

DEFAULT RULES, PENALTY DEFAULT RULES, AND NEW FORMALISM

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I. INTRODUCTION

The theme of this Symposium has been default rules, and much of the focus has naturally been on contract law. The elephant in the room that has gone almost without mention is new formalism. The new formalists in contract law, who are best represented by Alan Schwartz and Robert Scott,¹ argue that despite the conventional wisdom, there are in fact very few default rules in contract law.² What typically pass for default rules are, for the most part, vague standards that do more harm than good. Moreover, they argue that the very idea of a universal set of default rules that would govern most contract situations is in principle a quixotic quest³ and in practice even worse due to institutional incompetence⁴ and the influence of interest groups.⁵ Since much of the scholarship in contract law over the last few decades—including some of the contributions to this

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1. In fact, while much has been made about an alleged return to formalism or conceptualism in the jurisprudence of contract, *see, e.g.*, David Charny, *The New Formalism in Contract*, 66 U. CHI. L. REV. 842 (1999); Robert A. Hillman, *The “New Conservatism” in Contract Law and the Process of Legal Change*, 40 B.C. L. REV. 879 (1999); Ralph James Mooney, *The New Conceptualism in Contract Law*, 74 OR. L. REV. 1131 (1995); Thomas C. Grey, *The New Formalism* (Stanford Public Law and Legal Theory Working Paper Series, Paper No. 4, 1999), available at <http://ssrn.com/abstract=200732>, Schwartz and Scott are the only scholars I know of to give a systematic argument in favor of a return to formalism in contract law, and even they seldom use that term.

2. Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003).

3. *Id.* at 594-609.

4. Robert E. Scott, *The Uniformity Norm in Commercial Law*, in *THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW* 149-92 (Jody S. Kraus & Steven D. Walt eds., 2000); Alan Schwartz, *The Default Rule Paradigm and the Limits of Contract Law*, 3 S. CAL. INTERDISC. L.J. 389, 416 (1993); Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 848 (2000) [hereinafter Scott, *The Case for Formalism*].

5. Alan Schwartz & Robert E. Scott, *The Political Economy of Private Legislatures*, 143 U. PA. L. REV. 595, 610-11 (1995); Robert E. Scott, *The Rise and Fall of Article 2*, 62 LA. L. REV. 1009, 1009-12 (2002).

Symposium—has centered on the quest for better default rules, if they are right, the very value of that work is in serious question. A symposium on default rules at this juncture would be incomplete if it did not mention this important charge. As it turns out, Eric Posner's intriguing article on penalty default rules inadvertently sets the stage for such a discussion.

Posner's focus is not new formalism; indeed, he only mentions it in passing. Instead, his article takes on a subset of the default rules scholarship, that dealing with penalty default rules. He argues that there are no penalty default rules in contract law,⁶ a claim that will no doubt come as quite a surprise to many. His arguments purport to show candidate by candidate how various rules are in fact not penalty default rules after all, despite the influential work of Ian Ayres and Robert Gertner.⁷ In the end, Posner speculates as to why it would be the case that there are no penalty default rules and cites Schwartz and Scott's recent article⁸ for the argument that there are virtually no default rules in contract law at all. He says in passing that if there are no default rules, then obviously there are no penalty default rules.⁹ This seeming truism is my starting point. My aim is not to deny Posner's claim that there are no penalty default rules, but instead to show that new formalists like Scott and Schwartz are an unlikely source of support despite their rejection of the default rules project. I intend to show that the formalism they advocate is actually penalty-like in spirit, even though it is technically not the kind of penalty default rule about which Ayres and Posner disagree. Along the way I hope to explain better the relationship between formalism and default rules.

The term "default rules" is used in different ways. Sometimes it refers to any rule that can be contracted around by the parties to an agreement.¹⁰ Posner, on the other hand, uses the term in a more narrow way. For Posner, as well as Ayres and Gertner, default rules are rules that provide the terms needed to fill gaps in contracts.¹¹ Penalty default rules, roughly, are rules that fill those gaps with terms disfavored by most parties in order to force drafters to make their

6. Eric A. Posner, *There Are No Penalty Default Rules in Contract Law*, 33 FLA. ST. U. L. REV. 563 (2006).

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

8. Posner, *supra* note 6, at 587.

9. *Id.*

10. See, e.g., Adam J. Hirsch, *Default Rules in Inheritance Law: A Problem in Search of Context*, 73 FORDHAM L. REV. 1031, 1032 (2005) ("We style as mandatory those rules that legal actors are obliged to obey, irrespective of their wishes upon the matter. . . . Default rules, on the other hand, are freely breakable, applying only to a legal actor who forbears to take whatever steps the law requires to override them.").

11. Posner, *supra* note 6, at 565-66, 568.

agreements explicit, thus avoiding the unwanted terms.¹² Ayres and Gertner argued that penalty default rules are preferable to majority rules in certain cases where one party has information another party does not have.¹³ Clearly, under these definitions Posner's claim is true: if Scott and Schwartz are right that there are few or no rules that fill gaps in contracts, then there are few or no rules that fill gaps in contracts with disfavored terms. I do not dispute either this claim or Posner's main thesis that there are no penalty default rules.

I do wish, however, to call into question two distinctions Posner makes along the way, both of which new formalism implicitly rejects. Posner distinguishes on the one hand between default rules and formalities of contract law and on the other hand between default rules and rules of contract interpretation. Although they do not discuss these distinctions directly, I will argue that Schwartz and Scott are implicitly committed to rules of interpretation that are both default rules¹⁴ and formalistic—indeed, that is the essence of their project. Moreover, while these formal default rules of interpretation are not technically penalty default rules as Ayres defines the concept (thus I will leave Posner's thesis untouched), I will argue that they are more in the spirit of penalty default rules than Karl Llewellyn's vision of default rules that inspired much of the Uniform Commercial Code (U.C.C.). More importantly, I will argue that as the confusion over these distinctions will make clear, before we can evaluate the new formalists' arguments, we must give serious consideration to what formalism is and why we have it in contract law.

In Part I, I begin by discussing formalism, both the classical version (though as we shall see it is far from clear just what classical formalism was) and Schwartz and Scott's new formalism. I will then turn in Parts II and III to Posner's two distinctions and show that each is implicitly rejected by new formalism. Part IV concludes by suggesting that the exercise of distancing new formalism from Posner's specific arguments may teach us a lesson about how to evaluate new formalism.

II. CLASSICAL VERSUS NEW FORMALISM

Ideally, a discussion of new formalism would begin with an explanation of classical formalism. Unfortunately, there is little agreement in the literature as to what formalism in the law is, much less what it is in contract law.¹⁵ The traditional definition is the familiar carica-

12. *Id.* at 571-72.

13. Ayres & Gertner, *supra* note 7, at 91-95.

14. At least in the broad sense of the term and arguably in the more narrow, gap-filling sense as well.

15. There is, unfortunately, general agreement that the term is, or until recently was, used almost exclusively as a pejorative. *See, e.g.*, BRIAN H. BIX, A DICTIONARY OF LEGAL

ture of classical formalism as “mechanical jurisprudence.”¹⁶ Because two of the early alleged purveyors of this jurisprudence were contracts scholars—Christopher Columbus Langdell and Samuel Williston—mechanical jurisprudence is often associated with contract law in particular, though the relationship between classical formalism and contract law may go no deeper than the alleged common parentage.¹⁷ According to so-called mechanical jurisprudence, legal adjudication is a matter of logical deduction, of moving “mechanically or automatically from category or concept to conclusion, without consideration of policy, morality, or practice.”¹⁸ This brand of formalism is often associated with transcendentalism; that is, it is often thought to be based on first principles or abstract truths, perhaps from natural law, that can be known a priori.¹⁹

The idea that anyone of note ever really believed in such an extreme view is a myth that has now thankfully been largely debunked by careful thinkers.²⁰ Today one finds a variety of proposed definitions of formalism,²¹ most of which are in tension if not outright con-

THEORY 69 (2004) (“The term [‘formalism’] is usually used in a pejorative sense”); ERNEST J. WEINRIB, *THE IDEA OF PRIVATE LAW* 22 (1995) (“In contemporary academic discussion, ‘formalism’ is a term of opprobrium.”); Grey, *supra* note 1, at 1 (“It has long been an insult in sophisticated legal circles to call someone a formalist.”).

16. See, e.g., Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 821 (1935); Roscoe Pound, *Mechanical Jurisprudence*, 8 COLUM. L. REV. 605 (1908).

17. The most prominent noncontract law classical formalist was Joseph Beale, who is known primarily for his work on conflict of laws. For an excellent discussion of classical formalism and misconceptions about it, see ANTHONY J. SEBOK, *LEGAL POSITIVISM IN AMERICAN JURISPRUDENCE* 48-112 (1998).

18. BIX, *supra* note 15, at 69.

19. See SEBOK, *supra* note 17, at 48-112.

20. *Id.* (arguing that formalism as understood by its realists critics was actually invented by those same critics and was unfairly attributed to Langdell and Beale); Thomas C. Grey, *Langdell's Orthodoxy*, 45 U. PITT. L. REV. 1, 11-45 (1983) (arguing that classical legal orthodoxy, in particular that of Langdell, was not deductive or mechanical but rather inductive in the spirit of John Stuart Mill's understanding of logic); Mark L. Movsesian, *Rediscovering Williston*, 62 WASH. & LEE L. REV. 207 (2005) (arguing that the typical understanding of Williston's contracts theory as rigid and overly deductive fails to appreciate a strong pragmatic element in his work).

21. See, e.g., WEINRIB, *supra* note 15, at 24 (arguing that formalism is the view that the law is “rational,” “immanent,” and “normative,” and that each of these qualities are related such that the law has each “only insofar as it has the other two”); Larry Alexander, *“With Me, It's All er Nuthin’”*: *Formalism in Law and Morality*, 66 U. CHI. L. REV. 530, 531 (1999) (“By formalism I mean adherence to a norm's prescription without regard to the background reasons the norm is meant to serve (even when the norm's prescription fails to serve those background reasons in a particular case).”); William N. Eskridge, Jr., *The New Textualism*, 37 UCLA L. REV. 621, 646 (1990) (“Formalism posits that judicial interpreters can and should be tightly constrained by the objectively determinable meaning of a statute”); Grey, *supra* note 20, at 8 (“A legal system is *formal* to the extent that its outcomes are dictated by demonstrative (rationally compelling) reasoning.”); Frederick Schauer, *Formalism*, 97 YALE L.J. 509, 510 (1988) (“At the heart of the word ‘formalism,’ in many of its numerous uses, lies the concept of decisionmaking according to *rule*.”); Brian Leiter, *Positivism, Formalism, Realism*, 99 COLUM. L. REV. 1138, 1145-46 (1999) (reviewing SEBOK, *supra* note 17) (defining formal-

flict with one another, and none of which really speak to the special role that formalities play in contract law. The most comprehensive examination of the relationship between formalism and contract law that I know of remains Lon Fuller's well-known article *Consideration and Form*,²² itself now over sixty years old.

In that work, Fuller's primary aim was to explain the consideration doctrine. He argued that consideration was best understood as a formality, much like the requirement that certain kinds of contracts be in writing. To make his case, he discussed the function that legal formalities play in contract law. According to Fuller, formalities serve an evidentiary, cautionary, and channeling function.²³ They provide evidence of the parties' intention to enter into an agreement and thereby help to reduce fraud. They provide caution to parties about to enter into agreements, hopefully helping them to appreciate the gravity of entering a legally binding agreement. And they give legal documents a clear mark of enforceability, thereby channeling agreements into a form suited for adjudication in a court of law. Although not by any means a thorough account of classical formalism, Fuller's article remains the leading discussion of formalities in contract law.

Whatever classical formalism is, in contract law or elsewhere, Schwartz and Scott's version of new formalism in contract law is clear. It consists primarily of two main claims. First, they argue that courts and legislators should not try to write contracts *ex ante* by trying to anticipate which rules parties would want in their contracts and making those rules default rules.²⁴ Any attempt to come up with a single set of rules that could govern the vast array of transactions covered by such a broad net as the U.C.C. will inevitably be either prohibitively expensive, hopelessly vague, or both. It would be too expensive to come up with a list long enough to cover adequately the spectrum of possibilities in a large, heterogeneous economy. Thus, the U.C.C. contains a more manageable list of default "standards" rather than default rules, such as the warranty of "merchantability."²⁵ If left to their own devices, rational parties would create their own terms, precise and specific to their own situation. As it is, they are left with vague standards that are at best useless, as they provide no guidance and, at worst, are ripe for exploitation by those who seek to get out of bad contracts opportunistically. Therefore, parties

ism as "the descriptive theory of adjudication" according to which the class of legal reasons justifies one and only one outcome to a legal dispute and judges have no discretion in adjudicating cases).

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

23. *Id.* at 800-01.

24. Schwartz & Scott, *supra* note 2, at 594-609.

25. U.C.C. § 2-314 (2005).

must expend resources contracting around the unwanted default standards or else live with a heightened level of uncertainty. Worse yet, courts and legislatures are simply not the best drafters of default rules in the first place.²⁶

Secondly, the new formalists argue that courts should also not try to rewrite contracts *ex post* by allowing lots of evidence during litigation about the meaning of contracts.²⁷ Judges should be allowed to use only the text of the document and a standard, English dictionary when interpreting contract language, and they should reject attempts to bring such evidence as trade customs or the parties' prior dealings. Their reasoning is fairly simple: the more evidence that is brought in to litigate a dispute, the more expensive that process will be. Even if such a process would lead to more accuracy—and because of institutional inadequacy and the potential for opportunistic behavior there is reason to doubt that it would—the increased accuracy comes at a price. Rational parties would generally not be willing to pay that price *ex ante* since the potential litigation costs would eat into the expected value of the contract as a whole. The more expensive litigation process only becomes attractive *ex post* when one party realizes it is on the losing side of a contract and needs leverage in order to obtain a better settlement. Therefore, parties would prefer *ex ante* (when they do not yet know if they will be winning or losing on the deal) that their agreements be interpreted using only the written contract itself—as Williston famously put it long ago,²⁸ what is contained within the four corners of the document.

Having introduced, however incompletely, the concepts of formalism and new formalism, we are now in a position to return to Posner's discussion of penalty default rules. In the course of arguing that there are no such things as penalty default rules, Posner makes two distinctions I argue are questionable at best. As we will see, rather than supporting his views, the new formalists actually serve as counterexamples to his distinctions.

III. DISTINCTION 1: DEFAULT RULES AND CONTRACT FORMALITIES

One example Posner considers of an alleged penalty default rule offered by Ayres and Gertner is the “zero quantity rule.”²⁹ Under the common law, contracts that did not include essential terms were unenforceable.³⁰ The U.C.C., however, is not so shy about filling such gaps. Even terms as important as price can be left out, in which case

26. See *supra* notes 4-5.

27. Schwartz & Scott, *supra* note 2, at 584-90.

28. SAMUEL WILLISTON & RICHARD A. LORD, A TREATISE ON THE LAW OF CONTRACTS § 633, at 1015 (4th ed. 1990).

29. Posner, *supra* note 6, at 575-76.

30. E. ALLAN FARNSWORTH, CONTRACTS § 6.7, at 387-89 (4th ed. 2004).

the U.C.C. calls for courts to supply a “reasonable price.”³¹ However, if the parties fail to specify the quantity of goods sold, the contract will not be enforced even under the U.C.C.³² Ayres and Gertner interpret this requirement as a rule that the courts are actually to supply a quantity term: zero.³³ They then argue that this default rule is a penalty default, since clearly no one would contract for a zero quantity.³⁴ If the parties wanted to buy or sell zero goods, they would not need a contract that said so.

Posner argues that the “zero quantity rule” really does not fit the Ayres and Gertner model since, rather than penalizing one party for the failure to reveal information to the other party, it penalizes both parties for the failure to reveal information to the courts.³⁵ More interesting, for my purposes, is his argument that the rule is not a default rule anyway but rather a contract formality, implying that the two categories are mutually exclusive.³⁶ He gives three arguments in favor of the distinction. First, he argues that the organization of the U.C.C. suggests the framers intended the rule to be a formal requirement (section 2-201 is entitled “Formal Requirements: Statute of Frauds”)³⁷ while other default rules are more substantive.³⁸ But with no real discussion in the U.C.C. of the distinction or its importance, it would be a mistake to place much weight on this argument, and Posner does not.

Secondly, he briefly mentions that while parties can (by definition) contract around default rules, they cannot opt out of contract formalities.³⁹ However, while this is true of many formalities, it is not clear that it is true of all contract formalities. For example, not all modifications to a contract need be in writing, but the parties can require modifications to be in writing if they so desire.⁴⁰ As comment 3 to section 2-209 puts it, “Subsection [2-209](2) permits the parties in effect to make their own Statute of Frauds as regards any future modifications of the contract by giving effect to a clause in a signed agreement which expressly requires any modification to be by signed writing.”⁴¹ Similarly, section 2-206, which governs the formal requirements for offer and acceptance, provides the default rule that offers “shall be construed as inviting acceptance in any manner and by

31. U.C.C. § 2-305(1) (2005).

32. *Id.* § 2-201(1) & cmt. 1.

33. Ayres & Gertner, *supra* note 7, at 96.

34. *Id.* at 97.

35. Posner, *supra* note 6, at 577.

36. *Id.* at 576-77.

37. U.C.C. § 2-201 (2005).

38. Posner, *supra* note 6, at 576-77.

39. *Id.*

40. U.C.C. § 2-209(2) (2005).

41. *Id.* § 2-209 cmt. 3.

any medium reasonable in the circumstances” unless the offer “unambiguously” communicates that only a more limited manner of acceptance will suffice.⁴² So while it is true that most contract formalities cannot be contracted around, parties do have some level of control over the degree of formality required for the course of performance of their contract.

Thirdly, and most interestingly, Posner claims that default rules are meant to fill gaps in contracts while the purpose of contract formalities is to prevent fraud.⁴³ Although preventing fraud is one function contract formalities serve, it is arguably far from the entire story. In fact, formalities may also have much in common with default rules. Recall Lon Fuller’s claim that formalities serve three functions: evidentiary, cautionary, and channeling.⁴⁴ The evidentiary function certainly helps to prevent fraud,⁴⁵ but the cautionary and channeling functions are not primarily related to fraud. The cautionary function is meant to ensure that people appreciate the consequences of the contracts they sign. And by channeling agreements, formalities serve to provide a public mark of legal rights and duties. Such marks also provide evidence, but not so much to prevent fraud between the two parties. Instead, such marks clarify legal obligations for the two parties, for the courts, and for interested third parties.

The channeling function is worth particular attention since it is related to the current debate about default rules. Fuller saw legal formalities as a way of channeling ordinary transactions into a legal medium.⁴⁶ His analogy was the use of language: “One who wishes to communicate his thoughts to others must force the raw material of meaning into defined and recognizable channels; he must reduce the fleeting entities of wordless thought to the patterns of conventional speech.”⁴⁷ Similarly with agreements, if one wishes to make an agreement legally enforceable, one must conform to legal formalities. Parties cannot merely agree; rather, they must channel their agreement into a form suited for enforcement by the courts. This requirement also helps the parties, as well as third parties, to predict better how courts will adjudicate a dispute over the contract if one should arise.⁴⁸

42. *Id.* § 2-206(1)(a).

43. Posner, *supra* note 6, at 576-77.

44. Fuller, *supra* note 22, at 800-01.

45. It need not serve only that purpose. For example, a plaintiff may sincerely believe she and the promisor made a pact, when in fact the promisor sincerely believes they did not. Requiring the plaintiff to prove that the promisor objectively manifested assent helps to smoke out such misunderstandings.

46. Fuller, *supra* note 22, at 801-02.

47. *Id.* at 802.

48. *Id.* at 801.

It was against a backdrop of such formalist thinking that Karl Llewellyn drafted the U.C.C.,⁴⁹ including many of the default rules we know today. Llewellyn was opposed to excessive formalism in contract law and saw formal requirements as getting in the way of business.⁵⁰ What contract law needed to do was be more responsive to business, not force business persons to “channel” their transactions into legal forms. The idea behind many of the U.C.C.’s provisions was to make contract law better reflect business practices.⁵¹ The formalities were to be removed or, perhaps, made invisible by making them mimic business practices. Rather than building fences to channel business transactions down a legal path, Llewellyn wanted to build the fences around the already existing paths, which are (or at least were at that time) our best evidence of the most efficient rules of contracting.⁵² Default rules fit this project well. To the extent that we can anticipate by what rules parties would want their transactions to be governed, we can ensure that their agreements can be legally enforceable even though they themselves are doing less formal contracting rather than more. Most of the default rules scholarship (including some of the contributions to this Symposium) is aimed at coming up with better legal rules so that the parties will not have to do much more to make their transactions legally enforceable than what they would do (or, for some theorists, what they rationally should do) already. The U.C.C. sought to move Mohamed to the mountain, rather than the mountain to Mohamed.

Penalty default rules, on the other hand, do not have this purpose. The idea is to have a legal rule the parties would *not* want in order to force them to take a legal step (like information disclosure) that they would not otherwise take. This is more akin to forcing a party to channel an ordinary practice into a legal practice, rather than seeking to make legal rules conform to business practices. Therefore, in this more abstract sense, the absence of default rules would not necessarily entail the absence of penalty default rules. Default rules and penalty default rules are structurally meant to do very different

49. By the “U.C.C.” here, I primarily mean articles 1 and 2. Karl Llewellyn was the principle drafter of article 2, and although there were other influences, *see* WILLIAM TWINING, *KARL LLEWELLYN AND THE REALIST MOVEMENT* 271 (1973), at the level of generality at which I speak in this Article, it makes sense to talk of Llewellyn as the drafter and to talk of article 2’s aims and Llewellyn’s aims interchangeably.

50. Gregory E. Maggs, *Karl Llewellyn’s Fading Imprint on the Jurisprudence of the Uniform Commercial Code*, 71 U. COLO. L. REV. 541, 559-60 (2000).

51. TWINING, *supra* note 49, at 369; Dennis M. Patterson, *Good Faith, Lender Liability, and Discretionary Acceleration: Of Llewellyn, Wittgenstein, and the Uniform Commercial Code*, 68 TEX. L. REV. 169, 170-71 (1989).

52. Alan Schwartz, *Karl Llewellyn and the Origins of Contract Theory*, in *THE JURISPRUDENTIAL FOUNDATIONS OF CORPORATE AND COMMERCIAL LAW*, *supra* note 4, at 12, 14-17.

things—a conclusion that may help explain why, supposing Posner is correct, the U.C.C. contains no penalty default rules.

Recall new formalism. Both of Schwartz and Scott's main claims—the call to allow only a minimum of evidence to settle interpretation disputes and the rejection of default standards written by courts or legislators—are calls for formalism in that they insist that no matter what the moral obligations of the parties are or what a fair outcome or interpretation of the agreements would be, courts should only enforce agreements that meet a rather strict writing requirement. But their arguments for these formalities are not the prevention of fraud (though there is some reference to deterring opportunistic behavior), but rather are that a higher degree of formality would maximize welfare. The soundness of the arguments will apparently be determined by the empirical question of whether these measures really would maximize welfare, and not by the degree to which they uncover the precise intentions of the parties.⁵³

When put in the context of Fuller's three functions of contract formalities, the new formalists are primarily interested in the channeling function. Ironically, that is the one function that Fuller claimed was underappreciated. For example, these arguments show little concern for the evidentiary function. In fact, it is part of their point that accuracy is expensive, and rational parties will not be willing to pay for the most accurate interpretation possible.⁵⁴ According to the new formalists, the whole point of contracting (at least for sophisticated firms) is to maximize joint surplus.⁵⁵ They argue, in effect, that parties should be forced to channel their agreements into written documents that courts can easily and predictably interpret if they want the courts' help in enforcing them, rather than relying on unwritten norms in the industry or vague default standards not negotiated or clarified by these parties.⁵⁶

In sum, there is good reason to doubt Posner's claim that there is a clear distinction between contract formalities and contract default rules. There is no a priori reason for thinking them distinct, and indeed, there are some formalities we are willing to give the parties a certain amount of control over. More importantly, his explanation for

53. Scott, *The Case for Formalism*, *supra* note 4, at 875; *see also* Charny, *supra* note 1, at 850.

54. Schwartz & Scott, *supra* note 2, at 589 ("Business firms are content with interpretations of their language that are correct on average, not always correct . . ."); *id.* at 569 ("Put another way, the issue is not what interpretive style is best calculated to yield the correct answer. Rather, the issue is what interpretive style would typical parties want courts to use when attempting to find the correct answer.").

55. *Id.* at 549-56.

56. Ironically, Llewellyn shared virtually the same goals for contract, though he thought they could be better achieved through less formalism rather than more. *See* Alan Schwartz, *supra* note 52, at 14-15.

the distinction fails. Contract formalities arguably do much more than prevent fraud, and indeed, Schwartz and Scott argue that a highly formalistic system of contract is preferable not because of its ability to prevent fraud, but rather because its penalty-like channeling function would maximize the expected gains of contracting.

IV. DISTINCTION 2: DEFAULT RULES AND RULES OF INTERPRETATION

We have seen that Posner responded to one Ayres and Gertner example of an alleged penalty default rule by drawing a distinction between default rules and contract formalities, a distinction I have called into question. Similarly, he meets another alleged example of a penalty default rule with another distinction. In response to Ayres's claim that interpretive rules are in some cases penalty default rules, Posner draws a distinction between default rules and interpretive rules.⁵⁷ Interpretive rules govern how we are to read vague or ambiguous language, while default rules fill gaps. If there is a gap in the language with respect to that issue, then by definition there is nothing to interpret. According to Posner, it is only when there is language that needs to be interpreted that rules of interpretation come into play, and only when there is a gap in the language that default rules come into play.⁵⁸ Therefore, interpretive rules and default rules are distinct.

For example, consider the new formalists' proposed rule rejecting the U.C.C.'s course-of-dealing provisions.⁵⁹ Schwartz and Scott would prefer a default rule⁶⁰ whereby contracts are interpreted using only a bare minimum evidentiary base, such as a judge's background and a standard, English dictionary.⁶¹ The U.C.C., by contrast, allows parties to refer to a larger evidence base—for example, prior dealings between the parties and trade usage of those terms in the relevant industry—to interpret vague or ambiguous contract language. But by hypothesis the extra evidence is introduced in order to interpret existing language in the contract, not to fill in missing language. There-

57. Posner, *supra* note 6, at 579-81.

58. *Id.* at 579.

59. Posner, following Ayres, uses the example of the *contra proferentem* rule, Posner, *supra* note 6, at 579-81, but again, I am more interested in the relationship of new formalism to Posner's arguments.

60. Just to be clear, Schwartz and Scott are not opposed to *all* use of default rules. Rather, their complaint is that most of what we call default rules are really default standards. In most cases, the level of generality needed to cover most factual situations will result in a vague standard rather than a clear rule. However, in some cases, default rules can be successful. The interpretive rules for which they are calling serve as one example. Another is the rule that the breaching party must pay the nonbreaching party the difference between contract price and market price, but "[o]ther good default rules are hard to find." Schwartz & Scott, *supra* note 2, at 604 n.135.

61. See *supra* note 21 and accompanying text.

fore, following Posner's reasoning, the rule is a rule of interpretation and not a true default rule.

The distinction is problematic, though, and fortunately, even Posner calls it a "probably unimportant problem"⁶² with the idea that interpretive rules are penalty default rules. As he notes, despite the alleged clean conceptual distinction between the categories, in practice the distinction does not hold in every case (even under the more narrow, gap-filling definition of default rules Posner is using).⁶³ There could be, and indeed sometimes are, contractual clauses about how to interpret vague language in contracts. The U.C.C. even invites them, though they must be explicit in order to override the U.C.C.'s presumptions about interpretation.⁶⁴ Arguably, when there are no such clauses, there is a gap—the contract is silent on an issue about which it could have spoken—and in that sense, interpretive rules are really default rules.⁶⁵ Posner is probably right that since they are intended to be majoritarian rules they are still not penalty default rules that fit the Ayres and Gertner model, but his distinction between default rules and interpretive rules does not hold.⁶⁶

More importantly, for our purposes, Schwartz and Scott are implicitly committed to collapsing the distinction. Indeed, the whole goal of new formalism is to figure out the best rules of contract interpretation. The new formalists do not argue that we should never allow extrinsic evidence to interpret contracts. If parties wish to include such evidence when their disputes are adjudicated, they can say so in the contract. What Schwartz and Scott want is a change in the default rules such that when parties do not tell us what rules of interpretation they prefer—that is, when they are silent on the issue, leaving a "gap" to be filled—we should use a Willistonian default rule. In short, Schwartz and Scott's version of new formalism is a call for Willistonian default rules of interpretation.

62. Posner, *supra* note 6, at 579.

63. *Id.* at 579-80.

64. U.C.C. § 2-202 cmt. 2 (2005) ("Unless carefully negated [course of dealing, course of performance, and usage of trade] have become an element of the meaning of the words used.")

65. Similarly, in a new paper Richard Craswell argues that default remedies are best conceived of as "drafting requirements." Richard Craswell, *Expectation Damages and Contract Theory Revisited* 7-8 (Apr. 15, 2005) (unpublished manuscript, on file with *The Florida State University Law Review*). Interestingly, for our purposes, at one point he calls them "drafting formalities." *Id.* at 8.

66. Ironically, if Schwartz and Scott are right, then the U.C.C.'s interpretive rules are not majoritarian. They still would not be in the spirit of penalty defaults, however, since they were clearly intended to be majoritarian.

V. CONCLUSION: HOW TO EVALUATE NEW FORMALISM

I began this Article by noting that Posner is mistaken to consider the new formalists like Schwartz and Scott fellow travelers. While his conclusion that there are no penalty default rules technically follows from their conclusion that there are no default rules, he achieves this result by means inconsistent with the spirit of their project. He relies on a distinction between default rules and contract formalities and a distinction between default rules and rules of contract interpretation. By contrast, new formalism offers a theory of formalistic default rules of contract interpretation. Still, Posner refers to the new formalists only in passing, and even the distinctions he makes are not crucial to his overall arguments. What purpose does this Article serve, then, other than to nip at the heels of Eric Posner?

One lesson to take forward is that we do not really have a very good idea of what formalism is. I mentioned above that recent attempts to define formalism are in tension with one another and, in any event, do not address the potentially special role of formalities in contract law. Posner claims (in fairness, only in passing) that contract formalities are only meant to deter fraud. By contrast, the new formalists seem to have little interest in fraud and instead, are entirely focused on the channeling that formalities provide. Fuller mentioned both fraud and channeling, but his discussion of the latter was almost an afterthought. Additionally, he also emphasized the cautionary aspect of legal formalities. It is surprising to see so little consensus yet so little discussion of a topic as old as contract law itself.

It is telling that in recent work Schwartz and Scott do not call their view formalism, apparently deciding to follow Holmes's advice not to attach a "fighting tag"⁶⁷ to their work that might detract from the arguments themselves.⁶⁸ But until we decide what formalism is, which doctrines are meant to be formal requirements, and why we have formal requirements in the first place, we will be unable to evaluate adequately the arguments for or against formalism, either the new or the classical version. Thus it is false to say, as is now sometimes said,⁶⁹ that the success of new formalism will depend entirely on the empirical question of whether it maximizes welfare. That claim is only true once other possible reasons for having for-

67. Patrick J. Kelley, *A Critical Analysis of Holmes's Theory of Contract*, 75 NOTRE DAME L. REV. 1681, 1684 n.10 (2000).

68. In earlier work, they embraced the term "formalism." See Scott, *The Case for Formalism*, *supra* note 4; Alan Schwartz & Joel Watson, *The Law and Economics of Costly Contracting*, 20 J.L. ECON. & ORG. 2, 3 (2004). They do, however, in passing refer to their view as "Willistonian" even now and refer to "Willistonian formalism" in a footnote. See Schwartz & Scott, *supra* note 2, at 569 n.53.

69. Charny, *supra* note 1, at 850 ("Again, the issues here are fundamentally empirical.").

malities are either eliminated or shown to reduce to welfare maximization. To their credit, this is not a question Schwartz and Scott beg. They do argue explicitly for an “efficiency theory of contract,”⁷⁰ at least with respect to agreements among sophisticated firms, and hope thereby to settle all disputes of contract doctrine by appeal to welfare maximization.⁷¹ But they pay little attention, except by implicit exclusion, to the other functions Fuller argued formalities perform or to the relationship between what he called their “formal” and “substantive” aspects.⁷²

Ultimately, the more important question for new formalism may be whether rules of interpretation are distinct from formal requirements, not whether default rules are distinct from either formal requirements or rules of interpretation. The rules of interpretation that Schwartz and Scott discuss certainly seem to be formal requirements, formalities intended to perform a channeling function at that. If that is right, then we must ask ourselves whether these formalities serve any other function before we can decide which rules of interpretation we prefer. Along the way, we will also have to decide whether they are the sort of formalities we even want to allow parties to contract around at all.⁷³ Perhaps Schwartz and Scott’s arguments can stand on their own without addressing larger debates about formalism, though if we avoid those issues we should probably not think of their view as a new version of classical formalism. But on the other hand, it may turn out that Schwartz and Scott cannot avoid debates about formalism just by eschewing the fighting tag. What we need first is both a better understanding and a re-evaluation of classical formalism. Posner took on a recent fad in contract law, one centered on penalty default rules. Before we can evaluate the latest, related rage—new formalism—we need a more careful treatment of many of the concepts and distinctions Posner mentions in passing.

70. Schwartz & Scott, *supra* note 2, at 550-56.

71. Their view may or may not see the “social function” of contract law, like the “social function” of the market, as “subject to distributional and fairness constraints.” *Id.* at 549.

72. Fuller, *supra* note 22, at 799.

73. I have argued that Posner was incorrect to posit a *per se* rule that formalities cannot be contracted around. But at the other extreme, Schwartz and Scott suggest that if party preferences differ about a given rule, then that rule should be at most a default rule. Schwartz & Scott, *supra* note 2, at 569. (“Party preferences regarding judicial interpretive styles can differ. Therefore, interpretive styles should be defaults.”). The only explanation for making such rules mandatory, they argue, is an unjustified exercise of legal paternalism. *Id.* at 609-18. This may be going too far as well, but this is not the time to evaluate those arguments.