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Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms

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Inertia and Preference in Contract Negotiation: The Psychological Power of Default Rules and Form Terms

*Russell Korobkin**

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I. INTRODUCTION

In *The Problem of Social Cost*,¹ the foundational article of the law and economics movement, Ronald Coase suggested that when transaction costs are zero, the initial allocation of a legal entitlement is irrelevant to its eventual ownership.² Assuming no transaction costs, the Coase Theorem predicts that if party A values an entitlement more than does party B, A will keep the entitlement if it is initially allocated to him, and he will buy it if it is originally allocated to B.³ This powerful insight depends on the behavioral assumption that an individual's valuation of entitlements does not depend on ownership; that is, A values an entitlement neither more nor less if he is initially allocated that entitlement than if it is initially given to B.⁴

The assumption that preferences are exogenous to entitlement allocations is empirically testable, however, and has been demonstrated to be false, at least under some conditions. The empirical evidence, labeled alternately the "status quo bias,"⁵ the "endowment effect,"⁶ or the "offer/asking price gap,"⁷ instead suggests that the initial allocation of legal entitlements can affect preferences for those entitlements. The consequence is that completely alienable legal entitlements will be "sticky"—that is, tend not to be traded—even when such stickiness cannot be explained by transaction costs. The

1. Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

2. See *id.*; see also ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 81-82 (2d ed. 1997).

3. See Coase, *supra* note 1, at 6; see also A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 11-12 (2d ed. 1989) (explaining the Coase Theorem).

4. Cf. Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 VAND. L. REV. 1499, 1504 (1998) (noting that if people demand more money to sell something they own than they would pay to buy the same item, the Coase Theorem might "fail[] in real life").

5. See, e.g., Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 CORNELL L. REV. 608 (1998) [hereinafter Korobkin, *The Status Quo Bias*]; William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7 (1988).

6. See, e.g., Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990); Richard Thaler, *Toward a Positive Theory of Consumer Choice*, 1 J. ECON. BEHAV. & ORG. 39, 44 (1980).

7. See, e.g., Duncan Konnelly, *Cost Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387, 401 (1981); Russell Korobkin, Note, *Policymaking and the Offer/Asking Price Gap: Toward a Theory of Efficient Entitlement Allocation*, 46 STAN. L. REV. 663 (1994) [hereinafter Korobkin, *Policymaking*].

evidence thus describes an important flaw in the Coase Theorem's mighty armor. The principle goal of one branch of the discipline of "behavioral law and economics" or "law and behavioral science"⁸ is to explore the legal implications of this flaw.⁹

In a previous article, I argued that contracting parties are less likely to bargain around background—or "default"—contract terms established by the law than the Coase Theorem would predict because the parties are likely to view default terms as a constituent part of the status quo, much like an entitlement.¹⁰ The claim, if correct, has both positive and normative implications for the analysis of contract default rules. On the positive side, it leads to predictions that differ from traditional law and economics analysis regarding what circumstances are necessary for contracting parties to bargain around default rules.¹¹ On the normative side, it suggests somewhat different strategies (again, compared to traditional law and economics analysis) for lawmakers interested in selecting contract default rules that will enable private bargainers to maximize allocative efficiency.¹²

8. The newness of this subdiscipline of law is perhaps nowhere more evident than in its failure to find a widely agreed-upon name yet. Last year, the National Bureau of Economic Research sponsored a conference entitled "Behavioral Approaches to Law and Economics" that addressed questions similar to those addressed in this *Vanderbilt Law Review* Symposium. See *Behavioral Approaches to Law and Economics*, NBER REP., Winter 1997-98, at 18-19. The organizers of that conference have subsequently published a general article on the subdiscipline, entitled "A Behavioral Approach to Law and Economics." Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998). The problem with this syntax is that, by highlighting the strong ties of this body of legal scholarship to the law and economics movement, it perhaps obscures the equally strong ties the subdiscipline has to other disciplines that study human behavior, particularly psychology but also sociology and organizational behavior. For this reason, I prefer the monicker "law and behavioral science" for the movement as a whole. This is, in fact, the title that Professor Thomas Ulen and I have given to the course we teach that applies a wide range of research from behavioral decision theory to legal problems.

9. See, e.g., Herbert Hovenkamp, *Legal Policy and the Endowment Effect*, 20 J. LEGAL STUD. 225 (1991); Kennedy, *supra* note 7; Korobkin, *Policymaking*, *supra* note 7; Korobkin, *The Status Quo Bias*, *supra* note 5; David Millon, *Default Rules, Wealth Distribution, and Corporate Law Reform: Employment At Will Versus Job Security*, 146 U. PA. L. REV. 975 (1998); Jeffrey J. Rachlinski, *Remedies and the Psychology of Ownership*, 51 VAND. L. REV. 1541 (1998); see generally Langevoort, *supra* note 4. For an intellectual precursor of this line of inquiry, see Mark Kelman, *Consumption Theory, Production Theory, and the Coase Theorem*, 52 S. CAL. L. REV. 669 (1979).

10. See Korobkin, *The Status Quo Bias*, *supra* note 5.

11. See *id.* at 665-66 (claiming that parties will only bargain around a default rule if the party disadvantaged by the default term values the term more than the other party, determined by the sum of (1) the parties' joint transaction costs of bargaining, (2) the value to either party of not revealing information that must be revealed to contract around the term, and (3) the parties' joint preference for the status quo).

12. See *id.* at 670-75 (recommending "tailored" default rules and "non-enforcement" default rules).

This Article advances two primary claims in an attempt to broaden and deepen the scope of previous analysis. The first claim is that the status quo bias has broader ramifications for contract negotiations than causing parties to prefer terms identified as legal defaults to those that are not legal defaults. There is likely to be a bias in contract negotiations in favor of *any* contract term that serves as a reference point—or point of departure—for bargaining. Legal default rules may serve as such reference points, but so may terms in form contracts used as the basis for negotiations, or terms embodied in preliminary drafts prepared by one party. I assert that the operative dichotomy for negotiators is not between default terms and non-default terms, but rather between inaction (which parties generally prefer) and action (which parties prefer to avoid). Parties are likely to favor default terms, in many instances, because these terms are often correlated with inaction (i.e., the default terms will be operative if the parties do nothing). But contracting parties will tend to favor *any* terms that will operate in the absence of a specific agreement to the contrary. I call this the “inertia theory” of contract negotiation.

If this claim is correct, its positive implications are similar to, although broader than, those suggested in my previous article: terms contained in an initial “draft contract” will have far more staying power than the transaction costs associated with changing the terms, standing alone, would suggest. The claim also has significant prescriptive implications for parties negotiating contract terms. A bargaining party can gain a strategic advantage by establishing a set of favorable contract terms as the reference point for negotiations. This advantage is likely to be more powerful than would be suggested by the Coasean hypothesis that initially proposed terms are likely to “stick” only if the transaction costs associated with changing them exceed the difference in value between the initially proposed terms and alternatives.

This Article’s second claim concerns the motivational basis of negotiators’ preference for inaction over action. I contend that a bias in favor of inaction minimizes possible future regret that a negotiator might experience if agreed upon contractual terms turn out, in hindsight, to be undesirable. This claim rests on a large body of psychological literature demonstrating that individuals suffer more regret from taking ill-fated actions than from failing to act, and it is consistent with evidence that individuals are not biased against action when the consequences of actions are certain.

The Article proceeds as follows: Part II reviews existing data demonstrating that negotiating parties are biased in favor of default contract terms under some conditions. Part III develops the inertia theory of contract negotiation. It begins by explaining how, in some circumstances, a negotiator's bias in favor of default terms can be viewed as a rational, profit-maximizing strategy designed to take advantage of "network benefits" and "learning benefits" that accrue to users of common contract terms. It then presents experimental evidence, however, demonstrating that negotiators can be biased in favor of default terms even when these terms are not common, and can be biased against default terms even when these terms are common. The common conclusion of all of the experimental results is that negotiators tend to favor terms that will take effect if the negotiators do nothing, as compared to terms that become operational only through affirmative actions of negotiators. Part IV of the Article develops the claim that the preference for inertia is motivated by a desire to minimize future regret. It begins by reviewing the psychological literature on counterfactual thinking and regret theory consistent with this claim. It then presents experimental evidence demonstrating that the preference for inertia evaporates when there is no uncertainty as to the future consequences of choices—a result consistent with the predictions of the regret hypothesis.

II. THE BIAS IN FAVOR OF DEFAULT CONTRACT TERMS

The argument begins with the assertion that contracting parties prefer contract terms that are legal defaults to terms that are not legal defaults.¹³ This argument was advanced in a previous article and is based on the results of a series of experimental tests demonstrating that contracting parties are more likely to prefer a contract term if it is the default than if it is not.¹⁴ This preference for

13. Even in light of the large body of experimental literature demonstrating that individuals value entitlements more if they are endowed with the entitlement than if they are not, these results were far from obvious because contract default rules do not endow contracting parties (even the party who is favored by the content of the default term) with any entitlements at all. A default contract term can be advantageous to a contracting party *only* if he is able to convince his counterpart to enter into a contract that includes that term. Another way to put the point is to say that a contract default term that favors one party (a "buyer" for instance, in his dealings with a "seller") is not a vested entitlement in the way that a property right is a vested entitlement. A bargaining party's counterpart can render such an "illusory entitlement" worthless simply by refusing to enter into a contract without substituting another term for the default that the law would otherwise provide. See generally *id.* at 631-32.

14. See *id.*

default terms is evident even when transaction costs of contracting around the default are very low and there is no strategic advantage in choosing not to contract around the default. This Article thus begins with a brief synopsis of the evidence supporting this claim.¹⁵

The bias in favor of contract default terms, contrary to Coasean law and economics analysis, was demonstrated in three experiments, two of which will serve as a point of comparison for the new data presented in this Article. In both of these experiments, law students who had completed a contracts course were asked to play the role of an attorney in a series of hypothetical negotiation scenarios. In each scenario, subjects were provided with written fact patterns describing negotiations between their client, a company called "NextDay" that specializes in overnight package delivery, and a customer of NextDay's called "Gifts, Inc.," a catalog operator ready to enter into a contract with NextDay for the shipment of its packages around the country. After being presented with the relevant information, subjects were asked to provide advice to their client on how to proceed in the negotiations. The advice was solicited by asking the subjects to place a monetary value on contract terms that were the subject of negotiations.

For each negotiation scenario, subjects were randomly given one of two or more experimental conditions that differed from each other in only one way: the information provided about whether the contract term at issue was the default term (that would govern the parties unless they agreed otherwise) or an alternative to the default term. The importance of a term's status as the "default" was measured by comparing the value placed upon the term by subjects who were told that it was the default with the value assigned it by those who were told that it was an alternative to the default.

The first experiment ("Consequential Damages") dealt with a contract term delineating the amount of damages for which the subject's client, Next Day, could be held liable if it failed to deliver a Gifts, Inc. package on time. The experiment tested whether the subjects' preference for a favorable contract term depended on whether the term was the default or an alternative to the default. All of the subjects participating in this experiment were told that Gifts, Inc. would prefer a contract term that would hold NextDay liable for all damages caused by its failure to meet its delivery obligations. They

15. What follows is only a brief summary of the experimental design and results. For a more detailed description of the experiments and a discussion of the results, see *id.* at Parts III.A-B.

were also told that NextDay, in contrast, would prefer a contract term limiting its potential liability to damages that were “reasonably foreseeable” at the time that NextDay took possession of the package in question. Subjects were advised that NextDay’s accountants had estimated that there was a ninety-five percent chance that a contract including the broader “full liability” damages clause would cost NextDay, on average, \$0-\$10 more per package than would a contract with the narrower “limited liability” damages clause.¹⁶

Subjects randomly assigned to condition 1 (“Limited Liability”) of the experiment were told that the limited “reasonably foreseeable” damages term was the legal default in their state. They were asked how much money per package Gifts, Inc. would have to agree to pay NextDay above what the contract price would otherwise be before they would recommend that NextDay contract around the limited liability default in favor of a full liability term.¹⁷ In contrast, subjects assigned to condition 2 (“Full Liability”) of the experiment were informed that the default term was one of full liability. They were asked how much of a per-package reduction in the contract price (below what it would otherwise be) they would recommend NextDay be willing to accept for shipping if, in return, Gifts, Inc. would agree to include a limited liability term in the contract.¹⁸

The transaction costs associated with contracting around the default term in the experiment were negligible, if they existed at all. Contracting around the default did not require more mental effort than accepting the default, as all subjects were required to value the difference between the default term and its alternative. And there were no marginal drafting costs associated with contracting around the default, as both conditions of the experiment provided the subjects with the precise language that would be inserted into the contract if the parties agreed to contract around the default. Additionally, there were no strategic reasons for subjects to decline to contract around the default terms (it was clear to both parties prior to negotiating that NextDay would prefer limited liability, and that Gifts, Inc. would prefer full liability) or to be less than truthful in revealing the value they placed on contracting around the default (subjects were asked to provide their valuation to their client in order to determine a negotiating strategy, not to suggest a value that would actually be used in bargaining). Consequently, Coasean law and economics

16. See *infra* Appendices A1-A2.

17. See *infra* Appendix A1.

18. See *infra* Appendix A2.

analysis would predict that valuations would not differ, on average, between subjects assigned to condition 1 and those assigned to condition 2.

The mean valuations were, however, significantly affected by condition.¹⁹ Subjects in condition 1 ("Limited Liability") (N=26) recommended, on average, that NextDay demand a minimum of \$6.96 per package before agreeing to include a full liability term in the contract. Condition 2 ("Full Liability") subjects (N=28), on the other hand, recommended, on average, that NextDay be willing to offer a maximum discount of \$4.46 per package for Gifts, Inc.'s agreement to include a limited liability term in the contract. The difference between the mean responses of subjects in the two conditions can best be understood as one measure of the strength of the substantive bias for terms that are identified as the default over those identified as alternatives to the default.

Table 1.A. Consequential Damages Results

<i>Condition</i>	<i>N</i>	<i>Default Rule</i>	<i>Mean Valuation</i>
1	26	Limited Liability	\$6.96/package
2	28	Full Liability	\$4.46/package

The second experiment ("Impossibility Excuse") made use of the same background facts but changed the subject matter of the negotiation. Rather than being asked to value the difference between a contract with a full liability term versus a limited liability term, subjects were asked to value the difference between a contract which would excuse NextDay on the grounds of impossibility or impracticability and one that would not. In the former case, NextDay would be excused from its contractual obligations if an unforeseen contingency beyond its control were to occur that rendered performance of its obligations "commercially impracticable." In the latter case, NextDay would be forced to perform its obligations or pay damages, regardless of the occurrence of any contingency in or out of NextDay's control, foreseeable or not. Unlike the Consequential Damages experiment, the Impossibility Excuse experiment did not provide subjects with expert estimates of differences in costs that NextDay might expect to incur under a contract that recognized the impracticability excuse and one that did not.²⁰

19. $p < .001$.

20. See *infra* Appendices B1-B2.

Mirroring the design of the Consequential Damages experiment, approximately half of the subjects in the Impossibility Excuse experiment were randomly assigned to condition 1 ("Impracticability"). These subjects were told that the default legal rule provided for the impossibility/impracticability excuse and were asked to recommend the minimum amount NextDay should demand before agreeing to insert a "no excuse" clause in the contract.²¹ The other half of the subjects, assigned to condition 2 ("No Excuse"), were told that the default rule was one of "no excuse." They were asked for the maximum amount NextDay should be willing to pay if Gifts, Inc. would agree, in return, to include in the contract a clause providing for an impossibility/impracticability excuse.²²

Again, although Coasean economic analysis would suggest that the subjects' responses should not depend on the condition to which they were assigned (and thus what term they were told was the default), defining the default contract term differently had a significant effect on subjects' valuations.²³ Subjects assigned to condition 1 ("Excuse") (N=22) recommended, on average, that NextDay demand a side payment of at least \$188,000 before agreeing to include a "no excuse" term in the contract. Subjects assigned to condition 2 ("No Excuse") (N=25) recommended, on average, that NextDay be willing to pay no more than \$56,000 to convince Gifts, Inc. to add an "excuse" term to the contract.²⁴ Although subjects in both conditions clearly would prefer a contract with an "excuse" term to one with a "no excuse" term, their preference for the former was much stronger when it was identified as the default than when it was identified as the alternative. Again, labeling a term as the default appeared to strengthen subjects' preference for the term.

21. See *infra* Appendix B1.

22. See *infra* Appendix B2.

23. $p < .01$.

24. The distribution of responses to the various manipulations of the Impossibility Excuse scenario reported in this Article were non-normal (right-skewed). Consequently, all statistical tests reported were conducted on the natural logs of the responses, rather than on the raw responses themselves, and the reported mean values are geometric (rather than actual) means. For this reason, the mean values reported for conditions 1 and 2 differ from the mean values reported in *The Status Quo Bias and Contract Default Bias*. Compare Korobkin, *The Status Quo Bias*, *supra* note 5, at 643 (reporting the means of the raw responses).

Table 2.A. Impossibility Excuse Results

<i>Condition</i>	<i>N</i>	<i>Default Rule</i>	<i>Mean Valuation</i>
1	22	Excuse	\$188,000
2	25	No Excuse	\$ 56,000

III. TOWARD A GENERAL THEORY OF INERTIA

Can the traditional tools of Coasean economic analysis convincingly explain the demonstrated bias in favor of default terms in contract negotiations? The most obvious avenue for explaining the bias in traditional terms would be to focus on the incentive effects of transaction costs. Terms that will govern a contract only if the parties take affirmative steps to establish the term can be more expensive to implement than are terms that operate as a result of inaction. All other things equal, parties should rationally prefer contract terms that require less time and effort to negotiate and draft than alternatives.

Transaction cost explanations seem strained, however, in the context of the controlled experiments reported above. The experiments were designed so that no possible response from subjects implied longer or more complicated negotiations than any other response. In both the Consequential Damages and Impossibility Excuse scenarios, subjects were effectively told they *were* negotiating the terms in question; no value that they might have placed on favorable terms relative to unfavorable ones would have suggested lower costs of negotiating. In addition, subjects responding to both scenarios were provided with the text of the relevant "alternative" term (i.e., the term that they could select by contracting around the default). The existence of the alternative terms demonstrated that there were no higher costs of drafting associated with contracting for the alternative term rather than accepting the default term. Consequently, although transaction costs explanations are often powerful in understanding why parties select the apparent path of least resistance, something else appears to underlie the observed bias in favor of terms identified as the default.

From the perspective of the Coase Theorem, the results seem quite puzzling. If ownership of property should not affect its valuation, why would the identity of one possible contract term as the

“default” affect its valuation when transaction costs are at or near zero? An emerging economic literature on learning and network benefits suggests that such disparate valuations for default terms and alternative terms might in fact be fully rational and profit-maximizing for contracting parties under certain conditions. This Part first explains how the status quo bias could potentially be reconciled with rational profit maximization, but then presents experimental evidence that suggests this explanation is not fully convincing. It is possible that learning and network benefits could be important drivers of the status quo bias in some instances. But the experimental evidence suggests that the bias in favor of default terms is at least partially the result of deeply ingrained psychological instincts that cause us to favor inaction over action, even when doing so is not profit maximizing.

A. *The Rationalist Response: Learning and Network Benefits*

In recent articles, Marcel Kahan and Michael Klausner have developed a theory of why corporate contracts often contain standard, “boilerplate” terms.²⁵ Their analysis can be extended to explain why contracting parties would tend to prefer default terms, all other things equal. Kahan and Klausner’s explanation of standard terms is based on the insight that past or future use of contract terms by unrelated parties can provide value to contracting parties, above and beyond the intrinsic, or inherent, value of the term itself.²⁶ The authors define non-inherent value as “‘increasing returns’ to users as more firms adopt the same term.”²⁷ They then divide the carriers of this value into two related but distinct categories: “network” benefits and “learning” benefits.²⁸

Network benefits arise when the value of a product to one of its users depends on the number of other users of the same product.²⁹

25. See Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting* (or “*The Economics of Boilerplate*”), 83 VA. L. REV. 713 (1997) [hereinafter Kahan & Klausner, *Standardization*]; Michael Klausner, *Corporate Law and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

26. Elsewhere, Kahan and Klausner recognize that cognitive biases can also lead to standardization of contract terms. See generally Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 (1996) (discussing “learning” and “network” benefits) [hereinafter Kahan & Klausner, *Path Dependence*].

27. Kahan & Klausner, *Standardization*, *supra* note 25, at 718.

28. *Id.* at 716; see also Kahan & Klausner, *Path Dependence*, *supra* note 26, at 350-58.

29. Cf. Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424, 424 (1985) (explaining products subject to network

The prototypical example of an item with large network benefits is the telephone. A telephone would have no value if owned by only one person—he or she would have no one to call! Moreover, the value of a telephone to any particular user increases as the number of other users increases.³⁰ Put slightly differently, the demand for a telephone, like other network goods, depends not only on its price and quality (its inherent value) but also on the expected size of the network (other users).³¹ Today, the personal computer ("PC") is often used as an example of a product with large network benefits. Unlike the telephone, a PC would have value to a single user. But the value of a PC increases as its number of users increase, both because this gives users the chance to connect with each other via a computer network (direct network benefits), and because it increases the likelihood that complementary goods (e.g., software) will be developed for the machine (indirect network benefits).³²

Kahan and Klausner have suggested that contract terms can carry with them analogous network benefits.³³ That is, the users of a given contract term can conceivably benefit from other parties using the same term in their contractual relationships. Much like a computer, a contract term has inherent value to parties that adopt it, independent of its adoption elsewhere, and also a network value that increases as the number of other contracts in which the term appears increases. Contract terms might become more valuable as more parties adopt them, for example, because wider use of a term can lead to more judicial opinions interpreting the term. More interpretations, in turn, can benefit users of the term by reducing uncertainty over how the term would be interpreted by a court should the user become embroiled in litigation in the future.³⁴ Widespread use of a contract

externalities as "products for which the utility that a user derives from consumption of the good increases with the number of other agents consuming the good"; S.J. Liebowitz & Stephen E. Margolis, *Network Externality: An Uncommon Tragedy*, 8 J. ECON. PERSP. 133, 134 (1994) ("[G]oods exhibit a network externality wherever the consumer enjoys benefits or suffers costs from changes in the size of an associated network, that is, changes in quantities demanded").

30. See generally Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, 8 J. ECON. PERSP., Spring 1994, at 93, 94 (discussing fax machines).

31. See *id.* at 96.

32. See Klausner, *supra* note 25, at 772-73; see also Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 488-99 (1998) (using computer operating systems as an example of how network benefits can arise as a result of increasing returns based on positive feedback from the market); Liebowitz & Margolis, *supra* note 29, at 135 (distinguishing between direct and indirect network externalities).

33. See Klausner, *supra* note 25, at 774-89.

34. See *id.* at 776-77.

term can also create benefits for users by making lawyers³⁵ and other providers of legal services more facile in drafting, negotiating, interpreting, and, if need be, litigating the term. Such facility can create value to term users by increasing the quality of legal service and/or reducing its cost.³⁶ For contract terms important enough to affect a firm's value in the capital markets, widespread use of a term can lessen the difficulty that investment analysts will have in pricing a firm's securities, thus creating another type of network benefit.³⁷ In short, widespread use of a contract term can benefit users of the term by causing complementary goods (such as judicial precedents or professional services) to become more available, cheaper, or both.³⁸

Learning benefits arise from the same sources as network benefits, and they differ from their close cousins only temporally.³⁹ Network benefits accrue to users of a contract term when other parties choose to use the same term contemporaneously (i.e., the lives of the contracts that use the same term overlap). Learning benefits, in contrast, accrue to parties that select a contract term commonly used in the past (i.e., the contracts that create the positive externalities to the user are no longer active when the user adopts the term).⁴⁰ Learning benefits, for example, can take the form of existing judicial precedents that reduce uncertainty over interpretation of a term in the future and existing knowledge of and facility with a term on the part of legal and financial professionals.⁴¹

The promise of learning and network benefits could encourage firms to select default terms just as these benefits can provide an incentive for firms to adopt standard terms. This is because "a default term . . . may become a focal point around which a contractual network forms."⁴² Put another way, contracting parties might predict

35. Lawyers might have an independent incentive to favor commonly used terms. Kahan and Klausner have noted that lawyers are less likely to be criticized or, worse, sued, when misfortune arises from the use of a common term rather than a unique one. See Kahan & Klausner, *Path Dependence*, *supra* note 26, at 356.

36. See Kahan & Klausner, *Standardization*, *supra* note 25, at 725-27; Klausner, *supra* note 25, at 782-84.

37. See Klausner, *supra* note 25, at 785-86 (calling this type of benefit a "marketing network externalit[y]").

38. Cf. Liebowitz & Margolis, *supra* note 29, at 135 (describing indirect network externalities as a situation in which complementary goods become cheaper or more plentiful as the number of users of the primary good increases).

39. See Kahan & Klausner, *Path Dependence*, *supra* note 26, at 351 ("[N]etwork benefits mirror . . . learning benefits . . . but they arise in the future.").

40. See Klausner, *supra* note 25, at 786-88.

41. See Kahan & Klausner, *Standardization*, *supra* note 25, at 722-24; Klausner, *supra* note 25, at 786.

42. Klausner, *supra* note 25, at 828.

that, because of their salience, default terms will be adopted by most parties most of the time.⁴³ This assumption makes it rational for parties that wish to take advantage of learning and network benefits of contract terms to adopt defaults as well, regardless of whether the defaults have a higher inherent value than do alternative terms.

Kahan and Klausner point out that by incorporating in Delaware, corporations can effectively "purchase" a set of commonly used corporate law default terms, which permit incorporating firms to capture learning and network benefits.⁴⁴ The assumption that implicitly underlies the suggestion that contracting parties can take advantage of network benefits by adopting Delaware law is that most firms incorporated in Delaware do not contract around the default corporate contract terms in most instances. If firms systematically incorporated in Delaware, but then systematically contracted around Delaware default legal rules, the presumed network benefits of adopting Delaware law would not exist.⁴⁵

Similarly, when contracting parties are engaged in negotiations over contract terms, there will often be learning and network benefits that can be captured by accepting legal default terms, but only under the assumption that the default terms are commonly incorporated into other contracts. As long as this key assumption is accurate, learning and network benefits can reinforce the intrinsic value of a term that is favorable to a contracting party, and mitigate costs of an unfavorable term. Consequently, learning and/or network externalities could conceivably cause a bias among contracting parties for default terms, all other things equal.

While such an explanation is not consistent with the Coase Theorem in its most basic form, it is fully consistent with traditional law and economics more generally. It suggests that by favoring default terms, contract negotiators might rationally maximize the value of their contracts. Imagine that a particular contract term, "Term A," has an inherent value of "X" to a negotiating party, and an alternative term, "Term B," has an inherent value of "Y" to that same party. Imagine also that either term would have an additional value of "Z" if it were the default term, due to the learning and network benefits derived from the extensive adoption of default terms into other con-

43. Cf. Kahan & Klausner, *Path Dependence supra* note 26, at 350 ("Because many firms operate under the default rule, the default rule is, in effect, a standard contract term.").

44. See Kahan & Klausner, *Standardization, supra* note 25, at 718.

45. Under this set of assumptions, incorporating in Delaware would still permit a party to take advantage of network benefits created by that state's mandatory, or "immutable," terms, which, by definition, parties cannot contract around.

tracts. For some parties, the difference between the inherent value of the two terms (X minus Y) will be greater than the learning and network benefits associated with adopting the default term. For these parties, the designation of one of the terms as the default should not affect their preference for a term among the two options—the parties will contract for the term with the greatest inherent value. For other parties, however, the difference between the two terms' values might be small relative to the value of the learning and network benefits associated with using the default, such that $Z > (X \text{ minus } Y)$. While these parties might prefer one term over the other in the abstract, if a default term were identified, they would prefer the default regardless of defined intrinsic worth. As long as both types of parties exist across a large number of contracts, we should expect to see a bias in favor of the default term (even absent any transaction costs associated with contracting around the default). Such a result would be fully consistent with rational wealth-maximizing behavior.⁴⁶

B. Evaluating Network/Learning Benefits as Drivers of the Bias in Favor of Defaults

In theory, the incentive to capitalize on network and/or learning benefits could cause wealth-maximizing contracting parties to favor certain contract terms more when those terms are identified as legal defaults than when they are not.⁴⁷ But does the network/learning benefits account of contract term choice adequately explain the experimental results described above?

At first glance, the network/learning benefits account seems an unlikely explanation of the bias exhibited in favor of default terms in the experiments. Benefits from judicial interpretation of contract terms will be greatest when there is a wide range of terms in use to deal with a particular contracting contingency. In the experiments, however, subjects were told that there were only two terms to consider: If they contracted around the default of "limited liability," they

46. Cf. Klausner, *supra* note 25, at 791 (noting that network benefits can cause value-maximizing managers to adopt a term that is not socially optimal).

47. How significant network and learning benefits are in the context of contract terms is another question entirely, and one that is beyond the scope of this Article. One pair of commentators has vigorously disputed the practical value of the Kahan and Klausner application of network benefits theory to corporate contract terms. See Lemley & McGowan, *supra* note 32, at 568-70. Lemley and McGowan argue, for example, that specific contract terms gain little additional value from interpretation, and that the clarity to be gained from interpretations of open-ended terms is limited by the flexible nature of such terms and the relatively few reported decisions interpreting even common terms. See *id.* at 570-76.

could select only a "full liability" term (or vice versa); if they were to contract around the default of "no excuse," they could choose only the "impracticability excuse" term (or vice versa). Where choice of contract terms centers around two options, the advantage of the more common term relative to the less common term is likely to be small. This is because the less common term is still likely to be employed in a substantial number of cases, creating opportunities for judicial interpretation of the term. In addition, the experimental subjects—law students who had recently studied contract law—were aware that the more open-ended of the potential terms (that is, the terms that would benefit most from judicial interpretation) were default terms in at least some jurisdictions, even if they were not defaults in their jurisdiction. The limited liability term in the Consequential Damages scenario was taken from the famous case of *Hadley v. Baxendale*.⁴⁸ The impossibility excuse term is recognized in both the Restatement (Second) of Contracts⁴⁹ and the Uniform Commercial Code.⁵⁰ Consequently, when an experimental scenario did not identify these open-ended terms as the defaults in the subjects' hypothetical jurisdiction, it is plausible to hypothesize that at least some subjects likely assumed that the terms were common elsewhere, and thus the subject of a substantial number of judicial interpretations.

For similar reasons, it seems unlikely that the experimental subjects would have determined that a "limited liability" or "excuse" term (or their opposites) would be substantially more desirable when labeled the default because default status would suggest more familiarity with the terms among legal and financial professionals. Although common terms might have benefits over obscure terms in this regard, providers of professional services are likely to develop expertise not only with the *most common* contract terms, but also with other *fairly common* terms. Another way of putting this is to say that, after the use of a term reaches a critical level, there is unlikely to be much, if any, marginal benefit to users of that term when addi-

48. 156 Eng. Rep. 145 (Ex. 1854).

49. See RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981) ("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.").

50. See U.C.C. § 2-615(a) (1989) ("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-occurrence of which was a basic assumption on which the contract was made . . .").

tional parties employ the term.⁵¹ Nothing in any condition of the experimental scenarios suggests that the terms not identified as defaults are obscure. Consequently, it might have been quite reasonable for parties to assume that maximum network benefits could be captured by using either of the terms—the default or the alternative—offered in the experiments.

Although it seems unlikely that the observed bias in favor of default terms was created by subjects' desire to capture learning or network benefits they assumed would be associated with the default terms, this explanation cannot be ruled out based on the experimental results described above. Consequently, to better understand the observed bias in favor of default terms, it is necessary to explicitly test the learning and network benefits hypotheses.

1. Controlling for Learning Benefits of the Status Quo

According to Kahan and Klausner's nomenclature, parties accrue learning benefits from the use of a contract term prior to the formation of their contract. Thus, if learning benefits were the main driver of the bias in favor of default terms, it should matter little (if at all) if the former default term were no longer the default. That is, if a change in the law alters the default rule at approximately the same time as contract formation, negotiators concerned with capturing learning benefits associated with past use of the term should prefer the "old" default term to the "new" default term. If the identity of the default term were to change shortly before contracting and negotiators demonstrated a bias in favor of the "new" rather than the "old" default, this would suggest that factors other than learning benefits were driving the bias. The following experiment, based on the NextDay/Gifts, Inc. fact pattern described above, suggests that the bias in favor of default terms can persist—and persist strongly—even when there are no learning benefits associated with accepting the default.

To test the strength of the bias in favor of default terms in the absence of learning benefits, the Impossibility Excuse scenario was manipulated such that the default term had no learning benefits associated with it. Condition 3 subjects were told that, under their

51. Cf. Liebowitz & Margolis, *supra* note 29, at 140 ("[T]he fact that other people use the same sort of VCR that we use makes a tape rental market available to us, but the marginal benefits of increasing the number of households that own our kind of VCR are likely exhausted now that businesses that rent videotapes are about as prevalent as ones that sell milk").

state's law, impossibility or impracticability was not a valid excuse for non-performance until just last year. Now, however, under a recently enacted law, impossibility does constitute a valid excuse, unless the parties determine otherwise by contract.⁵² As was the case in condition 1, subjects were then advised that Gifts, Inc. was planning to offer NextDay a side payment to accept an explicit provision disclaiming impossibility as a valid excuse. Subjects were asked to state the lowest amount they would recommend NextDay accept to include the provision.⁵³

Condition 4 subjects were given opposite information about the default rule. They were told that impossibility had been a valid excuse under their state's law until recent legislation eliminated the excuse unless, of course, individual parties explicitly provided for the excuse in their contracts. They were asked for the maximum amount they would recommend NextDay pay Gifts, Inc. in return for Gifts, Inc. agreeing to include an explicit "excuse" provision in the contract.⁵⁴

Since condition 3 subjects were told that the default rule traditionally had been one of "no excuse," whatever learning benefits might have been accrued by contracting for a "no excuse" term were virtually identical to those available to condition 2 subjects, who had been informed that the default rule (past and present) did not permit the impossibility excuse.⁵⁵ If the status quo bias in favor of the default term noted in the original Impossibility Excuse scenario were driven by the potential for learning benefits, the responses of condition 3 subjects should be similar to, if not identical to, those of condition 2 subjects. In contrast to condition 2, however, condition 3 subjects were placed in a position where *inaction* (i.e., not agreeing to include the proposed provision) would result in a contract honoring the impossibility excuse, whereas *action* (i.e., including an additional term in the contract) would result in a contract without the impossibility excuse. Therefore, if the original status quo bias were driven by a preference for inaction over action, all other things equal, condition 3 subject responses should be similar to those of condition 1 subjects, who had been informed that the default rule provided for the impossibility excuse.⁵⁶

Precisely the opposite set of predictions follow for condition 4 subjects, whose state provided the traditional default rule of impossi-

52. See *infra* Appendices B3-B4.

53. See *infra* Appendix B3.

54. See *infra* Appendix B4.

55. See *infra* Appendix B2; see also *supra* notes 20-22 and accompanying text.

56. Compare Appendix B3, with Appendix B1.

bility as a valid excuse. The learning benefits, therefore, associated with contracting for an explicit "excuse" term were roughly identical to those that could be obtained by condition 1 subjects simply accepting the "excuse" default.⁵⁷ A preference for inaction, however, would suggest that condition 4 subjects would accept a contractual arrangement absent the impossibility excuse, whereas the affirmative action of adding a contract provision would result in a valid impossibility excuse—the same situation faced by condition 2 subjects.⁵⁸ If the status quo bias originally resulted from a preference for inaction (all other things equal), condition 4 subjects' answers should parallel those of condition 2 subjects. If the status quo bias resulted from the perceived presence of learning benefits, the responses of condition 4 subjects should be similar to those provided by condition 1 subjects.

The results of this manipulation support the hypothesis that the bias in favor of default terms exhibited by the original experimental subjects was not driven by subjects' attempts to capture learning benefits.⁵⁹ Condition 3 subjects (N=23) said, on average, that they would recommend demanding at least \$139,000 to include a "no excuse" term in the contract—even though they were informed that "no excuse" was historically the default term. On the other hand, condition 4 subjects (N=24) said, on average, that they would recommend paying no more than \$31,000 to include a term providing an impossibility excuse—even though they were told that the impossibility excuse was the historical default term. The gap between the responses of condition 3 and condition 4 subjects is highly significant,⁶⁰ and it is not significantly different than the gap between the responses of condition 1 and 2 subjects. In other words, subjects' responses suggest that a desire to capture learning benefits played no role in their decision making.

57. Compare Appendix B4, with Appendix B1.

58. Compare Appendix B4, with Appendix B2.

59. See *infra* Table 2.B. The findings presented here are consistent with those of Ritov & Baron who, in other contexts, attempted experimentally to disentangle preferences for inaction from preferences for the substantive status quo. See Ilana Ritov & Jonathan Baron, *Status-Quo and Omission Biases*, 5 J. RISK & UNCERTAINTY 49 (1992). In one experiment, the subjects said that hypothetical actors who suffered a negative event would feel worse if they had taken an affirmative step to maintain the status quo (which resulted in the negative event occurring) than if they had passively allowed a change from the status quo (which resulted in the negative event occurring). See *id.* at 51-54. In another experiment, subjects preferred inaction over action, but did not significantly prefer the status quo over alternatives when the action/inaction distinction was controlled. See *id.* at 54-57.

60. $p < .001$.

Table 2.B. Impossibility Excuse Results

<i>Condition</i>	<i>N</i>	<i>Default Rule</i>	<i>Mean Valuation</i>
1	22	Excuse	\$188,000
2	25	No Excuse	\$ 56,000
3	23	Excuse (previously <i>no excuse</i>)	\$139,000
4	24	No Excuse (previously <i>excuse</i>)	\$ 31,000

These results strongly imply, in essence, that contracting parties with a preference for the status quo are likely to treat the term that would result from inaction—*not* the term that they have traditionally understood to be the substantive default—as the “status quo” term. The practical policy implication of this is that lawmakers can probably change private parties’ preferences for contract terms quickly by altering contract default rules via legislation or judicial decision. For example, although the impossibility excuse has a long common law pedigree⁶¹ and a firm place in the Uniform Commercial Code,⁶² if legislators or judges were to announce tomorrow that parties must affirmatively include an impossibility provision in the contract or else the “no excuse” rule will govern, contracting parties’ preference for the excuse would likely decline sharply, even absent transaction costs or other impediments to bargaining. The path of least resistance, not ingrained historical tradition, appears to define the status quo for contracting parties.

The obvious shortcoming of this experimental test is that, while it suggests that a bias among contracting parties for default terms can persist even in the absence of learning benefits, it does not control for the possibility that the bias is due entirely to perceived network benefits. The experimental results are arguably consistent with⁶³ the hypothesis that contracting parties favor *current* default

61. See RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981).

62. See U.C.C. § 2-615(a) (1989).

63. If the bias in favor of default terms demonstrated in the initial experiments was driven by a combination of learning and network benefits, then the difference between the mean responses of condition 3 and condition 4 subjects should have been smaller (not larger) than the difference in responses between condition 1 and condition 2 subjects, even if subjects had consciously or unconsciously assumed that network benefits would be greater than learning benefits. In conditions 1 and 2, learning and network benefits both pointed toward accepting the term identified as the default. In conditions 3 and 4, however, learning and network benefits were in conflict, so the benefits of accepting the current default term in order to capture network benefits should have been tempered by the cost of giving up learning benefits associated with the former default term.

terms because of perceived network benefits associated with selecting the term most parties would likely use in the future. The following experiment demonstrates more clearly that there is likely to be a bias in favor of default terms even absent both learning and network effects.

2. Standard Industry Practice vs. Legal Defaults

Contracting parties would derive learning and network benefits by accepting default contract terms only on the assumption that most similarly situated parties, past or present, would also accept the default terms.⁶⁴ It is conceivable, of course, that it would be more common for contracting parties to opt out of a particular default term than to accept it. In such a circumstance, considerations of learning and network benefits associated with common usage should cause parties to favor contracting around the default rule, all other things equal, rather than the reverse. The following experimental manipulation of the Impossibility Excuse scenario suggests, however, that a preference for default terms, all other things equal, might persist, even when both learning and network benefit considerations would support the abandonment of the default.

Subjects responding to condition 5 of that scenario were told—like condition 1 subjects⁶⁵—that (1) the default rule allows impossibility as a valid excuse for non-performance; (2) Gifts, Inc. planned to offer NextDay a side payment if NextDay would include a term in the contract specifying that impossibility would not be a valid excuse in the parties' dealings; and (3) the subjects were to recommend the minimum amount NextDay should be willing to accept in return for agreeing to include the proposed term in the contract.⁶⁶ Condition 5 subjects, however, were also given one additional piece of information: Provisions like the one proposed by Gifts, Inc. are quite common—in fact, they are included in the vast majority of commercial shipping contracts, including the majority of NextDay's contracts with commercial shippers.⁶⁷

Condition 6 subjects learned—as did condition 2 subjects⁶⁸—that (1) the default rule was “no excuse;” (2) NextDay would have to offer Gifts, Inc. a side-payment to include a term providing an

64. See *supra* notes 33-43 and accompanying text.

65. See *infra* Appendix B1; see also *supra* note 17 and accompanying text.

66. See *infra* Appendix B5.

67. See *infra* Appendix B5.

68. See *infra* Appendix B2; see also *supra* note 18 and accompanying text.

impossibility excuse in the parties' contract; and (3) the subjects were to recommend a maximum amount that NextDay should offer for the inclusion of the term.⁶⁹ Condition 6 subjects received the same additional instruction as condition 5 subjects: that contracting around the default rule is common industry and company practice.⁷⁰ The implication of this instruction to condition 6 subjects, however, was that "excuse" terms are common in the industry and to NextDay, while the implication to condition 5 subjects was that "no excuse" terms are common for other shipping contracts, including NextDay's.

If the bias in favor of default terms observed in the initial experiment were based on perceived learning and/or network benefits that might be derived by adopting the more common term, subjects in condition 5 should provide responses similar to those of condition 2 subjects (both groups might have believed that the "no excuse" term was the more common one), rather than providing responses similar to those of condition 1 subjects (who should have assumed an "excuse" term was more common). For the same reason, subjects in condition 6 should have provided responses similar to those of condition 1 subjects, not condition 2 subjects.

The results of the manipulation did not support the hypothesis that subjects would favor a common term over a default term.⁷¹ Condition 6 subjects (N=18) provided an average "willingness to pay" value of \$20,000, while condition 5 subjects (N=18) provided a much higher average response of \$63,000. The difference between the responses provided by condition 5 and 6 subjects is significant,⁷² and is not significantly smaller than the difference between the responses of condition 1 and 2 subjects and condition 3 and 4 subjects. In other words, manipulating the information subjects were given about whether the alternative was commonly used by contracting parties⁷³ had no significant effect on subjects' bias in favor of the legal default term.

69. See *infra* Appendix B6.

70. Compare Appendix B6, with Appendix B5; see also *supra* note 67 and accompanying text.

71. See *infra* Table 2.C.

72. $p < .05$.

73. See *infra* Appendices B5-B6.

Table 2.C. Impossibility Excuse Results

<i>Condition</i>	<i>N</i>	<i>Default Rule</i>	<i>Mean Valuation</i>
1	22	Excuse	\$188,000
2	25	No Excuse	\$ 56,000
3	23	Excuse (previously <i>no excuse</i>)	\$139,000
4	24	No Excuse (previously <i>excuse</i>)	\$ 31,000
5	18	Excuse (industry norm: <i>no excuse</i>)	\$ 63,000
6	18	No Excuse (industry norm: <i>excuse</i>)	\$ 20,000

These results provide support for the supposition that the bias in favor of default terms is driven by more than a sophisticated, profit-maximizing intuition that learning and/or network benefits often counsel toward accepting default terms. Although learning and/or network benefits might underlie a preference for common terms in some instances, a general preference for inaction among contracting parties is likely to be a more important explanation for preferences for default terms.⁷⁴ This can be called the “inertia theory” of contract negotiation.

C. Form Contracts and the Power of Inertia

Assuming that the “inertia theory” explains the observed bias in favor of default terms (i.e., a general preference for inaction over action, all other things equal), the next question to consider is whether contract terms other than previous default terms can embody that power of inertia. In the previous experimental manipulation, subjects were given the choice between a legal default and an industry-standard contract term. The way the choice was posed suggested that *inaction* on the part of the negotiating parties would result in the operation of the default term rather than the industry standard. The action/inaction dichotomy can be reversed by making

74. It is important to emphasize that the experimental results *do not* suggest that contracting lawyers never favor common terms in order to maximize network and/or learning benefits inherent in such terms. It is possible, for example, that practicing lawyers are more sophisticated about such benefits than the student subjects who participated in the experiments. But the experiments clearly suggest that network and/or learning benefits are not likely to fully explain the preference for default terms.

the following reasonable assumption: Parties sometimes begin contract negotiations with a standardized form contract drafted by a private entity such as a law firm or an industry trade association, rather than with a blank sheet of paper backstopped by a set of legally defined default rules which will be operative except where the parties affirmatively contract around its terms. If the action/inaction distinction underlies the observed bias in favor of default terms, the use of a form contract as a basis for negotiations should create a similar bias in favor of the form terms. This hypothesis was tested in the following manipulation of the Consequential Damages scenario.

Like subjects in the original Consequential Damages scenario, subjects in the new manipulation (conditions 3 and 4) were asked to value the difference between a contract that would hold NextDay liable to Gifts, Inc. for all consequential damages caused by NextDay's failure to meet its delivery obligations, and a contract that would limit NextDay's liability to damages that were reasonably foreseeable at the time that Gifts, Inc. delivered any particular package to NextDay for shipment. Unlike subjects in the original experimental groups, the new subjects were told that the two companies had "agreed to adopt, as a starting point in negotiations, a standard form contract prepared by attorneys for the Overnight Delivery Trade Association ("ODTA"), to which both parties are members."⁷⁵ The form contract, the subjects were informed, "is typically used as a basis for negotiations in this type of transaction, with contracting parties making changes to the form provisions where necessary."⁷⁶

Condition 3 subjects were informed that the industry form contract included a term that provided damages would be limited to those "reasonably foreseeable when Carrier accepted merchandise from shipper," whereas the default rule that would govern the parties in the absence of any explicit term was one of full liability. They were asked to state the minimum amount, per package, that they would demand Gifts, Inc. offer NextDay, over and above what the contract rate would otherwise be, before they would recommend that NextDay agree to remove the favorable "limited liability" consequential damages term from the form contract, thus allowing the less favorable "full liability" default term to govern.⁷⁷ Condition 4 subjects were told that the industry form contract provided for full liability, whereas the legal default was one of limited liability. They were asked to reveal

75. Appendices A3-A4.

76. *Id.*

77. *See infra* Appendix A3.

the maximum amount of money NextDay should be willing to offer Gifts, Inc. (in the form of a per-package discount below what the contract price would otherwise be) in return for Gifts, Inc. agreeing to eliminate the form contract term providing "full liability," thus permitting the "limited liability" default to govern.⁷⁸

If inertia were driving the subjects' bias in favor of the legal default term over a contrary industry norm in the previous experimental manipulation, subjects responding to condition 3 of the Consequential Damages scenario should have provided larger responses than condition 4 subjects. Notice that from a Coasean perspective both groups of subjects were asked to perform the same task: place a value on the difference between a contract with a limited liability term and one with a full liability term. If parties do prefer inaction over action, however, condition 3 subjects should have placed a higher value on the limited liability term than condition 4 subjects, because limited liability would result from inaction for condition 3 subjects but not for condition 4 subjects.

The experimental results bear out the inertia hypothesis. Condition 3 subjects (N=33) revealed that they would demand, on average, a minimum of \$7.24 per package before recommending NextDay agree to remove the limited liability term from the industry form contract (leaving a full liability default to govern the contract). Condition 4 subjects (N=25), in contrast, would recommend, on average, that NextDay offer Gifts, Inc. a maximum discount of \$4.08 per package in return for Gifts, Inc. agreeing to remove a full liability term from the industry form contract (leaving a limited liability default). The difference between the condition 3 and 4 Consequential Damages subjects is statistically significant,⁷⁹ and the gap between condition 3 and 4 subjects is not significantly different than the gap between condition 1 and 2 Consequential Damages subjects. In other words, the experimental subjects showed a bias in favor of whatever consequential damages term would govern as a result of inertia (requiring no action at all on the part of the negotiating parties). Whether the term associated with inaction was derived from a legal default rule or an industry form contract serving as the basis for contract negotiations had no statistically significant effect on subjects' average responses.

78. See Appendix A4.

79. $p < .001$.

Table 1.B. Consequential Damages Results

<i>Condition</i>	<i>N</i>	<i>Default Rule</i>	<i>Mean Valuation</i>
1	26	Limited liability	\$6.96/package
2	28	Full liability	\$4.46/package
3	33	Full [form contract: limited]	\$7.24/package
4	25	Limited [form contract: full]	\$4.08/package

Notice that if this experimental result were examined alone, it would be plausible to hypothesize that the difference in responses between condition 3 and 4 subjects was driven by learning and/or network benefits associated with adopting the contract term provided by an industry trade association. But this analysis seems far less plausible when the results are compared to those of the previous version of the Impossibility Excuse scenario.⁸⁰ If learning and/or network benefits were driving the experimental results, subjects should always prefer, all else equal, either the standard industry term or the legal default term, depending upon which of these terms the subjects believed would likely provide the greatest benefits. But subjects would not be expected to exhibit a bias in favor of a legal default (and against an industry standard) in one case and for an industry standard (and against a legal default) in another case. The results considered in combination provide better support for the theory that contracting parties will prefer—again, all else equal—contract terms that operate without the parties taking any affirmative actions.

D. Prescriptive Implications

The psychological power of inertia suggests that negotiators who are able to define the status quo position, against which all proposed terms are judged, are likely to enjoy an important bargaining advantage. Before negotiating terms of a contract, a strategic negotiator should evaluate which of many plausible reference points for negotiations is most advantageous to her client's interests. Initial efforts to convince the opposing negotiator that the advantageous reference point is the most natural or reasonable from which to begin negotiations may have a large impact on the outcome of those negotiations. The initial terms are likely to be perceived as the terms that will govern the parties' relationship if no further action takes place, and thus as the status quo.

80. See *supra* Part III.B.2.

The prescriptive advice that negotiators should invest time and resources in attempting to control the initial reference point for contract negotiations is, of course, not unique to this Article. But the underlying reasoning for this advice—that terms understood as the status quo, or baseline, are likely to be sticky because negotiators will prefer inaction over action—differs from conventional wisdom. Implicit in conventional recommendations to negotiators to control the beginning point of negotiations is often the Coasean notion of the power of transaction costs. When contracting is expensive or difficult, an initial proposal is likely to find its way into the final version of the contract. Another common justification is rooted in the information asymmetries that commonly exist in negotiating situations. Since a negotiator is usually unaware of his opponent's reservation point, he may be wary of suggesting changes that depart drastically from what appears to be the status quo, for fear that the proposal might be inferior to the opponent than the opponent's no agreement alternatives.⁸¹ Thus, proposing a drastic departure from the status quo could lead to a bargaining impasse. Finally, any proposal favorable to the negotiator, whether or not it serves as an initial reference point, is likely to affect the final agreement if there is a strong social norm, or convention, requiring that parties "split the difference" between conflicting positions.

The psychological power of inertia, in contrast, suggests that the reference point for contract negotiations will affect the *preferences* of bargaining parties. Negotiators will prefer an advantageous term more strongly (or oppose a disadvantageous term less strongly) if the term is perceived to result from inaction rather than from action. Traditional accounts of the power of beginning points in negotiation emphasize factors external to the negotiator that might impose costs on deviations from the perceived status quo and, therefore, make parties more likely to adopt status quo terms. The inertia theory emphasizes the negotiator's internal response to the perceived status quo that can actually increase the parties' desire for certain terms.

81. In negotiation jargon, a negotiator's best "no agreement" alternative is known as his "BATNA," short for "best alternative to a negotiated agreement." See ROGER FISHER & WILLIAM URY, *GETTING TO YES: NEGOTIATING AGREEMENT WITHOUT GIVING IN* 97-106 (2d ed. 1991).

IV. UNCERTAINTY AND ANTICIPATORY REGRET

If transaction cost and learning/network benefits explanations are unsatisfying, why would contracting parties systematically favor contract terms that would operate in the event of inaction? In this Part, I propose an explanation rooted in emotional consequences of actions rather than calculated cost-benefit analysis.⁸² The theoretical hypothesis, for which I will provide empirical support, is that a preference for inaction is consistent with a decision-making strategy that seeks to minimize the likelihood of future regret over choices made.

A. *Counterfactual Thinking, Norm Theory, and Regret Theory*

I have previously suggested that a bias in favor of contract default terms might result from the parties' fear of regretting decisions to act affirmatively that turn out, in hindsight, to have led to undesirable, or suboptimal, results.⁸³ This Part elaborates on this theory and extends the theory to all terms that result from inertia. The following Part provides new experimental evidence supporting the theory.

A plausible explanation of the power of inertia is that negotiators fear they will suffer regret in the future over deciding to actively shape contract terms and, therefore, will act to minimize the possibility of experiencing such regret.⁸⁴ In most situations, contracting for terms that deviate from default rules or form contracts carries the risk of suboptimal results from the ex post perspective. That is, a negotiator knows when she contracts around a baseline or reference contract term that she is taking a gamble of sorts, which may or may not be profitable, depending upon unknown future circumstances. If a negotiator anticipates that an unprofitable ex post outcome would

82. Cf. Jonathan Baron, *The Effect of Normative Beliefs on Anticipated Emotions*, 63 J. PERS. & SOC. PSYCHOL. 320, 320 (1992) ("[E]motions, and the anticipation of these emotional consequences can affect the choice of options").

83. See Korobkin, *The Status Quo Bias*, *supra* note 5, at 657-60.

84. Cf. Richard P. Larrick, *Motivational Factors in Decision Theories: The Role of Self-Protection*, 113 PSYCHOL. BULL. 440, 440 (1993) ("Many decisions can be understood in terms of a desire to avoid the unpleasant psychological consequences that result from a decision that turns out poorly. Making a choice can be threatening to the self because a poor outcome can undermine one's sense of competence as a decision maker."); Marcel Zeelenberg et al., *Consequences of Regret Aversion: Effects of Expected Feedback on Risky Decision Making*, 65 ORG. BEHAV. & HUM. DECISION PROCESSES 148, 149 (1996) (noting that people sometimes avoid taking risks because they anticipate feeling regret if the worst outcome occurs).

cause her to regret having chosen the gamble *ex ante*,⁸⁵ she might demand a premium above the expected value of the gamble before she would be willing to choose the gamble.⁸⁶ Put another way, when deciding whether to take an action with uncertain consequences, the decision maker may determine that the expected utility of *choosing* the action is lower than the inherent expected utility of the action itself.⁸⁷

This description could plausibly apply to both experimental scenarios discussed in this Article. In the Consequential Damages scenarios, for example, subjects are informed by NextDay's accountants that costs associated with accepting full liability rather than limited liability are likely to fall between \$0 and \$10 per package, on average. One interpretation of this prediction is that the expected cost of agreeing to full liability when the inactive option is limited liability is approximately \$5 per package.⁸⁸ But there is no guarantee that if NextDay agreed to actively add a full liability term to the contract for a \$5 per-package premium the bargain would later appear favorable in hindsight. In fact, there is roughly a 50% chance that the

85. Note that the regret arises from having made the decision rather than from the outcome itself. See David E. Bell, *Regret in Decision Making Under Uncertainty*, 30 OPERATIONS RES. 961, 962 (1982). It is important to distinguish this negative effect from the disappointment that arises from the negative result itself.

86. It is perhaps important to observe that in most situations in which negotiators must choose between two contract terms, they can expect to learn at a later date how the outcome of their decision compares with the foregone alternative. Other researchers have demonstrated that choices made when the outcome of all alternatives will be known *ex post* can differ from choices made when only the outcome of the chosen alternative will ever be known. See, e.g., Ilana Ritov, *Probability of Regret: Anticipation of Uncertainty Resolution in Choice*, 66 ORG. BEHAV. & HUM. DECISION PROCESSES 228, 233-34 (1996) (finding that subjects choosing between two lotteries with different probabilities of winning and different dollar amounts but similar expected values made different choices depending if they knew they would learn the results of the lottery not chosen than if they would not learn these results). In a recent paper, Chris Guthrie demonstrated that subjects believe litigants are more likely to accept a given settlement offer if they know that they will learn what the results of adjudication would have been (and thus face the possibility of regret) than if they will never learn what would have happened in court. See Chris Guthrie, *The Anticipatory Regret Theory of Litigation*, 40-41 (March 1998) (unpublished draft, on file with the author); see also Zeelenberg et al., *supra* note 84, at 156 (demonstrating experimentally that individuals tend to avoid choices when they would learn the consequences that would have resulted from another choice). Consequently, it is plausible that fear of regret will not affect negotiators if they are confident they will never learn whether an alternative not chosen would have led to better results than the alternative chosen.

87. See generally Graham Loomes & Rebert Sugden, *Regret Theory: An Alternative Theory of Rational Choice Under Uncertainty*, 92 ECON. J. 805, 807-08 (1982).

88. To be precise, the expected cost of switching from limited to full liability is some amount greater than \$5 per package, as the scenario indicated that there was a 5% chance actual damages would not fall in the \$0-\$10 per-package range. The simplified assumption of a \$5 per-package cost is used here merely to illustrate the thought process some subjects might have used.

bargain will appear unfavorable in hindsight. Perhaps the fear that a negative outcome would lead to regret over the decision to contract for full liability caused experimental subjects to demand more than the inherent expected value of the gamble before they were willing to affirmatively agree to take it.

This explanation and illustration beg two difficult questions. First, why would subjects fear the possibility of contracting for full liability and having the decision turn out to be unprofitable in hindsight *more* than they would fear *not* contracting for full liability and having that decision turn out to be suboptimal in hindsight? It is intuitive that a person who takes what turns out to be a losing gamble might regret taking that gamble. It is less intuitive why the fear of regret associated with taking action would be greater than the fear associated with failing to act when (what turns out to have been) a profitable opportunity presented itself. If parties fear the possibility of future regret when they choose to act affirmatively but fear the possibility of future regret equally when they choose not to act, there should be no bias in favor of contract terms that take effect in the event of inaction.⁸⁹

In fact, there is a sound theoretical reason to believe that parties might feel just as much regret if their failure to actively contract for a term turns out (in hindsight) to be a suboptimal decision. Failing to actively contract for a term is to actively contracting for a term as opportunity costs are to out-of-pocket costs. From a traditional economic perspective, opportunity costs and out-of-pocket costs should be treated identically. A dollar not made has the same value as a dollar lost, and, similarly, an opportunity to add a favorable term to a contract should have the same value if it is taken that it has if it is not taken.

The second question raised by the regret avoidance hypothesis is why would the *fear* of possible regret that strikes an actor when he considers acting affirmatively not be balanced by the *hope* of rejoicing—the emotional opposite of regret⁹⁰—should the action yield desirable results? It is intuitively plausible that an actor facing a choice with uncertain results might be hesitant to act because an

89. Cf. Bell, *supra* note 85, at 970-71 (hypothesizing that when considering a gamble with long odds, "the consequence with the largest regret is that in which you choose not to bet").

90. See Loomes & Sugden, *supra* note 87, at 808 (defining rejoicing as "the extra pleasure associated with knowing that, as matters have turned out, [the decision maker] has taken the best decision"). But see Janet Landman, *Regret and Elation Following Action and Inaction: Affective Responses to Positive Versus Negative Outcomes*, 13 PERS. & SOC. PSYCHOL. BULL. 524, 525 (1987) (defining the opposite reaction to "regret" as "joy" or "elation").

undesirable result could yield regret. However, it also seems plausible that the actor might be spurred to action because a desirable outcome could yield rejoicing. That is, if an actor takes action that yields a desirable outcome, he might enjoy utility not only from the positive result but also from the knowledge that he made the decision that led to the positive result.⁹¹ If anticipated regret and anticipated rejoicing caused by action are roughly equal, there should be no general preference for inaction.

1. Action vs. Inaction

Substantial experimental evidence suggests that individuals predict that greater regret will follow an action that leads to an undesirable result than a failure to act that leads to the same undesirable result.⁹² Thus, acts and nonacts, while not "ontologically or logically distinct, are psychologically distinguishable."⁹³

Consider the following, well-known experiment conducted by Daniel Kahneman and Amos Tversky.⁹⁴ Experimental subjects were told a story of two hypothetical actors who had both made unfortunate investment decisions. Mr. Paul owned stock in Company A. He considered switching his holdings to Company B, but decided not to switch. Subsequently, he learned that he would have been \$1200 better off had he made the switch. Mr. George owned stock in Company B. He considered switching to Company A and made the switch. Consequently, he was \$1200 worse off than he would have been had he not made the switch.⁹⁵ An astounding 92% of experimental subjects judged that Mr. George would feel more regret about his decision than would Mr. Paul.⁹⁶

91. See Loomes & Sugden, *supra* note 87, at 808.

92. This conclusion has been called "perhaps the clearest and most frequently replicated finding in the entire literature on counterfactual thinking." Thomas Gilovich & Victoria Husted Medvec, *The Experience of Regret: What, When, and Why*, 102 *PSYCH. REV.* 379, 380 (1995).

93. Landman, *supra* note 90, at 526; cf. Thomas Gilovich et al., *Commission, Omission, and Dissonance Reduction: Coping with Regret in the "Monty Hall" Problem*, 21 *PERS. & SOC. PSYCHOL. BULL.* 182, 182 (1995) ("Consequentialist moral philosophers argue that there is no difference between actions and inactions that lead to the same outcome . . . Psychologists know better.").

94. See Daniel Kahneman & Amos Tversky, *The Simulation Heuristic*, in *JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES* 201 (Daniel Kahneman et al. eds., 1982) [hereinafter Kahneman & Tversky, *The Simulation Heuristic*].

95. See Daniel Kahneman & Dale T. Miller, *Norm Theory: Comparing Reality to Its Alternatives*, 93 *PSYCHOL. REV.* 136, 145 (1986) (describing the Kahneman and Tversky experiment).

96. See *id.*

This finding was replicated by Janet Landman in a set of similarly designed experiments.⁹⁷ Subjects were told three stories: a story of two students who received undesirable grades relative to a peer, one after switching into a class and one after choosing not to switch out of a class; a story of two workers who were laid off, one after changing jobs and one after deciding not to change jobs; and finally, a story of two families whose vacations were ruined by rain, one after switching to a new vacation venue and one after deciding to forego other options and return to their traditional vacation venue.⁹⁸ For each of the three vignettes, between 79% and 88% of subjects anticipated that the parties who acted would feel greater regret than parties who did not act.⁹⁹

The differential fear of ex post regret stemming from action over inaction is consistent with a range of other experimental and survey results, as well as a number of observable rules and regulations that seem otherwise difficult to explain. The actual experience of differential regret can explain why subjects in a blackjack experiment who responded "yes" to the question "do you want a hit?" or "do you want to stand?" and subsequently lost to the dealer reported feeling more regret than subjects who answered "no" to either question and lost the hand.¹⁰⁰ It can also explain why subjects given a box containing a prize of uncertain value who elected to switch boxes only to learn they ended up with the less valuable prize placed a higher value on that prize than subjects who kept their original box and later learned they had the same, less valuable prize.¹⁰¹ Decision-making strategies geared toward avoiding this differential regret can explain why people would choose not to vaccinate their children when vaccination can sometimes cause the targeted disease, even when the risk of contracting the disease is greater without vaccination.¹⁰² And it can

97. See Landman, *supra* note 90.

98. See *id.* at 528-29.

99. See *id.* at 530.

100. See Dale T. Miller & Brian R. Taylor, *Counterfactual Thought, Regret, and Superstition: How to Avoid Kicking Yourself*, in WHAT MIGHT HAVE BEEN: THE SOCIAL PSYCHOLOGY OF COUNTERFACTUAL THINKING, 305, 318 (Neal J. Roese & James M. Olson, eds., 1995) [hereinafter WHAT MIGHT HAVE BEEN].

101. See Gilovich et al., *supra* note 93, at 184-86. The experimenters concluded that the greater regret felt by subjects who had switched boxes and obtained an undesirable outcome than by subjects who had not acted required them to take greater steps to reduce dissonance by placing a high value on the prize they acquired. See *id.* at 186.

102. See Ilana Ritov & Jonathan Baron, *Reluctance to Vaccinate: Omission Bias and Ambiguity*, 3 J. BEHAV. DECISION MAKING 263 (1990). Ritov & Baron conclude their discussion of a series of experiments with the observation that "subjects are reluctant to vaccinate when the vaccine can cause bad outcomes, even if the outcomes of not vaccinating are worse." *Id.* at 275.

even plausibly explain such apparently baffling rules as the Spanish prohibition against matadors switching bulls prior to a bullfight.¹⁰³

The regret that arises from the occurrence of undesirable events can be understood as a response to what is known as "counterfactual thinking."¹⁰⁴ The occurrence of a negative event can cause people to attempt to mentally avoid the outcome by comparing the event to a counterfactual alternative,¹⁰⁵ that is, to some conception of "what might have been."¹⁰⁶ If the counterfactual event is perceived by the subject as more favorable than the experienced event, the subject is likely to experience regret.¹⁰⁷ In order to understand what type of events are likely to lead to the most regret, then, it is important to understand the process by which counterfactual alternatives are mentally constructed.

Daniel Kahneman and Dale Miller developed "norm theory"¹⁰⁸ to provide just such an explanation.¹⁰⁹ Kahneman and Miller theorize that counterfactual alternatives are constructed by beginning with the circumstances of the experienced event and then changing one or more elements of the factual predicate of the experienced event to create a different outcome.¹¹⁰ Individuals will tend to alter what Kahneman and Miller term the most "mutable" elements of the experienced event's factual predicate.¹¹¹ Elements of the experienced event that are considered abnormal or exceptional by a subject are most mutable; elements that are perceived as normal or usual, in contrast,

103. See Miller & Taylor, *supra* note 100, at 315.

104. For a good compilation of articles on this subject, see generally WHAT MIGHT HAVE BEEN, *supra* note 100.

105. See Neal J. Roese & James M. Olson, *Counterfactual Thinking: A Critical Overview*, in WHAT MIGHT HAVE BEEN, *supra* note 100, at 19-21 (reviewing evidence suggesting counterfactual thinking is more likely to follow negative outcomes than positive ones); see also Landman, *supra* note 90, at 532-34 (finding that positive outcomes did not lead to counterfactual thoughts). Social psychologists believe that positive events are likely to lead to counterfactual thoughts only when a negative event is very close to occurring. See Roese & Olson, *supra*, at 38.

106. Kahneman & Miller, *supra* note 95, at 136.

107. See Roese & Olson, *supra* note 105, at 37 (noting that it is "difficult to experience regret per se without first noting that things might have turned out better").

108. Kahneman & Miller, *supra* note 95.

109. Although the original article describing norm theory was published in 1986, it remains the key theoretical underpinning of current research in the field of counterfactual thinking. See Neal Roese & Jim Olson, *Preface*, in WHAT MIGHT HAVE BEEN, *supra* note 100, at vii-viii (calling the article a "milestone" in the field and "one of the most influential theoretical statements to have emerged in the 1980s").

110. See Roese & Olson, *supra* note 105, at 3 ("[A] counterfactual typically posits one possible world that is imaginably very close to the real world, containing only a very few (or just one) features that differentiate it from this world").

111. Cf. Kahneman & Miller, *supra* note 95, at 137.

are less mutable, and at the extreme are immutable.¹¹² Judgments of abnormality, in turn, are based on the availability of possible alternative events in the subject's mind.¹¹³ When elements of an experience seem normal and, thus, immutable, counterfactual comparisons will be less available, and outcomes will often seem inevitable.¹¹⁴ In contrast, when elements of an experience are mutable and a change in that element would avoid the negative event, that mutable element is likely to be perceived as the cause of the negative event.¹¹⁵

The link between norm theory and the tendency of individuals to favor choices correlated with inaction over action is the prediction that actions are more mutable than failures to act.¹¹⁶ Specifically, "it is usually easier to imagine oneself abstaining from actions that one has carried out than carrying out actions that were not in fact performed."¹¹⁷ As one pair of social psychologists summarized the research on this point, "people find it easy to imagine how taking an action that one need not have taken would produce tortured thoughts about what could have or should have been."¹¹⁸ This conclusion has a certain intuitive appeal: each day of our lives we take many affirmative actions, but this number is certainly exceeded by the number of possible actions that we do not take. Consequently, individuals are likely to perceive failures to act as relatively normal, or typical, and difficult to avoid, while they are likely to perceive actions as relatively atypical, usually avoidable, and subject to more second-guessing.¹¹⁹

112. *See id.*

113. *See id.* For a more thorough discussion of the concept of availability, see Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974) [hereinafter Tversky & Kahneman, *Judgment*]. *See also* SCOTT PLOUS, THE PSYCHOLOGY OF JUDGMENT AND DECISION MAKING 121-30 (1993).

114. *See* Roese & Olson, *supra* note 105, at 8, 16.

115. *See id.* at 12.

116. Another way of putting this point is to say that "actions are typically more vivid and salient than failures to act and thus exert more impact on information processing." Gilovich et al., *supra* note 93, at 182.

117. Kahneman & Miller, *supra* note 95, at 145.

118. Thomas Gilovich & Victoria Husted Medvec, *Some Counterfactual Determinants of Satisfaction and Regret*, in WHAT MIGHT HAVE BEEN, *supra* note 100, at 259, 264.

119. It is important to note that not all research on counterfactual thinking has found that individuals regret actions more than inactions. In one study, Gilovich and Medvec found that when people are asked what they would do differently if they had their lives to live over again, they typically voice regrets over inactions (e.g., failing to work hard at their education or spend enough time with their families). *See id.* at 266-69. This finding might suggest that for certain major life decisions, inaction is as mutable as action; that in some circumstances the negative consequences of inaction can never be known and tend to become exaggerated over time, *see id.* at 266; that inaction might lead to more regret than action over long periods of time, *see id.* at 270; or that immediate "hot regret" and long-term "wistful regret" are two different phenomena. *See* Daniel Kahneman, *Varieties of Counterfactual Thinking*, in WHAT MIGHT HAVE BEEN, *supra* note 100, at 375, 391. In any case, research focusing on more compartmentalized types of

A related explanation of the preference for inaction over action is that individuals often perceive greater personal control over actions. Researchers in social psychology have also identified controllability of an element as an important determinant of mutability.¹²⁰ That is, an individual is more likely to mentally alter an element of an event to produce a counterfactual alternative when that element is within his control.¹²¹ For example, one group of experimenters provided subjects with a scenario describing several occurrences that delayed the protagonist's drive home.¹²² When asked to revise the scenario to get the protagonist home more quickly, subjects tended to change elements within the protagonist's control (such as stopping for beer) rather than those beyond his control (such as waiting for sheep to cross the road).¹²³ It is intuitive that controllability is probably an important driver of the feeling of regret.¹²⁴ The thought that something bad happened when something good could have happened instead is likely to be more distressing when the actor also thinks he could have done something to avoid the negative outcome.¹²⁵ Actions, therefore, tend to be more mutable than failures to act both because they are contrary to the norm and because they tend to be perceived as within greater control of individual actors.¹²⁶

decisions, in which the consequences of choices will become relatively clear, at least after the fact—that is, problems more analogous to those presented to the subjects in contract negotiation experiments—has consistently found that action leads to greater ex post regret than inaction.

120. Cf. Itamar Simonson, *The Influence of Anticipating Regret and Responsibility on Purchase Decisions*, 19 J. CONSUMER RES. 105, 105 (1992) (noting that regret can result both from comparing an outcome with alternatives “and from the feeling of responsibility or self-blame for the disappointing outcome”).

121. See Roese & Olson, *supra* note 105, at 31-32; see also Miller & Taylor, *supra* note 100, at 322 (“[Regret] will arise whenever the individual can easily imagine himself or herself having acted differently.”). Miller and Taylor emphasize the counterintuitive finding that regret does not require that the decision leading to the negative outcome have been objectively bad or illogical. Compare *id.* at 322, with Robert Sugden, *Regret Recrimination and Rationality*, 19 THEORY AND DECISION 77, 89 (1985) (postulating that a rejected alternative can lead to regret if “the individual could sensibly blame himself” for having rejected it).

122. See Vittorio Girotto et al., *Event Controllability in Counterfactual Thinking*, 78 ACTA PSYCHOLOGICA 111 (1991).

123. See *id.* at 126-27.

124. Cf. Roese & Olson, *supra* note 105, at 38 (“The realization that an aversive incident might have been avoided can heighten distress.”).

125. See Ritov & Baron, *supra* note 102, at 275 (noting that subjects who said they would not vaccinate their child when the risk of death from the vaccination was positive, but less than the risk of death from disease in the absence of vaccination, explained their positions in terms of the heightened personal responsibility they would feel if they acted and their child died than if they failed to act and their child died).

126. See Gilovich et al., *supra* note 93, at 182-83 (noting that inaction is more often the “default” or “norm” and, because of this, individuals feel more personal responsibility for actions).

To better understand these concepts, consider the following hypothetical: Mr. Jones is driving home from work when his car is struck by another driver.¹²⁷ Assume that Mr. Jones left work at his standard time of departure but took the scenic route (which he usually did not take) in order to enjoy the nice weather. Norm theory would lead to the prediction that in constructing counterfactual alternatives in response to the experienced event, Mr. Jones would be likely to imagine ways that he could have avoided the accident. It would also lead to the prediction that Mr. Jones would be more likely to mentally construct a counterfactual in which he drove home along his usual route than one in which he left the office earlier (or later). The accident could have been avoided, of course, had Mr. Jones altered his route or his time of departure. But the route is likely to seem more mutable—that is, alternatives to the route are more mentally available—than the time of departure, because the route taken was unusual and within Mr. Jones's control, while the departure time was usual.

That the relative availability of counterfactual alternatives can affect an individual's emotional responses to events is demonstrated by the following simple experiment, performed by Kahneman and Miller, based on facts similar to the story involving Mr. Jones. Experimental subjects were given the following information and question: "Mr. Adams was involved in an accident while driving home after work on his regular route. Mr. White was involved in a similar accident while driving on a route that he only takes when he wants a change of scenery. Who is more upset over the accident?"¹²⁸

Eighty-two percent of subjects judged that Mr. White would be more upset, while only eighteen percent thought that Mr. Adams would be more upset.¹²⁹ Presumably, the reason is that Mr. White's negative experience resulted from an action that seemed highly mutable—choosing an abnormal route—while Mr. Adams's negative experience resulted from a form of inaction—taking the usual route. Consequently, it is easier for subjects to construct a counterfactual alternative to Mr. White's experience that is superior to the actual experience. The ease of this comparison creates the prediction among subjects that Mr. White will experience a more negative emotional

127. The example is a modification of an experimental scenario created by Kahneman and Tversky. See Kahneman & Miller, *supra* note 95, at 143.

128. Kahneman & Miller, *supra* note 95, at 145.

129. See *id.*

response to the event. "The availability of the counterfactual," concludes Daniel Kahneman, "controls the intensity of regret."¹³⁰

If the description of human cognition provided by norm theory is accurate, it becomes clear why subjects believed that Mr. George (who switched his stock holdings only to find that the decision had negative consequences) would regret his decision more than Mr. Paul (who chose not to act, to his ultimate financial peril) would regret his.¹³¹ It would be easier for Mr. George to imagine a counterfactual situation in which he had made a successful investment decision than it would be for Mr. Paul to imagine such a counterfactual situation. Consequently, Mr. George would be more likely to view his choice as the cause of his unfortunate result and regret making that choice, whereas Mr. Paul is more likely to see his poor result as uncontrollable or inevitable. While Mr. Paul might feel badly about losing money, his unhappiness is less likely to be compounded by feelings of regret over his choice.

2. Regret vs. Rejoicing

Even if the risk of regret is greater for actions than for failures to act, there should be no behavioral bias in favor of inaction if the potential psychological *benefits* of action relative to inaction are significant enough to compensate for the higher risk action entails. Psychological evidence suggests, however, that anticipation of regret over actions that yield disappointing results is usually stronger than the anticipation of rejoicing over actions that yield desirable results.¹³² For example, Landman found that experimental subjects believed that a student who changed classes and received a high grade would feel more elated than a student who did not change classes and received a high grade.¹³³ But this effect was much weaker than subjects' judgments that a student who changed classes and received a low grade would feel more regret than a student who did not change classes and received the same low grade.¹³⁴

That anticipated regret is likely to be stronger than anticipated rejoicing is consistent with the well-established theory of "loss

130. Kahneman, *supra* note 119, at 389.

131. *See supra* text accompanying notes 94-96.

132. *See generally* Landman, *supra* note 90, at 527-28.

133. *See id.* at 529-30.

134. *See id.* at 530.

aversion."¹³⁵ Loss aversion theory posits that the utility consequences to individuals of suffering a "loss" from a reference point will be greater than an equivalent "gain" from the same reference point.¹³⁶ If losses loom larger than gains, it follows logically that anticipated regret would loom larger than anticipated rejoicing. The primacy of regret over rejoicing is also consistent with the predictions of norm theory. Desirable events are likely to be more mentally available than undesirable events. A consequence of this is that an individual experiencing an undesirable event will likely have an easier time constructing a positive counterfactual alternative (and thus generating feelings of regret) than an individual experiencing a desirable event will have constructing a negative counterfactual alternative (and thus generating feelings of rejoicing.)¹³⁷

Finally, the primacy of regret over rejoicing is consistent with a large body of interdisciplinary research demonstrating that negative events generally evoke stronger responses than positive ones.¹³⁸ Humans, like other animals, experience greater physiological changes in the wake of negative events than positive events.¹³⁹ Negative events tend to have a larger effect on mood and tend to dominate conscious thought relative to positive events, and negative emotions are experienced more intensely than are positive ones.¹⁴⁰

3. Explaining the Contract Negotiation Experiments

Norm theory and the differential amount of regret that potentially can be experienced from action and inaction can serve as the basis for an explanation of the preference for inertia observed in the contract negotiation experiments. Subjects in conditions 1 and 3 of

135. See generally Amos Tversky & Daniel Kahneman, *Loss Aversion in Riskless Choice: A Reference Dependent Model*, 106 Q.J. ECON. 1039 (1991) [hereinafter Tversky & Kahneman, *Loss Aversion*]. "Loss aversion" is one aspect of Tversky and Kahneman's prospect theory of choice under uncertainty. For the initial presentation of prospect theory, see Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979) [hereinafter Tversky & Kahneman, *Prospect Theory*].

136. See, e.g., Tversky and Kahneman, *Loss Aversion*, *supra* note 135, at 1041-45 (reviewing empirical evidence that supports the theoretical prediction).

137. See Landman, *supra* note 90, at 533.

138. For a survey of this disparate literature, see Shelley E. Taylor, *Asymmetrical Effects of Positive and Negative Events: The Mobilization-Minimization Hypothesis*, 110 PSYCHOL. BULL. 67 (1991). Taylor states, "[i]n summary, then, negative events appear to mobilize physiological, affective, cognitive, and certain types of social resources to a greater degree than do positive or neutral events. In this sense, there appears to be an asymmetry in the impact of negative events." *Id.* at 72.

139. See *id.* at 68 (surveying the literature).

140. See *id.* at 69 (surveying the literature).

the Consequential Damages scenario had to determine how much money they would demand before they would agree to place a full liability term in NextDay's contract with Gifts, Inc. The actuarially expected cost of such a term (relative to a limited liability term) was approximately \$5. But if agreeing to the full liability term (action) carried with it a risk of greater future regret than did not agreeing to the term (inaction), subjects would be expected to demand a premium above the term's \$5 expected cost before agreeing to add the term. Conversely, subjects in conditions 2 and 4 had to determine how much they would be willing to pay to convince Gifts, Inc. to actively add a limited liability term to the contract. For these subjects, the expected actuarial benefit of a limited liability term (relative to a full liability term) was approximately \$5. But if (1) adding the limited liability term (action) could lead to a greater fear of ex post regret than passing up the opportunity to add the limited liability term (inaction), and (2) the possibility of ex post regret were not compensated for by the possibility of ex post rejoicing, then subjects would be expected to offer something less than full actuarial value in order to offset the increased risk of ex post regret. The results were, of course, consistent with this explanation: subjects in conditions 1 and 3 demanded considerably more than \$5 to act, while condition 2 and 4 subjects offered less than \$5 for action.¹⁴¹

Thus, the preference for inertia in contract negotiation can be plausibly explained by a desire to minimize the risk of ex post regret if a decision turns out to be suboptimal in hindsight. This explanation assumes that the subject negotiators did not attempt to maximize the expected profits of their client, but traded off profit potential against the negative utility consequences of potential ex post regret. Subjects' desire to minimize the fear of regret is not infinite, of course; subjects are willing to accept the risk of more ex post regret for a price.¹⁴² But the key to this explanation of the bias in favor of inaction is that subjects do demand a premium to take on the added risk of ex post regret that action implies.¹⁴³

141. See *supra* Table 1.B.

142. See generally Bell, *supra* note 85, at 963 ("[M]inimizing . . . regret is not the sole criterion for decision; rather, the disadvantages of regret are traded off against the value of assets received."); Larrick, *supra* note 84, at 444 ("On the one hand, people want to choose the option that maximizes their outcomes (in terms of the value of the outcome); on the other hand, they want to avoid making poor decisions that may engender feelings of failure or disappointment.").

143. If the regret avoidance hypothesis is correct, we might expect to observe an even more profound bias in favor of inaction in the real world than we can measure in the laboratory. In the laboratory setting, the experimental subjects do not actually see the results of their

B. The Uncertainty Predicate to the Regret Avoidance Account

The regret avoidance theory of inertia in contract negotiation provides an explanation for why negotiators might not arrive at the same distribution of contract rights regardless of how the alternatives are presented. The explanation remains plausible even when rational choice explanations are not; i.e., even when network or learning benefits do not provide parties with an incentive to use the most common terms, and even when the presentation of alternatives does not affect the relative transaction costs of adopting alternative terms. At its root is the prediction that individuals will mentally assess the results of opportunities actively taken differently than they assess the results of opportunities not taken.

The theory, though, can only potentially describe negotiating behavior under conditions of uncertainty: that is, when parties cannot be sure at the time they are bargaining over contract terms which of the alternative terms will be most beneficial in the future.¹⁴⁴ If parties can be certain of both the value of what they are giving up or foregoing in negotiations and the value of what they receive in return, then there would be no reason to fear future regret over the choice. In such a situation, the regret avoidance theory would lead to the prediction that there would be no inertia effect in contract negotiations; parties should bargain to identical contract terms regardless of which terms will govern in the case of inaction, at least in the absence of transaction costs, asymmetric information, or learning/network benefits to following others. Put another way, in unusual situations in which the choice of contract terms entails no risk, the Coase Theorem should hold true.

Two varieties of uncertainty, both fueled by regret avoidance behavior, can conceivably lead to inertia in negotiation. The first variety, which can be called "outcome uncertainty," exists when future, unpredictable events will determine the value of a proposed change from the status quo. The second variety, which can be called "preference uncertainty," exists when the negotiator's preference for a change from the status quo can change in the future.¹⁴⁵ A party considering whether to spend \$10 on a coin flip in which "heads" will

decisions, as they would in real life, which could make them *less* susceptible to fear of future regret than they otherwise would be.

144. The two articles that originally introduced the concept of regret theory to the economics literature state in their titles that the theory applies to decision making under conditions of uncertainty. See Bell, *supra* note 85; Loomes & Sugden, *supra* note 87.

145. Cf. George Loewenstein & Richard H. Thaler, *Intertemporal Choice*, 3 J. ECON. PERSP., Fall 1989, at 181.

return \$20 and "tails" will return \$0 faces outcome uncertainty because the unknown result of a future coin flip will determine the value of what he has purchased. But that party does not face preference uncertainty because the payoffs associated with the action (taking the gamble) and inaction (keeping the \$10) are commensurable: if the coin comes up heads, he is certain to prefer the \$20 payoff to his original \$10 entitlement; if the coin comes up tails, he is certain to prefer the original entitlement to his \$0 payoff. In contrast, a party who considers buying a mug for \$5 faces no outcome uncertainty because the payoffs associated with action and inaction are certain. He does, however, face preference uncertainty. At the time the purchase decision is made he may believe he prefers the mug to \$5, or vice versa, but his opinion on this matter might be different the following week or month.

When either variety of uncertainty exists, regret avoidance theory leads to the predictions that negotiators will be biased in favor of inaction. All other things equal, the bias is likely to be stronger when both forms of uncertainty exist, although it is not clear whether the strength of the bias will be additive. When neither type of uncertainty exists, however, the regret avoidance theory leads to the prediction that there should be no bias in favor of inertia.

A recent set of experimental results supports this prediction. Maya Bar-Hillel and Efrat Neter provided a group of subjects with a lottery ticket, and then offered to trade the subjects a different lottery ticket for the same lottery plus a small amount of cash for their original tickets.¹⁴⁶ More than half of the subjects refused to trade, perhaps because they anticipated feeling regret if they took action and the original ticket subsequently won the lottery.¹⁴⁷ When the experimenters endowed their subjects with a pen, however, and then offered to trade them an identical pen plus a small amount of cash for the original pen, more than 90% agreed to trade.¹⁴⁸

The direction of the results is consistent with the regret avoidance theory. Subjects endowed with lottery tickets faced outcome uncertainty when presented the opportunity to trade. Subjects endowed with pens faced neither outcome uncertainty nor preference uncertainty. Because they were asked to trade one pen for an identical pen plus cash, there was no possibility that they would later regret

146. See Maya Bar-Hillel & Efrat Neter, *Why Are People Reluctant to Exchange Lottery Tickets?*, 70 *J. PERS. & SOC. PSYCHOL.* 17, 17-20 (1996).

147. See *id.*

148. See *id.* at 23.

accepting the offer because it yielded an undesirable result. Consequently, there was no possibility that counterfactual thinking could lead to ex post regret.

C. *Testing the Uncertainty Predicate of Regret Theory*

The regret avoidance theory can be similarly tested in the contract negotiation context by asking experimental subjects to value contract terms where there is no outcome or preference uncertainty associated with actively agreeing to a particular contract term. The theory predicts that in such a situation there should be no observable preference for inaction. The following manipulation of the Impossibility Excuse scenario eliminates the outcome uncertainty present in the original manipulations¹⁴⁹ of the scenario in an effort to test this prediction. The results provide support—although they are not dispositive—for the regret avoidance explanation of the power of inertia in contract negotiations.

Subjects assigned to condition 7 of the Impossibility Excuse scenario, like those assigned to condition 1, were told that the legal default provides an excuse for a common carrier's failure to meet its delivery obligations when an unexpected contingency arises that makes delivery either impossible or commercially impracticable. Also like condition 1 subjects, they were asked how much money NextDay should demand before agreeing to add a term to the contract that would negate the impossibility excuse. But whereas condition 1 subjects were asked to place a value on a risky choice—i.e., it was unclear how much an "excuse" term might increase NextDay's liability under the contract for delivery failures—condition 7 subjects were told that the financial consequences to NextDay of adding such a term to the contract were certain: NextDay, these subjects were told, carries liability insurance that pays all claims for delivery failures.¹⁵⁰ The consequence of NextDay agreeing to a contract with Gifts, Inc. under which no impossibility excuse existed would be a \$75,000 increase to NextDay's annual liability insurance premium.¹⁵¹ Thus, although accepting a contract term that would negate the impossibility excuse would increase NextDay's business risk, that risk could—and would—be ceded to a third party for a fixed price. The insurance

149. The initial experiments create a condition of outcome uncertainty, but, because the action and inaction alternatives all lead to outcomes measured in dollars (which are commensurable), they do not create a condition of preference uncertainty.

150. See *infra* Appendix B7.

151. See *infra* Appendix B7.

contrivance established that NextDay would face no outcome uncertainty by agreeing to a full liability term.

Condition 8 subjects, like condition 2 subjects, learned that the legal default rule provided for no impossibility excuse. Also like condition 2 subjects, the condition 8 subjects were asked how much NextDay should be willing to pay Gifts, Inc. to convince Gifts, Inc. to agree to add a term to the contract that would provide for such an excuse. Unlike condition 2 subjects though, condition 8 subjects (like condition 7 subjects) learned that there was a *certain* benefit associated with the addition of such a term: NextDay's liability insurance carrier would reduce its annual premium by \$75,000 to compensate for NextDay's reduced business risk.¹⁵² Again, the presence of insurance eliminates the outcome uncertainty present in the initial Impossibility Excuse scenario manipulations.

If the regret theory of inertia in contract negotiations is correct, the addition of the third party insurance carrier that accepted for a fixed price all the risk associated with the presence or absence of an impossibility excuse term should have eliminated the inertia observed in the three prior manipulations of the Impossibility Excuse scenario. That is, the large, statistically significant difference between the responses of condition 1 and 2 subjects, condition 3 and 4 subjects, and condition 5 and 6 subjects, should evaporate. Condition 7 and 8 subjects should provide approximately identical responses to each other. The results support this prediction. Condition 7 subjects (N=29) provided a mean response of \$39,000, while condition 8 subjects (N=28) provided a mean response of \$69,000. This difference appears to suggest that subjects suddenly exchanged their preference for *inaction* for a preference for *action*, but the responses of condition 7 and 8 subjects were actually not statistically significant. Moreover, the gap between the responses of condition 7 and 8 subjects is significantly different than the gap between condition 1 and 2, condition 3 and 4, and condition 5 and 6 subjects.¹⁵³ In other words, removing outcome uncertainty from the Impossibility Excuse scenario neutralized subjects' preferences for inaction, just as the regret avoidance hypothesis would predict.

152. See *infra* Appendix B8.

153. $p < .01$.

Table 2.D. Impossibility Excuse Results

<i>Condition</i>	<i>N</i>	<i>Default Rule</i>	<i>Mean Valuation</i>
1	22	Excuse	\$188,000
2	25	No Excuse	\$ 56,000
3	23	Excuse (previously <i>no</i> excuse)	\$139,000
4	24	No Excuse (previously excuse)	\$ 31,000
5	18	Excuse (industry norm: no excuse)	\$ 63,000
6	18	No Excuse (industry norm: excuse)	\$ 20,000
7	29	Excuse (switching cost = \$75K)	\$ 39,000
8	28	No Excuse (switching cost = \$75K)	\$ 69,000

The results of this manipulation suggest that the regret avoidance hypothesis may provide a robust motivational theory to explain inertia in contract negotiations. It should be strongly emphasized, however, that such a conclusion is not definitively indicated and more work needs to be done to test this hypothesis in the contract negotiation context. Although the results are consistent with the regret avoidance hypothesis, they might be consistent with alternative hypotheses as well, which suggests that more subtle testing is necessary in the future to control for other possible explanatory factors. Additionally, in order to eliminate the uncertainty surrounding a "no excuse" term that existed in the initial Impossibility Excuse manipulation, the \$75,000 marginal cost of insurance was introduced into the final two manipulations of the scenarios. In addition to eliminating uncertainty (as was desired), this contrivance also added a focal point (the \$75,000 figure) into a scenario that previously had no focal points around which subjects' responses could coalesce. It is possible that the introduction of a focal point, rather than the elimination of uncertainty, caused the average responses of condition 7 and 8 subjects to converge.

V. CONCLUSION

This Article has attempted to expand on previous experimental work that suggested contracting parties prefer default terms over

alternative terms, all else equal, even when doing so appears to violate the Coase Theorem. Here, evidence was presented that suggests individuals negotiating contracts will prefer terms that will govern if they fail to take affirmative steps to supply a contract term. The preference for inaction is not limited to situations in which legal defaults will govern absent action, but also exists when standard form contracts will govern absent action. This violation of the Coase Theorem can be called the "inertia theory" of contract negotiation. The experimental evidence presented strongly suggests that observed inertia in actual contract negotiations cannot be explained by the learning and/or network benefits that firms can take advantage of by using the most common standard terms.

The experimental evidence also tends to support (with qualifications) the hypothesis that the inertia theory can be best explained by regret theory, an application of the observation that individuals do not always treat opportunity costs and out-of-pocket costs equivalently. Inaction is less likely than action to lead to ex post regret when bargaining decisions are made under conditions of uncertainty. Consequently, negotiators do not choose between possible contract terms solely on the basis of the inherent expected utility of each term. Rather, inaction is weighed as a positive factor in the negotiator's cost-benefit analysis. Before a negotiator will prefer action over inaction in the selection of contract terms, the inherent expected utility of the term that requires action must exceed the inherent expected utility of the term associated with inaction by the amount that inaction is preferred to action generally. The theory predicts that inaction will not be preferred to action when decision choices entail no uncertainty, and the experimental evidence is consistent with this prediction.

The inertia theory of contract negotiations perhaps has applications that go far beyond those described in this Article, and further study is indicated. One potentially important hypothesis for future testing that can be derived from the experiments presented in this Article is that contracting parties can gain a powerful advantage in negotiations by providing a set of draft terms as the basis for detailed negotiations with their contracting partners. The inertia theory suggests that, in this way, it might be possible for a party to convince an opposing negotiator that her uniquely preferred set of contract terms will be enacted through "inaction" rather than action, even if those terms are uncommon in the industry in question and contrary to legal defaults.

APPENDIX A1

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 liability (*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 A2

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 A3

Description of Situation:

NextDay and Gifts, Inc. have agreed to adopt, as a starting point in negotiations, a standard form contract prepared by attorneys for the Overnight Delivery Trade Association ("ODTA"), to which both parties are members. The form contract is typically used as a basis for negotiations in this type of transaction, with contracting parties making changes to the form provisions where necessary.

The following is one of the provisions in the form contract that is under discussion between the parties (in your situation, NextDay would be the "Carrier" and Gifts, Inc. would be the "Shipper"):

"In the event that Carrier fails to deliver Shipper's merchandise on time, Carrier's liability will be limited to damages that were reasonably foreseeable when Carrier accepted merchandise from Shipper."

The law in your state, which will govern the contractual relationship between the parties, specifies that common carriers like NextDay are liable for "all damages proximately caused by the Carrier's negligent failure to deliver Shipper's merchandise on time," unless the parties explicitly agree otherwise.

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 wants the provision removed from the contract between the parties (thus making NextDay liable for "all" damages rather than just "reasonably foreseeable" damages). NextDay would obviously prefer less liability to more liability, and therefore would like the provision to remain in the contract.

You must now recommend to NextDay's management the *minimum amount per package* that you believe NextDay should demand if it is to agree to remove the disputed provision from 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 the extra liability that NextDay would be subject to if the provision is removed from the contract (effectively making NextDay liable for "all" damages rather than "reasonably foreseeable" damages) would cost NextDay. 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 removing the provision would end up increasing NextDay's liability 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.

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 liability (*i.e.*, if Gifts, Inc. refuses to pay *at least* this much, you would recommend that NextDay refuse to remove the limited liability provision from 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 remove the provision 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 A4

Description of Situation:

NextDay and Gifts, Inc. have agreed to adopt, as a starting point in negotiations, a standard form contract prepared by attorneys for the Overnight Delivery Trade Association ("ODTA"), to which both parties are members. The form contract is typically used as a basis for negotiations in this type of transaction, with contracting parties making changes to the form provisions where necessary.

The following is one of the provisions in the form contract that is under discussion between the parties (in your situation, NextDay would be the "Carrier" and Gifts, Inc. would be the "Shipper"):

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

The law in your state, which will govern the contractual relationship between the parties, follows the traditional legal rule that carriers 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 carrier takes possession of the package from the shipper, unless the parties explicitly agree otherwise. Thus, if the above provision were to be *removed* from the contract between the parties, NextDay would be liable only for "reasonably foreseeable" damages, rather than "all" damages.

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. Gifts, Inc. likes that the provision in the form contract fully protects it from this risk. NextDay would obviously prefer less liability to more liability, and therefore would like the provision removed from the final contract.

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. agreeing to remove the provision from the final contract between the parties—you will, of course, attempt to give Gifts, Inc. less than the maximum discount (you might even convince Gifts, Inc. to remove the provision without any payment), 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 remove the disputed provision from 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 removing the provision would reduce NextDay's liability 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.

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 remove the unlimited liability provision from the form contract (*i.e.* if Gifts, Inc. refuses to agree to remove the provision for *that amount or less*, you would believe NextDay would be better off with the higher liability provided under the form contract than paying Gifts, Inc. what it demands, and thus recommend that NextDay accept that provision in the form contract)? *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 removing 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 B1

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 B2

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 B3

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. Until last year, the law of your state—as is true of the law of most states—provided that the occurrence of such a contingency is no defense to a breach of contract claim—that is, NextDay could be held liable for damages despite occurrences beyond its control.

Under the new law, 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 (unless the parties have specifically agreed otherwise). 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 that 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 and reduce its profits.

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 B4

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. Until last year, the law of your state—as the law of most other states—provided that 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. Under the new law, however, the occurrence of such a contingency is no defense to a breach of contract claim unless the parties specifically agree otherwise—that is, NextDay can be held liable for damages despite occurrences beyond its control.

You are considering proposing that NextDay's contract with Gifts, Inc. 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 forth 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 B5

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. Provisions like this are quite common—in fact, they are included in the vast majority of commercial shipping contracts, including the majority of NextDay's contracts with commercial shippers:

"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 B6

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. Provisions like this are quite common—in fact, they are included in the vast majority of commercial shipping contracts, including the majority of NextDay's contracts with commercial shippers:

"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 B7

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."

NextDay has insurance that would protect it against liabilities it might incur in such circumstances—that is, it would not have to pay damages it owes as a result of the proposed provision out of its own pockets. However, if the provision is included in the contract, NextDay's insurance company would *increase NextDay's annual insurance premium* by \$75,000 to cover the costs of assuming additional liability. (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.)

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.

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 B8

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 (although it purchases insurance to cover it for any such liability).

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."

Although NextDay has insurance that covers it for liability arising from its failure to deliver, it has an interest in limiting its liability. NextDay's insurance company has agreed to *reduce NextDay's annual insurance premium* by \$75,000 if the above provision is included in its contract with Gifts, Inc. (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.

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

