes 140-45 and accompanying text.

181 *See* COOTER & ULEN, *supra* note 9, at 17 (explaining that rational choice theory assumes that individuals' preferences can be completely ordered, meaning that the individual is "*not* allowed to say, 'I can't compare them'").

182 *See, e.g.*, Jeffrey L. Harrison, *Egoism, Altruism, and Market Illusions: The Limits of Law and Economics*, 33 UCLA L. REV. 1309, 1331-34 (1986) (claiming that individuals cannot reduce all desires to the same common denominator, but rather they arrange desires in hierarchies, and that items in one level of the hierarchy will not be traded for items in a lower level); Kelman, *supra* note 47, at 692 (noting a human desire "to withdraw spheres of activity from the realm of marginalism and calculation . . . because the commodity relationship is undesirable").

183 Jonathan Baron & Mark Spranca, Protected Values (1996) (unpublished working paper, on file with author).

184 *See id.* at 348-49.

185 *Cf.* Harrison, *supra* note 182, at 1333 (pointing out that the same individual who believes that breaching a contract is immoral and would therefore not do so for the opportunity to increase his wealth by $100 might breacb the contract if doing so will increase his wealth by $500).

186 *Cf.* Julie R. Irwin, *Buying/Selling Price Preference Reversals: Preference for Environmental Changes in Buying Versus Selling Modes*, 60 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 431, 436 (1994) (claiming that the body of empirical evidence suggests that the status quo bias depends on commodity type, with the bias being stronger for environmental commodities than for consumer commodities).

Boyce et al., who found that subjects' WTA prices for trees increased markedly when experimenters told the subjects that all trees that the subjects sold would be killed.[187] In contrast, WTP prices for trees did not increase significantly when subjects learned that unpurchased trees would be killed,[188] presumably because subjects felt no moral obligation to save the trees, only an obligation to avoid playing an affirmative role in their deaths.

It seems highly unlikely a priori that contracting parties would decommodify their entitlements to the protection of default contract rules, both because *contract* terms are usually thought to be means to the ends of wealth maximization rather than ends in themselves, and because *default* terms by their nature (given that parties are free to alter them) beg to be commodified and traded. It is plausible, though, that some parties may decommodify certain contract terms when they are entitled to such terms and refuse to trade-off those terms against other valuable consideration in a way that they do not refuse to do when they have no initial entitlement. The results from the Consequential Damages scenario lend some support to this hypothesis: 12% (3 of 26) of the subjects in condition 1 (the WTA condition in which the default term is limited liability), said that they would refuse to give up the limited-liability term for any amount of money. But the same results clearly show that more is motivating the status quo bias than an unwillingness to commodify entitlements to contract terms provided by default rules. Even with the responses of these "refuser" subjects removed from the data set, the difference between the mean responses of subjects in the two experimental conditions (WTA condition = $6.57; WTP condition = $4.46) is highly significant.[189]

4. *Loss Aversion*

The concept of "loss aversion" provides a more promising explanation of the status quo bias.[190] Since Amos Tversky and Daniel Kahneman coined this term as part of "prospect theory,"[191] their descriptive behavioral model offered as an alternative to expected-utility theory,[192] psychologists have gathered a great deal of evidence that

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187 Boyce et al., *supra* note 88, at 1369-71.

188 *See id.* at 1369.

189 $t(49) = 3.23$, $p < .005$.

190 Amos Tversky & Daniel Kahneman, *Loss Aversion in Riskless Choice: A Reference-Dependent Model*, 106 Q. J. ECON. 1039, 1041 (1991); *see also* Tversky & Kahneman, *supra* note 49, at S258 (describing "loss aversion" as it applies to decision-making that is motivated by values).

191 The first of many presentations of prospect theory by Tversky & Kahneman was published in 1979. Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979).

192 Prospect theory offers three predictions about decisionmaking behavior: (1) that when forced to choose between certain and uncertain alternatives, individuals will tend to

the utility consequences to individuals of suffering a loss from a reference point weigh more heavily than an equivalent gain from the same reference point.[193] If contracting parties are much more concerned with losing some rights than with gaining others, bargaining to change from the status quo to alternative states could be significantly limited.

Loss aversion could well explain the status quo bias observed in the contract default rule experiments. In the Attorneys' Fees scenario, subjects in condition 1 had the opportunity to substitute a "loser pays" term for the pay-your-own-fees default.[194] If subjects are loss-averse, they might feel more unhappiness from the prospect of losing the benefits of the pay-your-own-fees term than happiness from the thought of the benefits to be gained from the "loser pays" term, all other things being equal. (That is, they believe the benefits and the costs of the alternative systems are roughly equivalent in the abstract.) Subjects in condition 2 ("loser pays" default) might have the opposite response. These predictions are consistent with the finding that most subjects preferred the default term, regardless of which term it was.[195]

In the Consequential Damages and Impossibility Excuse scenarios, subjects were asked to place a monetary value on terms that would limit NextDay's liability for damages resulting from its failure to perform its contractual obligations. In condition 1 of each scenario, subjects stood to lose the limited-liability term and gain money.[196] In condition 2, subjects stood to gain the limited-liability term and lose money.[197] The concept of loss aversion is consistent with the subjects' greater preference for the limited-liability term when they stood to lose the term than when they stood to gain it.[198]

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make risk-averse choices when they perceive the alternatives as "gains" from some status quo position, but will tend to make risk-seeking choices when they perceive the alternatives as "losses" from a reference point; (2) that individuals value losses of a certain magnitude more heavily than gains of the same magnitude; and (3) that individuals value certainty more heavily than expected utility theory would predict. For a cogent explanation of all three of these branches of prospect theory by its creators, see Kahneman & Tversky, *supra* note 67, at 343-49. For a more detailed description of the first aspect of prospect theory, which is not considered in detail in this Article, see Korobkin & Guthrie, *supra* note 173, at 129-38; Russell Korobkin & Chris Guthrie, *Psychology, Economics, and Settlement: A New Look at the Role of the Lawyer*, 76 TEX. L. REV. 77 (1997).

193 *See, e.g.*, Tversky & Kahneman, *supra* note 190, at 1040-45 (reviewing empirical evidence of the phenomenon).

194 *See infra* Appendix D1.

195 *See supra* text accompanying notes 154-57.

196 *See infra* Appendices B1, C1.

197 *See infra* Appendices B2, C2.

198 *See* Tversky & Kahneman, *supra* note 49, at S258 (noting that "[l]oss aversion may . . . contribute to the observed discrepancies between the amount of money people are willing to pay for a good and the compensation they demand to give it up") (citations omitted).

5. *Regret Avoidance*

The concept of loss aversion provides a convincing descriptive account of the status quo bias, but it is neither completely satisfying nor helpful because it provides no motivational theory: *why* are individuals often loss-averse? One possible explanation is that when consequences of decisions are uncertain, there exists the possibility of ex post regret,[199] and that individuals experience greater regret when undesirable consequences follow from action than when they follow from inaction.[200] Under this theory, actively switching from the status quo position carries with it a higher risk of regret than failing to switch from the status quo to an alternative state, meaning that the loss outweighs a gain when the entitlements themselves have equivalent value.

Regret avoidance provides a plausible motivational explanation for the default-rules experiment results. In the Consequential Damages scenario, for example, condition 1 subjects were uncertain as to whether accepting full liability for Gifts, Inc.'s damages would cost NextDay more or less than the per-package premium it would collect. Actively moving from the status quo, accepting additional liability above what the default contract term provided, could result in a net loss to NextDay, as could retaining the status quo, limited-liability default. If *action* that leads to an undesirable outcome creates more regret than *inaction* that leads to an undesirable outcome, the possibility of regret is minimized by inaction, all other things equal. Consequently, subjects should demand something more than the five-dollar-per-package expected cost of accepting the full-liability term. For condition 2 subjects (full-liability default), either inaction or action, the act of giving Gifts, Inc. a discount for a limited-liability term, could potentially be the more costly choice. But for these subjects, the active choice that could lead to the greatest regret is providing the dis-

199 The regret avoidance theory has been suggested, by a number of theorists, as a plausible explanation for the status quo bias in other contexts. *See, e.g.*, Harrison, *supra* note 182, at 1360 ("Th[e] imbalance [between the way people think about out-of-pocket expenses and about opportunity costs] may be fueled by a desire to avoid the risk of regret associated with having made an 'incorrect' change."); Kelman, *supra* note 47, at 688-89 (giving an example of an individual who experiences greater loss from losing $50 than from having saved $50); Knetsch & Sinden, *supra* note 76, at 517 ("The observed reluctance to give up money or assets seems likely to be, at least in part, due to various cognitive biases and such motives as an incentive to protect against a feeling of regret that might accompany a deliberately made exchange in asset[s].").

200 Thaler notes that regret is tied to feelings of responsibility, which are likely to be stronger when an individual makes an affirmative choice than when she makes no choice, leading individuals to sometimes choose not to choose. Thaler, *supra* note 53, at 52. He offers as an example consumer demand for first-dollar (no deductible) health insurance, which allows consumers to avoid the regret that could follow from deciding not to purchase an expensive diagnostic test for a low-probability severe illness, only to learn later that they have the illness and could have been helped by having the test. *Id.* at 53-54.

count for the limited-liability term. If these subjects can minimize the possibility of regret through inaction, they should be willing to offer a maximum discount of something less than the five-dollar-per-package expected benefit of including the limited-liability term in the contract.

The analysis is even simpler for the Attorneys' Fees scenario. Ex ante, subjects have no way of knowing whether a pay-your-own-fees or a "loser pays" rule will work to NextDay's benefit over the course of its relationship with Gifts, Inc.—either choice could turn out to be costly ex post. If less regret accompanies a poor outcome preceded by inaction rather than by action, subjects who perceive the expected benefits of one fee rule to be greater than the other should opt for their preferred fee rule, regardless of the status quo, but subjects with only a marginal preference for one of the fee rules over the other should favor the inactive choice of not contracting around the default term in order to minimize the risk of regret.

The regret avoidance theory's critical assumption—regret is greater when poor results follow action than inaction—is not obviously correct, but it does have intuitive appeal. Choices made are probably more salient in people's minds than choices not made.[201] Kahneman and Tversky,[202] along with others,[203] have conducted experimental research that provides support for this intuition. In one of their experiments,[204] Kahneman and Tversky told subjects that Mr. Paul, who owns stock in Company *A*, considered switching his holdings to Company *B*, but ultimately decided against it. He later learned that he would have been $1200 richer had he made the switch. The authors told the same subjects that Mr. George owned stock in Company *B*, and then switched to Company *A*, later to find out that he would have been $1200 richer had he left his stock in Company *B*.[205]

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201 Mark Kelman made this point particularly well, noting that being more concerned with losing out on something one possesses than something one does not possess "hardly qualifies a person for the loony bin; spending one's life fixated on 'what would have been' if one had followed through all opportunities seems a far surer path to the psychiatrist's couch." Kelman, *supra* note 47, at 689.

202 Daniel Kahneman, *Varieties of Counterfactual Thinking*, *in* WHAT MIGHT HAVE BEEN: THE SOCIAL PSYCHOLOGY OF COUNTERFACTUAL THINKING 375, 388-89 (Neal J. Roese & James M. Olson eds., 1995) [hereinafter Kahneman, *Varieties*]; Daniel Kahneman & Amos Tversky, *The Simulation Heuristic*, *in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 201 (Daniel Kahneman et al. eds., 1982).

203 *See, e.g.*, Thomas Gilovich & Victoria Husted Medvec, *The Experience of Regret: What, When and Why*, 102 PSYCHOL. REV. 379, 380-84 (1995) (discussing other studies on regret); Janet Landman, *Regret and Elation Following Action and Inaction: Affective Responses to Positive Versus Negative Outcomes*, 13 PERSONALITY & SOC. PSYCHOL. BULL. 524 (1987) (describing study which found correlation between regret and failed action).

204 Kahneman, *Varieties*, *supra* note 202, at 388.

205 *See id.* at 388-89.

Ninety-two percent of the subjects judged that Mr. George—who affirmatively acted—would feel greater regret.[206]

If regret avoidance provides the correct motivational explanation for the status quo bias as it applies to contract default rules, the status quo bias should diminish when it is nearly certain that the benefits to be gained by deviating from the status quo will exceed the costs and, consequently, there is little or no reason to fear the possibility of future regret. This insight could explain why Schwab failed to find a significant status quo bias in his experiment dealing with the negotiation of a collective bargaining agreement.[207] Recall that subjects in his experiments knew precisely the number of "points" they would receive for negotiating favorable clauses.[208] Consequently, during the course of negotiations each subject knew whether he was better off demanding a relocation clause that favored his client or accepting an unfavorable relocation clause in return for a favorable term concerning another issue that would provide more points. In Schwab's world of complete certainty as to the value of different contract terms—a world that probably reflects only a small fraction of actual contract negotiations—there is virtually no possibility of ex post regret that would create a bias in favor of the status quo.

The results of a fascinating recent study by Maya Bar-Hillel and Efrat Neter provide support for this explanation of why Schwab's experiment failed to reveal a status quo bias.[209] The experimenters found that when they endowed experimental subjects with a pen and then offered them a small amount of compensation to trade their pen for an identical pen, more than ninety percent agreed to trade.[210] But when they endowed subjects with a lottery ticket and offered them similar compensation to trade their ticket for one with a different number but an identical probability of winning, more than half refused.[211] Bar-Hillel and Neter conclude from this data that because two lottery tickets have the potential for different outcomes, a trade

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206 *See id.* at 388. Terry Connelly et al. recently reported a set of experiments in which subjects judged that a college student who moved from a section of a course of "average" quality to a "bad" section of the same course would feel more regret and unhappiness than a subject who began and remained in the bad section, but that the student who switched sections would feel no worse if the change resulted from his own choice or from random reassignment by a computer over which he had no control. Terry Connolly et al., Regret and Responsibility in the Evaluation of Decision Outcomes 7-12 (1996) (unpublished manuscript, on file with the authors). These results further refine the causes of decision regret, providing evidence that the change from the status quo, rather than the actor's choice to change from the status quo, creates regret if the change turns out in hindsight to be for the worse.

207 *See supra* notes 94-100 and accompanying text.

208 *See supra* text accompanying note 96.

209 Bar-Hillel & Neter, *supra* note 58, at 25.

210 *Id.* at 23.

211 *Id.* at 17-19.

would "induce an anticipation of regret," and this regret would be larger if the trade were made than if it were refused.[212] If this observation is correct, it would follow logically that Schwab's subjects, who knew with certainty whether or not a trade would produce a more desirable outcome than a refusal to trade, would behave more like Bar-Hillel and Neter's pen subjects. In contrast, the subjects in the experiments reported in this Article, who did not know the outcome of a trade with certainty, would behave more like Bar-Hillel and Neter's lottery ticket subjects. The generalized implication of this is that the preferences of parties for contract terms are likely to be more affected by the choice of default rules when there is substantial uncertainty about the consequences of contracting around the default, and less affected as uncertainty about ex post consequences diminishes.

The agency relationship built into the design of the default-rule experiments, in which a lawyer must consider both his client's interests and his own, puts a unique twist on the possibility of regret from contracting around a default rule. Recall that the background information provided to all subjects informed them that:

> At the end of the year, NextDay will review how it fared under the contract you negotiate and decide whether to retain you as their attorney in future dealings, so you have a strong personal stake in making sure that the contract serves the needs of NextDay *and* reflects well on your judgment and ability.[213]

Attorneys, who presumably want to remain employed, have an incentive to minimize not only their regret, but their principal's regret as well. For this reason, a conceivable hypothesis posits that an agent will seek to minimize regret even more than would a principal. The same instruction could also encourage regret-averse behavior because it indicates—as is often true in the legal profession—that the subject would learn the consequences of her advice to her client. Some research has supported the intuitively appealing conclusion that individuals will exhibit more regret aversion when they know that they will learn the consequences of their decision, although other research has disputed this finding.[214]

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212 *Id.* at 26.

213 *See infra* Appendix A2.

214 *Compare* Bar-Hillel & Neter, *supra* note 58, at 18 (citing I. Ritov, Probability of Regret: Anticipation of Uncertainty Resolution in Choice (paper delivered at the 14th Subjective Probability, Utility, and Decision Making conference, Fribourg, Switzerland, August 1993)) (finding that a choice between pairs of binary gambles was affected by whether the resolution of the rejected gamble would be made known), *with* Bar-Hillel & Neter, *supra* note 58, at 18-21 (finding no difference in subjects' willingness to trade their lottery ticket for another ticket and compensation based upon whether the subjects would learn whether the original ticket was a winner). For a theoretical statement of regret theory in general, see Graham Loomes & Robert Sugden, *Regret Theory: An Alternative Theory of Rational Choice Under Uncertainty*, 92 ECON. J. 805, 808 (1982); *see also* David E. Bell, *Regret in*

D. The Objection: External Validity Concerns

The results from this series of experiments document the existence of a strong status quo bias in preferences for contract terms and begin to document some of the contours of that bias. But do they help confidently predict the preferences and behaviors of actual contracting parties outside the confines of a laboratory experiment? Specifically, the experimental design implicates three important concerns about the external validity of the results: the laboratory experiment method, the subject pool, and the exclusive use of agents rather than principals as parties in the hypothetical scenarios. This Section briefly considers each of these issues.

1. *The Experimental Method*

The use of the experimental method as a basis for legal policy recommendations inevitably raises the concern that individuals responding to the incentives of legal rules in the "real" world may not behave precisely like subjects in controlled experimental conditions.[215] This might be true both because the scenarios used in the experimental setting must necessarily abstract from the complexities of actual bargaining interactions rather than replicate actual interactions, and because subjects might lack the incentive to make optimal decisions in an experimental setting than would motivate them in an actual bargaining setting.[216]

There is no completely satisfying response to these concerns—the experimental setting can never perfectly mirror the nuanced incentives of the real world—but the between-subjects methodology employed in this set of experiments and the content of the experiments

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Decision Making Under Uncertainty, 30 OPERATIONS RES. 961, 971 (1982) (suggesting that a person who has chosen a lottery number but not played it might avoid regret by avoiding hearing the winning number).

215 *Cf.* Thaler, *supra* note 163, at 96-98 (listing external validity objections commonly made to social science experimental evidence).

216 *But cf.* Kahneman & Tversky, *supra* note 191, at 265 (acknowledging that "hypothetical choice" laboratory experiments "rel[y] on the assumption that people often know how they would behave in actual situations of choice, and on the further assumption that the subjects have no special reason to disguise their true preferences," but defending the hypothetical choice experimental method as "the simplest procedure by which a large number of theoretical questions can be investigated"); Thaler, *supra* note 163, at 96. According to Thaler:

> *If the stakes are large enough, people will get it right.* This comment is usually offered to rebut a demonstration of embarrassing inconsistency on the part of a group of undergraduate students participating in an experiment at one of our leading universities. Many such demonstrations have offered the subjects little or no incentive to think hard or to get the "right" answer.... Do people tend to make better decisions when the stakes are high? There is little evidence that they do.

Id.

obviates these concerns to some degree. First, subjects had no incentive to answer the questions provided with anything other than the advice that they would provide to an actual client, as they were instructed to do. No answer choices could be seen as self-serving or more socially acceptable than others. Moreover, no less attention, concentration, or effort was required to provide any answer as any other possible answer. In other words, it is not clear why subjects would provide an answer to the survey that did not reflect the advice they would offer to an actual client in an actual negotiation setting. Second, because conclusions were based on the differences between the responses of two or more groups of subjects rather than on subjects' absolute responses, any deviations between subjects' responses and the advice they would have provided in an actual negotiation are important only to the extent that the deviations are greater for subjects in one condition than another condition of the same scenario. Again, this is possible, but it is not obvious why this would be the case.

2. *The Representativeness of the Subject Pool*

A second external-validity concern is that the experimental subject pool—first-year law students—might not accurately represent the class of attorneys whose role they are asked to assume.[217] If attorneys would respond to the experimental scenarios differently than would the law-student subjects, the results are of questionable value even if the law students behaved in the experimental setting exactly as they would have in the real world.

Although it is possible that there are fundamental analytical differences between attorneys and nonattorneys that could cause attorneys to respond differently to the experimental scenarios,[218] the subjects resemble attorneys in most of the ways likely to be relevant to the strength of the status quo bias. Having chosen to attend and been accepted to law school, the subjects are drawn from the same segment of the general population as practicing lawyers. Having completed

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217 In a test of the status quo bias in another context, however, Jonathan Baron and Joshua Greene found no significant differences between the effect of the bias on University of Pennsylvania students and subjects recruited from the general population in the Philadelphia train station. Jonathan Baron & Joshua Greene, *Determinants of Insensitivity to Quantity in Valuation of Public Goods: Contribution, Warm Glow, Budget Constraints, Availability, and Prominence*, 2 J. EXPERIMENTAL PSYCHOL.: APPLIED 107, 113 (1996).

218 *Cf.* Korobkin & Guthrie, *supra* note 173 (finding that practicing attorneys playing the role of plaintiffs' lawyers in hypothetical experimental situations to test the effects of a series of psychological phenomena made systematically different decisions about settlement than did undergraduate students playing the role of plaintiffs in the same hypothetical experiments). *But cf.* Linda Babcock et al., *Forming Beliefs About Adjudicated Outcomes: Perceptions of Risk and Reservation Values*, 15 INT'L REV. L. & ECON. 289, 291-97 (1995) (finding that responses of lawyers and nonlawyers participating in a series of experiments were not often significantly different).

nearly all of their first year of law school, the subjects had been intensively exposed to the forms of legal thinking and argumentation, just as practicing lawyers have, and they have studied the basic principles of contract law.

The subjects varied substantially from practicing lawyers in only one potentially relevant way: the amount of experience they had in analyzing disputes and advising clients. Although it is plausible that more experience will make lawyers less susceptible to the status quo bias than law students, this seems unlikely. Even assuming that contracting parties normatively should evaluate contract terms without reference to the status quo, experience alone is generally not a reliable means of improving decisionmaking skills.[219] Experience is useful only when accompanied by systematic feedback.[220] Although practicing lawyers have more experience evaluating contracting options and advising clients, they are unlikely to receive objective feedback helpful in evaluating whether they gave the "optimal" advice.[221]

3. *The Exclusive Use of Agents*

A final concern with the experimental methodology is that, by relying on the responses of individuals playing the role of lawyers, it ignores the possibility that the status quo bias will have less of an effect on commercial entities than on individual agents. A standard assumption of law-and-economics analysis is that, although individuals might have idiosyncratic, non-wealth-maximizing preferences, market competition will force commercial parties to persistently maximize wealth.[222] Because a preference for the status quo, regardless of its

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219 *See, e.g.*, Robin M. Dawes, *Experience and Validity of Clinical Judgment: The Illusory Correlation*, 7 BEHAV. SCI. & LAW 457 (1989) (illuminating the limits of psychological testing); Howard N. Garb, *Clinical Judgment, Clinical Training, and Professional Experience*, 105 PSYCHOL. BULL. 387, 387-91 (1989) (demonstrating that experience does not equate with decisionmaking ability); Tversky & Kahneman, *supra* note 49, at S274-75 (questioning the possibility of learning to avoid certain types of error).

220 *See* MARGARET A. NEALE & MAX H. BAZERMAN, COGNITION AND RATIONALITY IN NEGOTIATION 93 (1991); Thaler, *supra* note 163, at 96.

221 When attorneys advise clients under conditions of uncertainty, at best they can learn after the fact whether gambles that they recommended paid off for the client. Learning whether their advice turned out well in hindsight, however, is not the same as learning whether the advice represented the optimal gamble for the client. Unlike a lawyer, a doctor who prescribes one of two medications for his patient, each with a less than 100% chance of saving a dying patient, and then watches his patient die, learns whether he made an optimal choice. Given the practical inability of lawyers to assess objectively the quality of their advice ex post, it is highly doubtful that experience in providing advice would cause lawyers who were affected by the status quo bias in their earlier years (created by the content of contract default rules), to suddeuly become resistant to the powerful allure of the bias.

222 *See, e.g.*, Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1758 (1989) (pointing out that neoclassical economic theory assumes firms seek to maximize profits); *cf.* Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV.

content, is antithetical to wealth maximization, it follows that commercial parties should not exhibit such a preference.

One difficulty with employing this theoretical framework as a basis for creating contract law is that multiple-agency problems make even commercial parties reliant on the limits of individual rationality. In negotiating a complex commercial contract, it is highly likely that a commercial party—like NextDay in the experimental scenarios—will rely on the advice of an attorney who herself is an individual, especially when the bargaining goes beyond price and quantity and focuses on the finer issues of allocating the risk of unlikely contingencies. Even when the client closely scrutinizes the advice of counsel, the scrutiny necessarily comes from an executive who is also an individual acting as an agent for the corporation.[223] Finally, although evolutionary theory would suggest that commercial entities that sacrifice large amounts of wealth in pursuit of their agents' psychological satisfaction will be unable to attract customers, capital, or both,[224] the presence of the status quo bias suggests only that such entities might deviate from wealth-maximizing decisionmaking only on the margin, but not when an alternative to the status quo option is far superior to the status quo. How parties contractually allocate low-probability contingencies is not unimportant, but neither is it likely to affect a company's survival prospects to the extent that only companies immune to the effects of the status quo bias on preferences for contract terms would survive in the competitive commercial environment.

IV
IMPLICATIONS OF THE STATUS QUO BIAS FOR DEFAULT RULES

A. The Importance of Default Rules

The most fundamental insight for contract theory provided by evidence of the status quo bias is that the choice of default rules matters all of the time, not just when the parties face high transaction costs or asymmetric information. If lawmakers' choice of default terms alters parties' preferences for contract terms—causing an in-

L. REV. 641, 641 (1996) ("The classical evolutionary paradigm has a strong grip on law and economics scholarship. What survives is presumptively efficient: if it were inefficient, the practice, the law, or the custom would be challenged by its more efficient competitors.").

223 *Cf.* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 121-22 (photo. reprint 1982) (1933) (arguing that the stockholders' interests in profit maximization may be ignored by corporate managers pursuing their own interests).

224 *See, e.g.*, STANLEY FISCHER ET AL., ECONOMICS 129-30 (2d ed. 1988) (suggesting that managers who do not strive to act in the best interests of the organization will eventually be "driven out" of the market by competition).

crease in the strength of their preferences for the default term and a decrease in the strength of their preferences for alternative terms—the choice of default terms has the potential to affect *any* private contract. The status quo bias suggests that the difference between default and immutable contract rules might be one of degree rather than of kind—default rules can be seen as "quasi-immutable" rules.

Consider, again, the rule of *Hadley v. Baxendale* limiting damages for breach of contract to those that were reasonably foreseeable at the time of contracting.[225] Under traditional economic analysis of default rules, a contract that does not explicitly address the scope of consequential damages, and thus implicitly adopts the *Hadley* default term, raises concerns of inefficiency only if the parties face high costs of negotiating or drafting an alternative term, or if one party has a motive to strategically withhold private information from the other. If neither high transaction costs nor asymmetric information exist, traditional economic analysis concludes that the *Hadley* rule must efficiently allocate between the two parties the risk of damages resulting from breach if they do not contract around the rule.

The status quo bias makes it impossible to be sure that the failure to contract around the default rule signifies that the default term is efficient for the parties, even absent transaction costs and private information. To borrow from the facts of *Hadley* again, if a common carrier conld avoid the risk of negligent nondelivery or insure against unforeseeable damages more cheaply than a shipper, the shipper and the carrier might still fail to contract around the reasonably foreseeable default term because the value that they implicitly place on maintaining the status quo could exceed the gains in trade of contracting for an alternative allocation of risk.

Taking into account the status quo bias also requires reinterpreting a situation in which parties do bargain around default terms by explicitly including alternate terms in the text of the contract. Under traditional economic analysis, such a scenario would indicate that the difference in joint value to the parties between the explicitly adopted term and the defanlt term exceeds the transaction costs of contracting around the default term and any strategic benefit one party might be able to capture by concealing information inherent in an attempt to contract around the defanlt term. The status quo bias suggests that when parties contract around a default term, the value of the difference between the alternative term and the default term must be greater than what traditional economic analysis would conclude: the difference must exceed (1) the parties' joint transaction costs, (2) the value to either party of not revealing information that must be

225 *See supra* notes 20-22 and accompanying text.

revealed to contract around the default term, *and (3) the parties' joint preference for the status quo.*

Although it is impossible to predict quantitatively the strength of the contracting parties' preference for the status quo in any individual case, the status quo bias at a minimum suggests that parties will not contract around a default contract term when it would only be *marginally* efficient for them to do so (i.e., doing so would result in a relatively small Pareto improvement) compared with the alternative of accepting the default provision (i.e., the parties' joint wealth would be marginally higher under the alternative term). They are, however, likely to contract around the default term when doing so would be *overwhelmingly* efficient (i.e., doing so would result in a large Pareto improvement).

B. The Efficiency Implication of the Status Quo Bias

Why should lawmakers care whether contracting parties prefer the status quo to wealth-maximizing contract terms in marginal cases? Although such a choice fails to maximize the parties' joint wealth, it apparently maximizes their joint utility.[226] Although law-and-economics scholars often equate wealth maximization with utility maximization,[227] nowhere is it written that parties are required to consider only the best methods to create wealth when they negotiate contract terms. David Cohen and Jack Knetsch have argued that the fact that individuals place more importance on items they possess than on foregone gains "reflect[s] powerful human sentiments" that the law should take into account.[228]

This argument is normatively correct as far as it goes, but it does not go far enough. There is nothing necessarily irrational about pre-

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226 If not, rational parties would not be biased by the status quo. *Cf.* POSNER, *supra* note 14, at 14 ("[W]illingness to pay can be determined with great confidence only by actually observing a voluntary transaction."). If succumbing to the status quo bias were truly irrational behavior, a strong argument could be made that the bias can affect only the irrational fringe of contracting parties, rendering it of minimal concern to lawmakers. As discussed in the remainder of this subsection, the status quo bias's effect is likely to be fully rational behavior on the level of individual contracting parties and often will be a locally efficient equilibrium.

227 *See supra* notes 48-50 and accompanying text.

228 Cohen & Knetsch, *supra* note 79, at 741. Cohen and Knetsch argue that the law should reinforce, rather than attempt to neutralize, the status quo bias as it applies to property rights. For example, they point out that if a buyer of a car sells and transfers possession of the car to a second buyer before paying the original seller in full, the second buyer will prevail over the original seller in an ownership dispute. *Id.* at 738-39. However, if the buyer has collected payment from the second buyer but not yet transferred possession of the car, the original seller will prevail over the second buyer. *See id.* Cohen and Knetsch argue that because the status quo bias reflects the attachment individuals feel to items they possess, the law is efficient in both cases, *id.* at 738, although wealth maximizers will claim that there is no difference between the two scenarios, and the law, therefore, ought to treat them the same.

ferring the status quo to alternative states and willingly sacrificing some degree of wealth to maintain the status quo.[229] It follows that parties that choose to indulge their preference for the status quo do not necessarily behave inefficiently by doing so. The flaw in this argument, as applied to default-rules analysis, is that it confuses a local optima for a global optima. The status quo position (i.e., the default term) is imposed on the contracting parties by an external source—a legislature or court. The selection of a default term can create what Mark Roe calls "semi-strong form path dependence," meaning that it is efficient for the parties to maintain the status quo given the initial determination of the status quo, but it would have been more efficient for an alternative status quo to have been created initially.[230] Given the establishment of default term *A*, it might well be *locally efficient* for two parties to adopt term *A* rather than contracting around it in favor of term *B*, which would require sacrificing the value to them of maintaining the status quo. But the parties might have enjoyed a higher combined utility if lawmakers had established term *B* as the default instead, thus allowing the parties to have both the wealth-maximizing contract term *and* the status quo, rather than having to choose one or the other.

The conclusion that follows is this: parties do not necessarily behave irrationally when they choose not to contract around a default term that fails to maximize their joint wealth because of the value they place on maintaining the status quo, but this determination does not mean that the default rule itself is optimal.[231] By choosing a different default rule, thus creating a different perceived status quo, lawmakers

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229 *Cf.* Korobkin & Guthrie, *supra* note 173 (arguing that a litigant who demands a trial knowing that its risk-adjusted expected value is lower than a settlement offer is not necessarily irrational if the settlement amount would not restore the litigant to the status quo position he enjoyed prior to the events that led to the litigation and maintaining the status quo has high value to him).

230 Roe, *supra* note 222, at 648-50; *see also* S.J. Liebowitz & Stephen E. Margolis, *Path Dependence, Lock-In, and History*, 11 J.L. ECON. & ORG. 205, 207 (1995) (using the term "second-degree path dependence"). Roe explains "semi-strong form" path dependence as a situation in which a structure was once determined for political reasons, by chance, or because it was then efficient, and, although that structure is now suboptimal, it is not so suboptimal that it is worth changing. Roe, *supra* note 222, at 648-50. An example of semi-strong form path dependence might be the QWERTY typewriter: in the era of manual typewriters, QWERTY was efficient because it minimized keys sticking; today it is inefficient relative to other keyboard layouts, but the costs of changing are sufficiently great that doing so would not be worth the candle. *See id.* at 648. By contrast, "strong-form" path dependence implies that the status quo is so suboptimal that it is worth changing, notwithstanding the costs of doing so, but decisionmakers still do not make the change. *See id.* at 651-52.

231 Michael Klausner has recently made a similar argument about the efficiency of terms in corporation charters where network externalities are present, which cause firms to select terms that are suboptimal because a critical mass of corporations have already adopted the terms. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 829-34 (1995).

might steer the contracting parties to a more desirable equilibrium. In so doing, they can promote private contracting that is closer to optimal efficiency. The next three Sections discuss how lawmakers might accomplish this task.

C. Mimicking Versus Facilitating the Market for Contract Terms

Evidence of the status quo bias adds an element to the discourse on contract default rules that goes beyond the boundaries of traditional law-and-economics analysis. It also has implications for the debate within the law-and-economics paradigm over whether majoritarian default rules, which attempt to mimic a market for contract terms free of transaction costs, or penalty default rules, which attempt to facilitate private parties' contracting for efficient terms, are most likely to lead to efficient contracts. The status quo bias strengthens the relative case for majoritarian defaults.

Supporters of penalty default rules—defaults that disadvantage the party with private information in order to force that party to reveal the private information in an effort to contract around the default[232]—concede that it is dangerous policy to set default rules that are not majoritarian in circumstances in which transaction costs are likely to be high. The reason why is obvious: penalty defaults can often force a majority of parties to contract around the default rule. But if it is prohibitively expensive for parties to do so, the information-forcing goal of the penalty default will not be fulfilled, and the result will be that the majority of contracting parties are left with inefficient contract terms. The friction in bargaining caused by transaction costs, if high, can nullify the benefit that otherwise could be achieved by penalty defaults.

The status quo bias effectively presents another source of friction, different in origin from transaction costs—which are usually understood to be the costs of (1) searching for negotiating partuers, (2) bargaining over terms, and (3) enforcing agreements[233]—but similar in its effect on bargaining. Consequently, it suggests another reason why penalty defaults may fail to force disclosure of private information. Assume again that most common carriers are cheaper cost avoiders or insurers of all damages resulting from negligent nondelivery than most shippers, whether the damages are foreseeable or not. The proper penalty default might be to hold the carrier responsible only for reasonably foreseeable damages—forcing the shipper with private information about the magnitude of its possible losses to re-

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232 For a more complete discussion of penalty, or information-forcing defaults, see *supra* notes 34-43 and accompanying text.

233 For a discussion of how "transaction costs" are typically defined, see COOTER & ULEN, *supra* note 9, at 84-87.

veal this information by bargaining for the carrier to accept full liability for damages resulting from breach—although such a default would force a majority of parties to contract around it. But if the benefit of having the liability reside with the carrier rather than the shipper is marginal, the status quo bias may swamp the economic benefit of contracting around the rule, causing the parties to accept the default rule and resulting in private information remaining hidden. The status quo bias is more troubling to the efficient operation of penalty defaults than are transaction costs because it is more likely that lawmakers can predict ex ante what types of contracts are likely to have large transaction costs—multiple-party contracts, for example—than that they can predict when the status quo bias is likely to be large relative to the gains in efficiency from contracting around a default rule.

Just as majoritarian default terms are proper when the source of inefficient contract terms is friction caused by transaction costs that make it prohibitively expensive for parties to contract around default rules, so are they also the proper response to friction caused by the status quo bias. If the status quo bias will cause some parties to fail to contract around default terms that are inefficient for them, the best response is for lawmakers to create default terms that are efficient for as many parties as possible, reducing the total social cost of status quo bias friction.

It is ironic that while the status quo bias provides an argument in favor of majoritarian defaults (at least relative to penalty defaults), it simultaneously casts doubt on the conventional wisdom for how lawmakers can identify majoritarian defaults. Typically, identifying majoritarian defaults requires lawmakers to look at the contracting behavior of contracting parties. Given that efficient contract terms are Pareto-superior to inefficient terms (because the parties can use side payments to divide the additional value created by efficient terms, making both parties better off), legal economists assume that contracting parties will settle on them, except in situations of high transaction costs.[234] It follows from this assumption that if few parties contract around a default rule, it must be efficient and should be retained, whereas if most parties contract around the default, it must be inefficient and should be changed. In a textbook example of this methodological approach, J. Hoult Verkerke recently argued that the proper majoritarian default rule of employment contracts should permit dismissal "at will" rather than only for "just cause" because only

234 *See, e.g.*, Klausner, *supra* note 231, at 829 (describing the accepted wisdom concerning majoritarian default terms).

fifteen percent of employers and employees contract around the standard "at will" default.[235]

Evidence of the status quo bias suggests that this methodology is highly suspect: that parties do not contract around an existing default is not necessarily evidence that the rule is optimal, even if transaction costs are low. In order to identify majoritarian default terms, lawmakers must imagine a counterfactual world—one without any defaults—and attempt to predict which terms most parties would agree upon in such a world. Such an approach obviously carries a high risk of error. Fortunately, superior approaches exist to avoid the inefficient contracting that can result from the status quo bias.

D. The Case for Tailoring

The three experimental scenarios described in this Article implicitly assume, as do most discussions of default rules, that whatever the applicable default contract term, it will be applied by courts to all contracting parties that fail to provide an explicitly contrary term in their contract: *all* sellers will be liable for either all damages proximately caused by its breach or only reasonably foreseeable damages (unless they contract around the default term)[236]; *all* sellers will or will not be able to rely on the impossibility excuse[237]; *all* parties will or will not be governed by a loser pays fee allocation rule.[238] All of these terms, then, are "untailored" defaults, in the sense that they apply to all affected parties regardless of the unique characteristics of the parties or their circumstances.

Default rules need not be untailored, however. Rather than favoring all carriers or shippers, or all buyers or sellers, "tailored" default rules require lawmakers—generally judges—to create default terms to govern a relationship between contracting parties based on the specific characteristics and circumstances of those parties.[239] For example, the UCC's default price term—a "reasonable" price[240]—is a tailored default, because it requires a judge to consider the circumstances of the parties and the transaction before determining the unspecified price, instead of applying a uniform rule to all parties.

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235 J. Hoult Verkerke, *An Empirical Perspective on Indefinite Term Employment Contracts: Resolving the Just Cause Debate*, 1995 WIS. L. REV. 837, 867-75.

236 *See infra* Appendices B1-2.

237 *See infra* Appendices C1-2.

238 *See infra* Appendices D1-3.

239 *See* Ayres, *supra* note 15, at 4 ("'[T]ailored' defaults condition legal treatment on particular attributes or conduct of the contracting parties."); *cf.* Kathleen M. Sullivan, *Foreword: The Justices of Rules and Standards*, 106 HARV. L. REV. 24, 59 (1992) ("Standards allow the decisionmaker to take into account all relevant factors or the totality of circumstances.").

240 U.C.C. § 2-305(1) (1995).

While the content of untailored defaults is clear to all contracting parties ex ante through statutory text or judicial precedent, the content of tailored defaults is unclear to parties prior to contracting. Because of the situation-specific inquiry that they demand, tailored default terms cannot be given content until after the parties complete their contract and a contingency occurs for which the contract does not explicitly provide. In this sense, untailored defaults bear a close resemblance to what are often known as "rules" in the familiar rules/standards dichotomy,[241] whereas tailored defaults bear a close resemblance to what are termed "standards."[242] The lawmaker charged with determining a tailored default term must ask not what term *most* contracting parties would have agreed to had they made provisions for a contingency—a question that does not require an inquiry into the specifics of any one transaction—but what term two *particular* parties would have agreed to had they provided for the contingency.

The arguments for tailored versus untailored default terms generally mirror those of standards versus rules.[243] Untailored defaults, like rules in the rules/standards dichotomy, enhance ex ante private ordering by making the law clear and predictable to those governed by it,[244] but they are usually overinclusive. If most carriers are superior

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241 The rules/standards construct is usually credited to Duncan Kennedy. Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976). For a detailed description of the differences between the two forms, see KELMAN, *supra* note 13, at 15-63. For different perspectives on the tradeoffs between the use of rules and standards in the law generally, see Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988); Pierre Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985); Sullivan, *supra* note 239.

242 There are at least two schools of thought on the difference between rules and standards. Under one, rules reduce the number of factors relevant to a legal determination more than do standards. *See, e.g.*, Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 265 (1974) ("[T]hat the outcome of a dispute, if it is litigated, will be determined by application of a rule rather than a standard should make it easier for the parties to predict the outcome."). Under the other, rules provide clear notice of the legal threshold of behavior ex ante, whereas standards can be applied to particular parties only ex post. *See, e.g.*, Kaplow, *supra* note 241, at 557 ("[S]tandards tend to be more costly for individuals to interpret when deciding how to act and for an adjudicator to apply to past conduct."). Under either definition, tailored defaults resemble standards—they permit decisionmakers to consider more factors and they can be known with certainty only after a dispute arises—and untailored defaults resemble rules—they constrain the scope of factual inquiry and can be known with certainty by parties prior to contracting. For a more in-depth discussion of the relationship between the tailored/untailored default rules dichotomy and the rules/standards dichotomy, see Ayres, *supra* note 15, at 1-6.

243 A detailed description of the usual arguments for and against rules and standards is beyond the scope of this Article. For a useful overview of the standard positions familiar in most areas of legal discourse, see Schlag, *supra* note 241, at 383-90.

244 *Cf.* Rose, *supra* note 241, at 590 ("[P]recise entitlements facilitate the efficient allocation of goods; they allow us to identify right-holders and to organize trades with them until all goods arrive in the hands of those who value them most."); Sullivan, *supra* note

risk avoiders to most shippers, for example, an untailored default term making carriers liable for all damages proximately caused by their breach of contract whether foreseeable or not, while more efficient than a foreseeable-damages term, will be inefficient for the minority of contracting parties between whom the shipper is the superior risk avoider.[245] At best, the minority parties are forced to incur the costs of contracting around the untailored default. A tailored default, under which a court decides which term is efficient for each set of contracting parties, has the benefit of avoiding this problem,[246] but at the cost of creating ex ante uncertainty as to the parties' rights,[247] and burdening courts that must determine tailored default terms anew for each set of disputants.[248]

The status quo bias adds another wrinkle to this comparison, enhancing the argument for tailored defaults even when transaction costs (as traditionally understood[249]) are low. As the experiments reported in this Article demonstrate, contracting parties can perceive untailored default terms, by virtue of their clarity prior to contracting, as the status quo. When those parties prefer the status quo to alternative states of the world, all else being equal, they will choose not to contract around the untailored default rule in some instances even when the rule is economically inefficient for them. Lawmakers can use tailored defaults, in contrast, to avoid the contractual inefficiencies created by the status quo bias. Because parties cannot know the exact content of a tailored default term at the time of contracting, they are unable to perceive the content of a tailored default as the status quo. If the parties do not know whether, in the absence of an explicit contract term, a court forced to resolve a later dispute be-

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239, at 62 ("[R]ules afford certainty and predictability to private actors, enabling them to order their affairs productively.").

245 For readers who are growing tired of the *Hadley* hypothetical, Douglas Baird and Robert Weisberg illustrate the overinclusiveness problem of rules (relative to standards) in the contract context with a hypothetical fact pattern involving the default warranty term. Douglas G. Baird & Robert Weisberg, *Rules, Standards, and the Battle of the Forms: A Reassessment of § 2-207*, 68 VA. L. REV. 1217, 1250-51 (1982).

246 *Cf. id.* at 1249 (arguing that a benefit of standards (relative to rules) is that standards permit more "parties to get the terms they want without the costs associated with establishing them through negotiations").

247 *Cf.* Sullivan, *supra* note 239, at 62 ("Standards produce uncertainty, thereby chilling socially productive behavior.").

248 If disputes arise frequently, a regime of legal standards requiring case-by-case, fact-specific analysis will be more expensive to administer than a regime of bright-line rules. *See id.* at 63 ("[R]ules promote economies for the legal decisionmaker by minimizing the elaborate, time-consuming, and repetitive application of background principles to facts."). Some have argued, however, that if disputes arise infrequently, it might be more expensive to create an initial set of clear rules than to resolve the relatively few disputes that arise under a standard that is easier to promulgate ex ante. *See* Kaplow, *supra* note 241, at 621-22.

249 *See supra* note 233 and accompanying text.

tween them would find the carrier liable for all damages flowing from its breach or only liable for foreseeable damages, there is no status quo position to anchor the parties' preferences for either of the potential contract terms. Contract default rules cannot be neutral[250]—they must favor some terms over others—but tailored defaults can shroud the law's preference at the time of contracting, when the status quo bias operates.

Consider the possibility of the following tailored default rule governing the *Hadley* parties, as opposed to either untailored default heretofore presented:

> In the event that contracting parties do not specify the extent of the breaching party's liability for consequential damages suffered by the nonbreaching party, the breaching party will be liable for consequential damages that are reasonable under the circumstances, taking into account which party was in a better position to avoid and/or insure against the risk of damages.

Under this default rule, parties that would bargain to the efficient consequential damages term in the absence of the status quo bias and transaction costs would either (1) bargain to the efficient term (if transaction costs are low), or (2) leave a gap in the contract, requiring a court to identify, if a breach occurs, what term the parties would have agreed upon had they addressed the issue (if transaction costs are high). In either case, the efficient term would govern the parties' relationship, unimpeded by any status quo bias.[251]

E. Nonenforcement Defaults

Although contract default rules usually specify how courts will fill gaps in private contracts, they can announce instead that courts will refuse to fill certain contractual gaps, thereby declining to enforce contracts with such gaps altogether. The most notable example of a nonenforcement default rule in contract law is section 2-201 of the

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250 *Cf.* Sunstein, *supra* note 58, at 229 (pointing out that background legal rules cannot be neutral because even the government's refusal to act favors some rights claimants over others).

251 Although tailored default rules should eliminate the default term as a source of status quo bias, it is possible that parties may respond by looking elsewhere for evidence of a status quo term rather than behaving as if there were no such term. It is, for example, possible that when the default rule yields no clear status quo allocation of rights and responsibilities, parties will then take local or industry norms into account. This question requires further research. Even if tailored defaults cause parties to substitute industry norms for default terms as the perceived status quo, however, tailored defaults would still play an important role in lessening the number of inefficient contract terms attributable to the status quo bias. Although industry norms are not tailored to the specific circumstances of particular parties, because they are specific to an industry they are substantially more tailored than untailored, majoritarian defaults. Consequently, they are far more likely than untailored, majoritarian defaults to reflect an optimally efficient allocation of rights and responsibilities between two parties in that industry.

UCC, which provides that contracts for the sale of goods that do not specify a quantity term are not enforceable.[252]

Like tailored defaults, lawmakers can use nonenforcement defaults as a tool to reduce the impact of the status quo bias on contract terms.[253] Although tailored defaults avoid the status quo bias by not creating a status quo term that acts as an illusory endowment, nonenforcement defaults neutralize the status quo bias by literally overwhelming it: they create a status quo term that all contracting parties will dislike so intensely, that even parties with a strong preference for the status quo will not fail to contract around it. Recall that the status quo bias will affect the contracts of parties that only marginally prefer an alternative term to the default, but will not affect the contracts of parties with a strong preference for an alternative term.[254] Because all parties who go to the trouble of negotiating and drafting contracts presumably have a strong preference for enforcement of the contract over nonenforcement, few, if any, parties will only marginally disprefer a nonenforcement default and thus fail to contract around it because of a preference for the status quo.

Because tailored and nonenforcement defaults, in theory, can be equally successful at neutralizing the status quo bias, lawmakers concerned with minimizing the bias should choose between these two options on the basis of their relative costs along other dimensions. The most significant disadvantage of nonenforcement defaults is the harsh consequences that occur if they are ever invoked. Consequently, nonenforcement defaults will be an appropriate means of minimizing the status quo bias when the relevant contract term relates to a high-probability contingency or a highly salient aspect of the contract, such that the likelihood of the parties failing to contract around the nonenforcement default are low. The most important shortcoming of tailored defaults is that, like other standards, they impose high ex post costs on courts forced to determine highly individuating default terms. Accordingly, tailored defaults will be an appropriate response to the problem of the status quo bias if a contract term relates to a low-probability contingency, such that courts will have to create party-specific default terms only infrequently.

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252 U.C.C. § 2-201 cmt. 1 (1995).

253 Ayres and Gertner classify nonenforcement defaults as a type of penalty defaults that penalize both parties for failing to reveal information through the contracting process. Ayres & Certner, *supra* note 3, at 95-97. Thus, nonenforcement defaults can serve an information-forcing purpose when both parties, rather than just one, are likely to possess material private information that, if not revealed, could impede efficient contracting. My argument does not take away from this point; rather, it argues that courts can use nonenforcement defaults for a different purpose than the one suggested by Ayres and Gertner.

254 *See supra* Part I.D.

The UCC's nonenforcement default rule for the quantity term in the sale of goods[255] is a particularly apt example of how this theory should be applied. Because a quantity term is critical in every contract for the sale of goods, and because it is a term of high salience to the contracting parties, the cost of filling gaps in contracts that fail to specify a quantity term with a nonenforcement default is relatively low—few parties are likely to fail to specify a quantity term in the face of such a threat. On the other hand, a tailored default for unspecified quantity terms would have relatively high costs; if parties were not discouraged from leaving a gap by a nonenforcement default, courts would be forced to tailor quantity terms quite frequently. Consequently, a nonenforcement default appropriately governs the quantity term in a contract. In contrast, the default rule for whether a contract includes an impossibility excuse is better served by a tailored than a nonenforcement default. Because the contract term would govern a low-probability contingency, courts would incur the costs of tailoring relatively infrequently. In addition, because it governs a low-probability contingency, parties would be likely to leave the term unspecified fairly often even under the threat of a nonenforcement default.

CONCLUSION

This Article has made the positive claim that the preference exogeneity assumption, implicit in all law-and-economics theories of efficient contract default rule selection, is probably false, and the normative claim that its falsity has important implications for efficiency theory. Lawmakers' choice of default terms is likely to affect contracting parties' preferences for substantive contract terms. Contracting parties may view the default term—the term that will govern the parties if they fail to contract for an explicit term—as a status quo endowment. Because individuals tend to prefer the status quo to alternative states, they are likely to prefer the default term, whatever it may be, to other options, all other things being equal.

As a result, theoreticians and lawmakers concerned with creating efficient default rules must add to and account for in their analysis another source of contractual inefficiency in addition to the usual litany: not only might parties fail to contract around inefficient default rules because of high transaction costs or strategic incentives to withhold private information, they might also fail to contract around inefficient defaults when their preference for maintaining the status quo relative to alternative states swamps their preference for the alternative contract term relative to the default term. This additional source

255 U.C.C. § 2-201 (1995).

of contractual inefficiency counsels lawmakers toward majoritarian rather than penalty default rules, and toward tailored or nonenforcement defaults rather than untailored defaults generally.

There is a (weak) positive hypothesis, which could serve as the basis for further development, to accompany this normative conclusion. Although the rich fabric of contract law contains default rules that can be classified as majoritarian, penalty, nonenforcement, tailored, and untailored, both the common law of contracts and the UCC's article 2—the modern law of contracts for the sale of goods[256]—tend to favor, on balance, tailored default rules. The *Restatement (Second) of Contracts*' catch-all statement of the law of default rules provides that when contracting parties "have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court,"[257] a perfect example of a tailored default. Under the UCC, to select just a few of many possible examples, when parties do not explicitly provide a price for goods in their contract, the court will impose a "reasonable price";[258] the default term for time of delivery is a "reasonable time";[259] and a requirements contract permits the buyer to demand any amount of goods from the seller "as may occur in good faith," except that it can be "no quantity unreasonably disproportionate to any stated estimate or . . . to any normal or otherwise comparable prior . . . requirement[ ]."[260] This structure of contract default rules is consistent with an implicit concern for the effects of the status quo bias and an empirical hunch that, in most circumstances, the costs of tailored defaults will be less than the costs of nonenforcement defaults.[261]

These textual snippets obviously provide scant evidence on which to base an all-out positivist claim that contract law *does favor*, as opposed to my primary claim that it *should favor*, tailored default terms because they minimize inefficient contracting caused by the status quo bias. Perhaps they do suggest, however, that the policy of neutralizing the status quo bias as efficiently as possible in the selection of default rules, heretofore not explicitly discussed by contract law theorists, is one of the policy considerations embedded deep within our complex system of contract law.

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256 *Id.* § 2-102.

257 RESTATEMENT (SECOND) OF CONTRACTS § 204 (1981).

258 U.C.C. § 2-305(1).

259 *Id.* § 2-309(1).

260 *Id.* § 2-306.

261 It is important to qualify this point, however, by noting that this structure of default rules is also consistent with a hunch that transaction costs, as traditionally understood, are likely to often be high enough to impede efficient Coasean bargaining.

APPENDIX A1

SURVEY INSTRUCTIONS

The attached survey asks you to play the role of an attorney advising a commercial client during contract negotiations with one of its customers. You are asked to consider three issues and then to answer 2-4 questions about each concerning how you would advise your client. No knowledge of contract or commercial law is required; the relevant law needed to assess the situations presented is provided in each scenario. In fact, *you should rely only on the law as it is described to you in the survey for purposes of answering the questions.* Do not rely on your prior understanding of contract law.

This survey is part of a research study that seeks to better understand how lawyers and law students think about selected contract issues. *There are no right answers to any of the questions.* It is important for the success of the survey that you read each section slowly and carefully, and that you provide the advice that you believe you would provide if you were *actually* advising a client, assuming, of course, that your knowledge of the relevant facts and law were limited to what is provided in the questionnaire. Please do not discuss the questionnaire with anyone else prior to completing it.

Your participation—which will take about 15 minutes—is greatly appreciated but not required. The responses that you provide will be aggregated with other responses, and you will not be personally identified.

Thank you very much for your time and attention.

APPENDIX A2

GENERAL BACKGROUND INFORMATION

You represent a company called "NextDay" that specializes in overnight delivery of packages (similar to Federal Express). NextDay has reached an agreement in principle to provide shipping services for a company called "Gifts, Inc." (which markets gifts by catalog and ships orders overnight around the country) for a fixed per-package charge, regardless of the size, value, or destination of the package. The company that handled Gifts, Inc.'s shipping last year charged it $20 per package; the price that Gifts, Inc. will pay NextDay has not yet been finalized.

You are currently engaged in negotiations with Gifts, Inc. over certain provisions of the contract. NextDay's management has asked you to provide recommendations concerning certain issues that have arisen and will almost certainly rely on your advice. At the end of the year, NextDay will review how it fared under the contract you negotiate and decide whether to retain you as their attorney in future dealings, so you have a strong personal stake in making sure that the contract serves the needs of NextDay *and* reflects well on your judgment and ability.

APPENDIX B1

DESCRIPTION OF SITUATION

The law in your state, which will govern the contractual relationship between the parties, follows the traditional legal rule that delivery companies like NextDay that negligently lose a package or fail to deliver it on time—which happens occasionally—are generally liable only for damages that were *"reasonably foreseeable"* at the time the delivery company takes possession of the package from the shipper.

Gifts, Inc. has proposed that you contract around this rule by adding a term to your contract with them that states:

> *"NextDay will be liable for all damages proximately caused by NextDay's negligent failure to deliver Gifts, Inc.'s merchandise on time, whether or not such damages were reasonably foreseeable when NextDay accepted merchandise from Gifts, Inc."*

Such a term in the contract would be fully enforceable in court.

Gifts, Inc. has explained that it will be sending many packages with NextDay of various values and various levels of urgency for its corporate clients and that, depending on the circumstances, a failure to make delivery could be very costly to it even if this is not obvious from looking at the package itself. It would like to be protected fully from this risk. Of course, Gifts, Inc. understands that it will have to pay a higher per-package fee to NextDay—over and above what the contract rate would otherwise be—for NextDay to agree to add the proposed term increasing its liability.

You must now recommend to NextDay's management the *minimum amount per package* that you believe NextDay should demand if it is to include Gifts, Inc.'s proposed term in the contract—you will, of course, attempt to negotiate for *more* than that minimum demand, but you need to establish a "bottom line" before you begin to negotiate.

You do not have a precise way to predict how much extra liability the proposed term would create above the liability that would exist under the usual "reasonably foreseeable" damages rule. Based on the value of Gifts, Inc.'s shipments with other companies over the last several years and NextDay's history of occasionally failing to make deliveries on time, NextDay's accountants have estimated for you that, statistically, the chances are better than 95% that an enhanced liability provision will end up costing NextDay between $0 and $10 per package, on average (this takes into account that few packages will be mishandled but those that are could subject NextDay to substantial liability)—within this range the accountants cannot predict the exact cost the provision would have. The accountants believe it is very unlikely that such a provision would either (a) not increase NextDay's costs at all, or (b) increase them more than $10 per package, on average.

QUESTIONS

What is the *minimum* additional charge per package, over and above what the per-package rate would otherwise be, that you will recommend that NextDay insist upon in return for agreeing to Gifts, Inc.'s proposed expansion of lia-

bility (i.e., if Gifts, Inc. refuses to pay *at least* this much, you would recommend that NextDay refuse to include the proposed enhanced liability provision in the contract)? *Choose one* of the following choices:

____ I would recommend a minimum of $1 additional per package

____ I would recommend a minimum of $2 additional per package

____ I would recommend a minimum of $3 additional per package

____ I would recommend a minimum of $4 additional per package

____ I would recommend a minimum of $5 additional per package

____ I would recommend a minimum of $6 additional per package

____ I would recommend a minimum of $7 additional per package

____ I would recommend a minimum of $8 additional per package

____ I would recommend a minimum of $9 additional per package

____ I would recommend a minimum of $10 additional per package

____ I would recommend that NextDay *refuse* to include the proposed term *at any price.*

Is the law concerning contract damages described in this problem consistent with your prior understanding of the law?

____ Yes ____ Not Sure/Don't Know ____ No

APPENDIX B2

DESCRIPTION OF SITUATION

The law in your state, which will govern the contractual relationship between the parties, specifies that delivery companies like NextDay are liable for *"all damages proximately caused by the delivery company's negligent failure to deliver a shipper's merchandise on time."*

NextDay would like to add a term to its contract with Gifts, Inc. that would limit its liability for negligently failing to deliver on time—which happens occasionally—by stating that:

> *"In the event that NextDay fails to deliver Gifts, Inc.'s merchandise on time, its liability will be limited to damages that were reasonably foreseeable when NextDay accepted merchandise from Gifts, Inc."*

Such a term in the contract would be fully enforceable in court.

Gifts, Inc. has explained that it will be sending many packages with NextDay of various values and various levels of urgency for its corporate clients, and that, depending on the circumstances, a failure to make delivery could be very costly to it even if this is not obvious from the package itself. It likes that the law fully protects it from this risk (by making NextDay liable for all damages). NextDay understands that it will have to pay Gifts, Inc.—in the form of giving Gifts, Inc. a discount on what it would otherwise charge per package for overnight delivery—if it is to induce Gifts, Inc. to accept NextDay's proposed liability limitation provision.

You must now recommend to NextDay's management the *maximum per-package discount* that you believe NextDay should offer Gifts, Inc. in exchange for Gifts, Inc. including the proposed term in the contract—you will, of course, attempt to negotiate for *less* than the maximum discount, but you need to establish an "upper limit" before you begin to negotiate.

You do not have a precise way to predict how much NextDay would save by convincing Gifts, Inc. to include the liability limitation clause in the contract. Based on the value of Gifts, Inc.'s shipments with other companies over the last several years (which they have documented for you) and NextDay's history of occasionally failing to make deliveries on time, NextDay's accountants have estimated for you that statistically there is a better than 95% likelihood that the limitation provision will save NextDay between $0 and $10 per package, on average (this takes into account that few packages will be mishandled but those that are could subject NextDay to substantial liability under the usual liability rule)—within this range the accountants cannot predict precisely how much savings such a provision would create. The accountants believe it is very unlikely that such a provision would either (a) not increase NextDay's costs at all, or (b) increase them more than $10 per package, on average.

QUESTIONS

What is the *maximum* discount per package, below what the per-package rate would otherwise be, that you will recommend that NextDay offer Gifts, Inc. in return for Gifts, Inc. agreeing to include the liability limitation provision in

the contract (i.e., if Gifts, Inc. refuses to agree to the provisions for *that amount or less,* you would recommend that NextDay accept the usual liability prescribed by law)? *Choose one of the following choices:*

____ I would recommend a maximum discount of $1 per package.

____ I would recommend a maximum discount of $2 per package.

____ I would recommend a maximum discount of $3 per package.

____ I would recommend a maximum discount of $4 per package.

____ I would recommend a maximum discount of $5 per package.

____ I would recommend a maximum discount of $6 per package.

____ I would recommend a maximum discount of $7 per package.

____ I would recommend a maximum discount of $8 per package.

____ I would recommend a maximum discount of $9 per package.

____ I would recommend a maximum discount of $10 per package.

____ I would recommend that NextDay *refuse to offer any discount* for the provision.

Is the law concerning contract damages described in this problem consistent with your prior understanding of the law?

____ Yes ____ Not Sure/Don't Know ____ No

APPENDIX C1

DESCRIPTION OF SITUATION

Occasionally, an unexpected contingency arises that makes it impossible or commercially unreasonable for NextDay to meet its obligation of providing "next day" delivery, as promised. Under the law of your state, as in most others, the occurrence of a contingency that is both unforeseen and beyond the control of the delivery company that makes it physically impossible or commercially impractical within reason for it to meet its delivery obligation constitutes a valid excuse for non-performance of the delivery obligation. In such a situation the delivery company must refund the money it charged its customer for the delivery but is not responsible for any additional damages.

Gifts, Inc. has proposed its contract with NextDay include the following provision, which would be enforceable:

> *"NextDay will be liable for applicable contract damages should it fail to deliver a package on the next day, as promised under the contract, regardless of the occurrence of any contingency, whether or not it is unforeseen or beyond NextDay's control."*

Gifts, Inc. is planning to offer NextDay a flat amount of money in return for NextDay agreeing to include this term in the contract for next year. NextDay expects that, under its contract with Gifts, Inc., it will earn revenues of approximately $2 million per year, of which about 20% will be profit. Agreeing to include this term in the contract would increase NextDay's exposure to the possibility that events beyond its control could result in substantial liability.

QUESTIONS

What is the *minimum* amount of money that you would recommend that NextDay demand from Gifts, Inc. in return for the inclusion of the above provision in the contract for next year (i.e., the *lowest amount* that NextDay should be willing to accept, not the amount it should propose in initial negotiations)?

$ _____ (flat amount for inclusion of the provision in next year's contract).

What amount would you recommend that NextDay put forward as its initial demand for the inclusion of the provision (as opposed to the minimum amount it would accept)?

$ _____

Is the law described in this problem consistent with your prior understanding of the law?

____ Yes ____ Not Sure/Don't Know ____ No

APPENDIX C2

DESCRIPTION OF SITUATION

Occasionally, an unexpected contingency arises that makes it impossible or commercially unreasonable for NextDay to meet its obligation of providing "next day" delivery, as promised. Under the law of your state, as in most others, the occurrence of such a contingency is no defense to a breach of contract claim—that is, NextDay is still held liable for damages despite occurrences beyond its control.

NextDay would like to propose to Gifts, Inc. that the contract between the two include the following provision, which would be enforceable:

> *"If a contingency that is both unforeseen and beyond NextDay's control occurs making it physically impossible or commercially impractical within reason for NextDay to meet its 'next day' delivery obligation, NextDay will refund the money paid for the shipment of the package but Gifts, Inc. will not be entitled to any additional contract damages."*

NextDay expects that, under its contract with Gifts, Inc., it will earn revenues of approximately $2 million per year, of which about 20% will be profit. NextDay is considering offering Gifts, Inc. a flat amount of money in return for Gifts, Inc. agreeing to include this term in their contract for next year, thus reducing NextDay's exposure to the possibility that events beyond its control could result in substantial liability and reduced profits.

QUESTIONS

What is the *maximum* amount of money that you would recommend that NextDay offer Gifts, Inc. in return for the inclusion of the above provision in the contract for next year (i.e., the *most* that NextDay should be willing to pay, not the amount it should propose in initial negotiations)?

$ _____ (flat amount for inclusion of the provision in next year's contract).

What amount do you recommend NextDay put forward as its *initial offer* for the inclusion of the above provision (as opposed to the maximum amount it would be willing to pay)?

$ _____

Is the law described in this problem consistent with your prior understanding of the law?

____ Yes ____ Not Sure/Don't Know ____ No

APPENDIX D1

DESCRIPTION OF SITUATION

When private parties litigate a legal dispute between them, each generally must pay its own attorneys' fees. However, if the parties wish to specify by contract that in any future litigation the losing party must pay the attorneys' fees of the prevailing party, such a provision is fully enforceable. Such provisions have the potential to discourage lawsuits that lack merit (because the plaintiff will have to pay the defendant's fees) and could encourage the prompt settlement of suits that are meritorious (because the defendant will want to limit the plaintiff's fees as well as its own). On the other hand, such provisions also have the potential to discourage out-of-court settlement of disputes that both parties believe they will win (because each will assume it will have its attorneys' fees reimbursed) and could discourage some meritorious suits from being brought.

Would you favor or oppose adding a provision to NextDay's contract with Gifts, Inc. stating that, should litigation arise between the parties, the losing party must pay the attorneys' fees of the prevailing party?

Favor adding such a provision
(switch from the usual fee allocation rule) ____

Not favor adding such a provision
(stay with the usual fee allocation rule) ____

On the following 1-5 scale, indicate how strongly you feel about your previous response (*please circle only 1 of the answer choices*):

5	4	3	2	1
Feel Very Strongly (unlikely to change mind)				Feel Unsure (could easily change mind)

Is the law described in this problem consistent with your prior understanding of the law?

____ Yes ____ Not Sure/Don't Know ____ No

APPENDIX D2

DESCRIPTION OF SITUATION

Under the law of your state, in litigation arising from disputes between merchants, the losing party generally must pay the attorneys' fees of the prevailing party. However, if the parties wish to specify by contract that in any future litigation each party must pay its own attorneys' fees, such a provision would be fully enforceable. Such provisions have the potential to encourage the prompt out-of court settlement of disputes that both parties believe they would win (because each will have to bear its own fees regardless of outcome) and could encourage the filing of more meritorious lawsuits. On the other hand, such provisions also have the potential to encourage lawsuits that lack merit (because the plaintiff will not have to fear paying the defendant's legal fees) and could discourage the prompt settlement of suits that are meritorious (because the defendant will not have as strong of an incentive to minimize attorneys' fees).

Would you favor or oppose adding a provision to NextDay's contract with Gifts, Inc. stating that, should litigation arise between the parties, each party must pay their own attorneys' fees?

Favor adding such a provision
(switch from the usual fee allocation rule) ____

Not favor adding such a provision
(stay with the usual fee allocation rule) ____

On the following 1- 5 scale, indicate how strongly you feel about your previous response (*please circle only 1 of the answer choices*):

5	4	3	2	1
Feel Very Strongly (unlikely to change mind)				Feel Unsure (could easily change mind)

Is the law described in this problem consistent with your prior understanding of the law?

____ Yes ____ Not Sure/Don't Know ____ No

APPENDIX D3

DESCRIPTION OF SITUATION

Under the law of your state, for either party to seek court adjudication of a dispute between merchants arising out of a contract, the contract in question must include one of the following two provisions. Some of the pros and cons of each are provided:

(1) *In the case of litigation between the parties to this contract, each party will pay its own attorneys' fees.*

This provision has the potential to encourage the prompt out-of-court settlement of disputes that both parties believe they would win (because each will have to bear its own fees regardless of outcome) and could encourage the filing of more meritorious lawsuits. On the other hand, it also has the potential to encourage lawsuits that lack merit (because the plaintiff will not have to fear paying the defendant's legal fees) and could discourage the prompt settlement of suits that are meritorious (because the defendant will not have an incentive to minimize the plaintiff's fees as well as its own).

(2) *In the case of litigation between the parties to this contract, the losing party will pay the attorneys' fees of the prevailing party.*

Such a provision has the potential to discourage lawsuits that lack merit (because the plaintiff will have to pay the defendant's fees) while encouraging prompt settlement of suits that are meritorious (because the defendant will want to limit the plaintiff's fees as well as its own). On the other hand, it also has the potential to discourage out-of-court settlement in disputes where both parties believe they will win (because each will assume it will have its attorneys' fees reimbursed) and could discourage some meritorious suits from being brought.

Which provision will you favor including in NextDay's contract with Gifts, Inc.?

Favor provision #1 ____

Favor provision #2 ____

On the following 1-5 scale, indicate how strongly you feel about your previous response (*please circle only 1 of the answer choices*):

5	4	3	2	1
Feel Very Strongly (unlikely to change mind)				Feel Unsure (could easily change mind)

Is the law described in this problem consistent with your prior understanding of the law?

____ Yes ____ Not Sure/Don't Know ____ No