

THREE PROPOSALS TO HARNESS PRIVATE INFORMATION IN CONTRACT

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How should judges decide contract cases when they realize that private parties know more about what is good for them than the judges themselves know? This is a crucial question in structuring contract law, because if judges knew private valuations, we could dispose of contracts altogether and simply let judges order welfare-maximizing trade. Savvy judges, however, realize that they are normally less informed than private litigants and will accordingly be prone to error in deciding cases. The famed “nirvana fallacy”¹ appears when judges or commentators forget that it is difficult for third parties to identify the social optimum. How then should judges operating under conditions of relative ignorance avoid the nirvana fallacy?

My general (but rather uninteresting) answer is that judges deciding contract cases should harness the parties’ private information. This is not a new answer. In some ways it is the idea behind the theory of efficient breach. Expectation damages encourage a promisor to breach only when her information tells her that breach is likely to be efficient.²

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1. The “nirvana fallacy” occurs when one compares the failings of the unregulated market to some “ideal institution [that] has never existed or . . . has been proven impossible to devise.” Richard L. Hasen, *Clipping Coupons for Democracy: An Egalitarian/Public Choice Defense of Campaign Finance Vouchers*, 84 CAL. L. REV. 1, 17 (1996) (quoting Maxwell L. Stearns, *The Misguided Renaissance of Social Choice*, 103 YALE L.J. 1219, 1229-30 (1994)).

2. The notion that liability rules (including expectation damages) could harness private information is implicit in Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972), and was recently formalized in Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713 (1996). Alan Schwartz’s theory of relational contracting is also centered on the notion that judges systematically know less than the private litigants. See Alan Schwartz, *Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies*, 21 J. LEGAL STUD. 271 (1992).

But instead of merely explaining existing rules,³ I want to apply this idea of harnessing private information to make three proposals about how judges should decide contracts cases. In particular, I favor (1) interpretive safe harbors; (2) extending the rule of *Hadley v. Baxendale*⁴ to benefit buyers as well as sellers; and (3) giving defendants the option of making injunctions inalienable.

I. INTERPRETIVE SAFE HARBORS

My first claim concerns interpretive disputes—where parties to a contract disagree about what obligations the actual contract created. In resolving these disputes, judges must decide which interpretation wins. But in addition to deciding who wins, judges should routinely tell the losing side what magic words would have reversed the result. In other words, judges should give the litigants an interpretive safe harbor that would establish the contractual obligations that the losing side preferred. Judges need not detail the *necessary* conditions for reversing the result or describe the complete legal mapping from all possible words to all possible legal outcomes, but they should at least announce

3. The goal of harnessing private information might, for example, explain the common-law rule that counteroffers destroy the effectiveness of offers. An initial offeror often cannot know whether or not there are gains of trade to be had in a particular negotiation. Thus, if Ellickson offers to buy Rose's house for \$x, Ellickson might not know whether Rose's value (known as the best alternative to negotiated agreement ("BATNA"), or reservation price) is greater or less than \$x. But some offerees know for sure that there are gains of trade. If Rose's reservation price is less than \$x, Rose has private information that there are gains of trade. If Rose's reservation price is more than \$x, Rose cannot know whether or not there are gains of trade. Ellickson might not have offered all that he is willing to pay and further negotiations might reveal a zone of agreement.

Here is where the counteroffer rule comes into play. The rule discourages offerees who know there are gains of trade from continuing to bargain—but does not discourage offerees who are trying to learn whether there are gains of trade. Offerees who know there are gains of trade risk losing a valuable option when they make a counteroffer, but offerees who receive an offer less favorable than their BATNA do not give up anything when they destroy an offer they would never accept. The counteroffer rule thus dissuades offerees from continuing to bargain when they know that bargaining is inefficient (merely for the purpose of redistributing gains of trade) while not discouraging efficient bargaining (for the purpose of discovering whether gains of trade exist). This analysis of the counteroffer rule was proposed in rough form by Ben Burman in his first semester contracts course at Yale Law School. The idea that contract law should discourage individual parties from taking actions that they know to be socially inefficient is parallel to later discussion of using inalienable injunction to discourage parties from threatening performance they know to be inefficient. See *infra*, text accompanying notes 22-28.

4. 9 Ex. 341, 156 Eng. Rep. 145 (1854).

a *sufficient* condition for producing the contractual result desired by the losing side.

Routinely providing interpretive safe harbors would be a judicial innovation. Judicial opinions in contract cases almost never include this information. This failure to provide alternative contractual language is particularly striking where the parties have tried to contract around a default obligation but the court rules that their efforts were insufficient to displace the default. For example, in *Peevyhouse v. Garland Coal & Mining Co.*,⁵ the litigants added language to a form contract, apparently in an attempt to contract around the "diminution in value" damage measure that applies in absence of agreement to the contrary.⁶ The Oklahoma Supreme Court held that the contract's additional language was not sufficient to avoid the "diminution in value" default and create "cost of performance" damages instead. Even if the court's substantive decision was correct,⁷ the court erred by not indicating to future contractors what words would be sufficient to produce a cost of performance result.

Interpretive safe harbors harness the private information of prospective contractors. Safe harbors reduce the costs of judicial mistakes, because future parties can easily avoid the inefficiencies of bad decisions by simply using the magic words.⁸ Moreover, providing language sufficient to produce an alternative result protects freedom of contract. Safe harbors make clear that the court's holding is not an immutable or mandatory rule. Charles Goetz and Robert Scott have documented the tendency of courts to change default rules into immutable rules that are impossible for future parties to avoid.⁹

5. 382 P.2d 109 (Okla. 1963).

6. *See id.*, at 111-12. In *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889 (N.Y. 1921), the litigants made a similar attempt to contract around this gap-filler.

7. There are strong reasons to judge it incorrect. A cost of performance interpretation would have given the repeat and more powerful player (for example, the coal company) a better incentive to inform the other party when the only measure of damages might be diminution in value.

8. A participant at the Symposium worried that uninformed parties might unwittingly use the magic words to produce an unintended result. This should not be a problem as long as the safe harbor language conforms to common understandings. Alternatively, if the magic words included a reference to the case citation itself ("Contrary to *Peevyhouse*, we intend to award cost of performance damages."), ignorant litigants would not be able to blunder into the safe harbor.

9. *See* Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261 (1985).

A practice of announcing alternative language would work against this tendency and force courts to state more directly when (and why) they were choosing to displace freedom of contract.

By thus reinforcing future parties' freedom to structure their contractual obligations as they see fit, interpretative safe harbors are consonant with judicial constraint. While urging the judiciary to decide the legal import of alternative contractual words smacks of judicial activism, in the realm of contract judges effectively eschew power by telling prospective parties how they might alternatively order their respective obligations.

At the Symposium, I pointed to the famous language in *Miranda* as an example of how courts can usefully provide safe harbor language.¹⁰ Several audience members reflexively retorted that any proposal analogized to *Miranda* must be bad. But especially if you do not think the government should have a duty to warn suspects, the Court's willingness to provide a safe harbor warning mitigated the harm of the decision. Imagine how much worse the *Miranda* decision would have been if the Court had told police to warn suspects, but refused to articulate what type of warning would be sufficient.

In recent years, a number of federal circuits have begun routinely analyzing the standard of review even though choosing between different standards of review is often not necessary to decide particular cases. This simple change has quickly provided a wealth of new law, as evinced by an exploding West Key Number. A similar practice of routinely analyzing how the losing litigant might have achieved its proffered interpretation could give future contractors the option of prospectively overruling misguided judicial decisions by contracting around them.

II. EXTENDING *HADLEY*

The *Hadley v. Baxendale* principle of limiting damages to those that are foreseeable is such a good idea that we should allow buyers to benefit from it as well as sellers. Currently, sellers can use the *Hadley* principle to limit the amount of their damages when they have breached.¹¹ Rather bizarrely, there is no

10. *Miranda v. Arizona*, 384 U.S. 436, 467-70 (1966).

11. In *Hadley* itself, the seller-carrier was able to reduce its liability for failing to deliver on time.

analogous rule to benefit buyers. When buyers breach contracts, they cannot limit the sellers' damages only to those that are reasonably foreseeable.

The possibility of a seller claiming unforeseeable damages is particularly probable when the seller is claiming damages for lost profit. Since the seller's mark-up is often not known by the buyer,¹² awarding lost profit can at times subject a buyer to considerable uncertainty about the consequences of breaching. Imagine, for example, that you have contracted to purchase a speed boat (as in *Neri v. Retail Marine Corp.*¹³), but have had a change of heart and are considering whether or not to breach. It may be extremely difficult for you to predict your potential damages because courts will not limit lost-profit damages to those that were reasonably foreseeable.

A bit of personal narrative underscores the buyer's dilemma. I once negotiated with Orkin Corporation to have monthly pesticide treatment for my home. Orkin insisted that they would enter only into year-long contracts. However, I was thinking about moving to another city in six months. So like a good Holmesian, I asked "What would be the consequences if I breach? What are you going to claim as lost profits?" Orkin, of course, steadfastly refused to tell me what the damages would be. Even when buyers inquire, they are not protected by the *Hadley* principle. And a story similar to my pesticide experience could be told with regard to a number of different transactions, including, for example, Book-of-the-Month Club agreements and cellular phone contracts.

What then explains why *Hadley* only protects sellers? If we move beyond the rather arid doctrinal characterization that a seller's lost profits are not considered to be "consequential" damages,¹⁴ there is a substantive distinction concerning the contract price. Consequential damages for a seller's breach can be significantly larger than the contract price, while lost profits for a buyer's breach can never exceed this price. Hence, the contract price itself puts an upper bound on potential damages

12. See Ian Ayres & F. Clayton Miller, "I'll Sell It To You at Cost": *Legal Methods to Promote Retail Markup Disclosure*, 84 NW. U. L. REV. 1047 (1990).

13. 285 N.E.2d 311, 312 (N.Y. 1972).

14. One might merely restate the question as follows: why does the *Hadley* principle apply only to consequential damages, or why are lost profits not considered to be consequential?

that a buyer might have to pay. Sellers need the *Hadley* principle more because neither the price nor any other contractual term provides a ceiling for a seller's potential liability.

Yet admitting that sellers need *Hadley* protection more than buyers does not establish that it is unwise to extend the principle. In competitive markets, lost-profit damages would be a small fraction of the total price. Accordingly, the structural damage cap provides relatively weak protection against lost-profit damages substantially exceeding the amounts that a consumer foresaw. For example, in buying a new car for \$25,000, a breaching buyer can take little solace in the fact that her lost-profit liability cannot be above \$25,000. The possibility of seller's lost-profit damages of three, five, or eight thousand dollars would still be largely unforeseen by many buyers.

Breaching buyers who face large lost-profit have some hope of reducing their damages by claiming that the initial contract was unconscionable. Unconscionability, however, (like the structural damage ceiling) is a poor substitute for the *Hadley* principle. Contracts are almost never struck down for unconscionable price terms.¹⁵ Moreover, there is a substantive difference between an unconscionable profit and an unforeseeable profit. A wide range of seller markups that are substantively conscionable might still be unforeseeable.¹⁶ At the end of the day, the current rules governing lost-profit damages might subject buyers to substantial, unforeseeable damages, even when buyers make inquiry.

The *Hadley* principle would mitigate this problem by making damages more foreseeable. Because the *Hadley* principle is a default rule, limiting sellers' liability to foreseeable damages gives buyers an incentive to inform sellers of their idiosyncratic sensitivity to sellers' breach, and often leads to avoidance of the default rule through the use of a liquidated damages clause in the initial contract. The *Hadley* principle thus has an information-forcing quality that harnesses the private

15. See 1 STEWART MACAULAY ET AL., *CONTRACTS: LAW IN ACTION* 756 (1995).

16. Foreseeability is related only to the procedural aspect of unconscionability, not the substantive aspect. See Arthur Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485 (1967).

information of buyers and gives sellers a better idea of the consequences of breach.¹⁷

Analogously, extending the *Hadley* principle to protect buyers would harness the private information of sellers. Limiting sellers' lost-profit damages to those that were reasonably foreseeable would encourage sellers to disclose unusually high markups.¹⁸ Such disclosure would promote efficiency by letting buyers calculate how much effort they should expend to avoid breach. When there is a high probability that a buyer will need to breach (as in my Orkin example), disclosure of lost-profit damages through a liquidated damages provision would give the buyer a better sense of whether the contract was on net beneficial.

To be sure, some sellers contracting for high profits under a *Hadley* regime will prefer to take the chance of non-disclosure (and reduced damages if the buyer breaches) rather than inform the buyer of a high markup. Therefore, it might be even advisable to go beyond the *Hadley* default and institute a zero-dollar default for lost profits.¹⁹ Sellers would remain free to contract for full lost-profit damages by means of appropriate disclosure in a liquidated damages clause. Even if the *Hadley* or zero-dollar defaults did not induce disclosure, these defaults would at least promote equity by exposing buyers only to those damages that were reasonably foreseeable.

At the Symposium, Eric Posner was surprised to hear me suggest extending the *Hadley* principle, because Rob Gertner and I had previously shown that the *Hadley* principle was the efficient default for seller's breach only under certain conditions.²⁰ Yet given the widespread acceptance of this principle on grounds of equity as well as efficiency, it is difficult to argue that it should not be extended to protect buyers. Indeed, once the *Hadley* default is seen as an information-forcing or pro-disclosure rule, the current state of the law seems

17. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 101-04 (1989).

18. See *id.*

19. See *id.* at 105; Victor P. Goldberg, *An Economic Analysis of the Lost-Volume Retail Seller*, 57 S. CAL. L. REV. 283 (1984).

20. See Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 YALE L.J. 729 (1992); Lucian A. 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).

particularly perverse. Steven Shavell has insightfully shown that most disclosure rules are directed at sellers, not buyers.²¹ However, under current contract law, it is the buyer and not the seller who is encouraged by the *Hadley* principle to disclose unexpectedly large damages.

III. INALIENABLE INJUNCTIONS

Whenever a judge uses his equitable power to grant an injunction, he should give the party against whom the injunction is running the option of making the injunction inalienable.²² As an empirical matter, a substantial proportion of injunctions are purchased, not performed. Plaintiffs seeking injunctions often do not want the injunction for its own sake, but instead want to use the threat of forced performance as bargaining leverage to extract a payment from the defendant larger than any monetary damages the court might award.

Myriad examples of this phenomenon come to mind,²³ but to focus on a specific context, consider the classic encroachment case of *Pile v. Pedrick*.²⁴ In *Pile*, the subterranean foundation of the defendant's brick wall encroached one and three-eighths inches underneath the plaintiff's property. As is routine in such circumstances, the plaintiff landowner brought suit seeking an injunction to remove the wall and rejected the option of monetary damages. Because monetary damages were likely to be only one-twentieth the cost of moving the fence (say, \$500 as likely monetary damages versus \$10,000 to move the foundation), an injunction might allow the plaintiff to extract from the defendant a sum substantially above the likely monetary damages amount.

What is striking about cases like *Pile* is this: the plaintiffs know that performance of the injunction would be inefficient.

21. See Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale*, 25 RAND J. ECON. 20 (1994).

22. The ideas in this section will be presented more fully in a forthcoming article, Ian Ayres & Kristin Madison, *Threatening Inefficient Performance* (unpublished manuscript, on file with author).

23. See, e.g., Judge Richard Posner's decision in *Northern Indiana Pub. Serv. Co. v. Carbon County Coal Co.*, 799 F.2d 265, 279-80 (7th Cir. 1986) (stating that "Carbon County is seeking specific performance in order to have bargaining leverage with NIPSCO, and we can think of no reason why the law should give it such leverage").

24. 31 A. 646 (Pa. 1895). I would like to thank Robert Ellickson for bringing this case to my attention and for generally holding my hand throughout my maiden voyage as a property professor.

Nonetheless, these plaintiffs ask the court to order inefficient behavior so that they can induce the defendant to pay to avoid the inefficiency. It is presumptively inefficient for plaintiffs to ask courts to order inefficient performance. Such behavior by plaintiffs creates needless bargaining costs, and when bargaining fails, results in inefficient performance. Moreover, these plaintiffs (and their lawyers) seem to be perpetrating a fraud on the court. The plaintiffs represent that no amount of monetary damages would be sufficient to make them whole and then, before the ink is dry on the injunction, they turn around and try to sell their injunctive rights for money.

One way to deter such behavior would be for judges to issue "inalienable injunctions" whenever they thought that the plaintiff was seeking inefficient performance.²⁵ An inalienable injunction would not only order the defendant to perform but would also prohibit the defendant from paying the plaintiff money as an alternative to discharging this duty.²⁶ The prospect of an inalienable injunction would deter some plaintiffs from seeking inefficient performance. In the encroachment context, for example, monetary damages of \$500 may look more attractive to a plaintiff than having the defendant move the wall an inch.

25. The common law already at times calls upon judges to assess the efficiency of injunctions. See RESTATEMENT (SECOND) OF TORTS §826(a) (1979) (stating nuisance is unreasonable if "the gravity of the harm outweighs the utility of the actor's conduct"). See also Thomas W. Merrill, *Trespass, Nuisance and the Costs of Determining Property Rights*, 14 J. LEGAL STUD. 13 (1985).

26. The inalienability would only restrict the plaintiff from selling the benefits of the injunction back to the defendant. For example, if the injunction ordered a seller to specifically perform its promise to supply widgets, the buyer could of course resell the widgets to anyone else in the world—it simply could not sell its right to receive widgets to the seller.

Implementing inalienable injunctions creates at least two complications. First, both plaintiff and defendant, notwithstanding the settlement prohibition, would have an ex-post incentive to agree to payment instead of inefficient performance. To make the injunction truly inalienable, therefore, judges would probably need to place a judicial lien on the defendant's property that would be lifted only upon showing that the injunction had been performed. And second, the courts would need to prohibit monetary settlements after the defendant had irrevocably opted for an injunction (instead of monetary damages). If defendants could irrevocably opt for injunctive relief early in litigation, then plaintiffs would have the same incentives to settle for inflated amounts before the injunction actually issued. For this reason, the courts should probably give the defendant a choice of an inalienable injunction only at a late stage in the proceeding (possibly after the liability determination). See generally, Ayres & Madison, *supra* note 22.

While judicially imposed inalienability harnesses the defendant's information and guides defendants to seek injunctions more often when performing the injunction is actually efficient, we can do still better. The problem with judicially imposed inalienability is that judges do not have perfect information about when performing an injunction would be inefficient (that is, when the defendant's cost of performance is greater than the plaintiff's benefit from performance). Accordingly, judges might mistakenly impose inalienability too rarely or too often.²⁷

Instead of letting the judge decide whether an injunction should be inalienable, it is better to let the defendant decide. Inalienability is supposed to deter the plaintiff from threatening enforcement of inefficient injunctions by making those threats not credible. But the defendant knows better than the judge when inalienability is likely to deter the plaintiff from seeking an injunction. Giving the defendant an inalienability option allows the defendant's private information to impede inefficient action by the plaintiff. The defendant's option constructively offsets the plaintiff's option of choosing injunctive or monetary relief.²⁸ These offsetting options harness both sides' information. Returning to our earlier example, a defendant encroacher should have the right (read: option) to say to the court, "Your honor, if you decide to issue an injunction against me, at least don't let the plaintiff turn around and use the injunction to extract money from me."

27. At first, it might seem that inalienability should be judicially imposed in all cases. But the possibility of undercompensatory damages could lead to circumstances in which inalienability creates inefficiency. For example, consider an encroachment case in which the defendant's cost of performance is \$10,000, the plaintiff's benefit of performance is \$2,000, but the monetary damages that a court would award are only \$1,000. Under these assumptions, the injunction is inefficient ($\$10,000 > \$2,000$), but because damages are not fully compensatory ($\$2,000 > \$1,000$), the plaintiff would opt for an inalienable injunction instead of damages—causing an \$8,000 inefficiency loss. The defendant might well prefer to be subject to an alienable injunction, where if the litigants split the gains of trade, the defendant would only have to pay \$6,000 to avoid its injunctive duty. In Ayres & Madison, *supra* note 22, we explore a system of privately imposed additur and remittitur to harness private parties' information and mitigate such problems of super- or subcompensatory damages.

28. See Ian Ayres & J.M. Balkin, *Legal Entitlements as Auctions: Property Rules, Liability Rules, and Beyond*, 106 YALE L.J. 703, 720-27 (1996) (demonstrating how reciprocal taking options can harness two parties' private information as they decide whether to take a particular piece of property).

IV. CONCLUSION

This essay has sketched three rather disparate proposals for changing contract law. But the proposals are connected by the idea of harnessing the superior knowledge of private parties. Interpretive safe harbors harness the private information of prospective contractors who can more accurately tailor the distribution of contractual obligations. Extending the *Hadley* principle to benefit buyers harnesses sellers' private information by encouraging disclosure of lost-profit information which will allow buyers to take more efficient precaution. Finally, giving defendants the option of making injunctions inalienable harnesses both plaintiffs' and defendants' information to deter plaintiffs from threatening inefficient enforcement.

Let me underscore that each of these proposed rules should be default rules that would allow people to reach other results when they contract for them explicitly. Yet even the process of contracting out of these proposed rules would harness the parties' information. Great strides have been made in the last twenty years in understanding the economics of imperfect information. This relatively new body of knowledge should aid Professor Manne's project of using economics to further personal freedom.²⁹

29. See Henry G. Manne, *The Judiciary and Free Markets*, 21 HARV. J.L. & PUB. POLY 11 (1997).

