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False Efficiency and Missed Opportunities in Law and Economics

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This Article points out a simple flaw common to many law-and-economics analyses, ranging from fundamental models like the Hand Formula to narrower arguments like those that oppose the doctrine of unconscionability.

The flaw is straightforward: economic analyses of law often assume, either implicitly or explicitly, that when it is more efficient for an activity to occur than for it not to occur, it is efficient for legal rules to encourage the activity. Even on grounds of efficiency alone, however, knowing in isolation whether an activity produces more wealth than its absence is insufficient to conclude that the activity is efficient. The determination of efficient legal rules requires an answer to a further question too often neglected by legal economists: what are the activity's alternatives? Even if an activity is more efficient than its absence, it may produce less wealth (perhaps significantly less wealth) than its alternatives, once its harms are taken into account. Encouraging all activities that appear to produce wealth on their own runs the risk of encouraging opportunistic behavior whose effect is more to transfer wealth than to create it.

As a simple example, a legal regime that followed the Hand Formula would encourage businesses to earn $100,000 by causing $95,000 worth of unavoidable harms to others; that incentive alone, while probably objectionable for other reasons, is not inefficient because, instrumentally speaking, the $100,000 social gains justify the $95,000 social losses. But a rule based on the Hand Formula would also encourage economic actors to engage in that $100,000-earning activity rather than one that paid $90,000 but caused no harms; that incentive is inefficient.

Some economic analyses acknowledge related points, but the law-and-economics movement insufficiently understands the flaw that this Article describes. Similarly, critics of the law-and-economics movement—while aware of other fundamental flaws in legal-economic analysis, such as the inapplicability of the rational-actor model in many circumstances—do not readily enough engage economic models on their own terms. This Article attempts to remedy those oversights, and in doing so, it suggests greater caution in applying economic reasoning to law.

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I. INTRODUCTION

Despite the prominence of law-and-economics arguments in subjects like tort law and contract law,[1] many courts and commentators retain serious doubts about the arguments' application, particularly where economic reasoning purports to dictate specific legal rules rather than simply to shed light on the general analysis of law.[2] These doubts are justified for at least two broad reasons. First, economic goals do not exhaust the law's function; for example, reasons of fairness and autonomy, not just those of efficiency and wealth

1. *See, e.g.*, Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 829 (2003) ("[E]conomic analysis of contract law . . . , many scholars would agree, has become the dominant academic style of contract theory."); Benjamin C. Zipursky, *Rights, Wrongs, and Recourse in the Law of Torts*, 51 VAND. L. REV. 1, 4 (1998) (referring to "law and economics" as one of the two "most prominent theoretical approaches to tort law").

2. *See, e.g.*, Posner, *supra* note 1, at 830 (discussing "the failures of economic models to explain contract law or to justify reform"); Richard W. Wright, *Hand, Posner, and the Myth of the "Hand Formula,"* 4 THEORETICAL INQUIRIES L. 145 (2003) (showing that even Richard Posner, though an academic proponent of the Hand Formula, has not applied it consistently as a judge).

production, can justify legal rules.[3] Second, economic models do not always make the right predictions about how real humans, rather than hypothetical rational actors, respond to incentives; these concerns have given rise to a critique of the classical law-and-economics movement known as "behavioral law and economics," which seeks to apply economic tools with the recognition that people are not perfectly rational.[4]

The purpose of this Article is to highlight a third kind of doubt about the effectiveness of determining legal rules through economic modeling.[5] Specifically, the Article is motivated by a concern that there are serious internal flaws in prominent, orthodox legal-economic arguments. Too rarely do legal commentators challenge the details of standard economic arguments or test their theoretical and institutional applicability, even though a potential strength of legal scholarship is to merge an understanding of facts, context, and institutional considerations with theories and methodologies of external disciplines, like economics. This Article aims, in a small way, to help advance that mode of reasoning.

Though this Article engages economic arguments on their own terms, it is important to say that my goal is not to elevate economic or instrumental goals above all others. My argument here is not that efficiency is always paramount and that economic arguments are

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3. *See generally* MELVIN ARON EISENBERG, THE NATURE OF THE COMMON LAW 14-26 (1988) (describing the "moral norms" that, in addition to propositions about efficiency and other matters, may serve as the basis of legitimate legal arguments).

4. *See, e.g.*, Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 CALIF. L. REV. 1051 (2000).

5. My claim is not that this kind of doubt is new; indeed, my previous work has aimed to highlight other concerns of this form. *See* Shawn J. Bayern, *The Limits of Formal Economics in Tort Law: The Puzzle of Negligence*, 75 BROOK. L. REV. 707, 745 (2010) [hereinafter Bayern, *Negligence*] (calling for "a kind of economic analysis that has not yet been done" in analyzing activity levels in tort law); Shawn J. Bayern, *Rational Ignorance, Rational Closed-Mindedness, and Modern Economic Formalism in Contract Law*, 97 CALIF. L. REV. 943 (2009) (critiquing on instrumental terms a leading economic argument for contract formalism). My point in the text, at this stage, is only that internal critiques—critiques of prominent economic arguments on broader economic terms—are not sufficiently prominent in legal scholarship.

Others have recently made similar calls, though somewhat more general than mine, for broader economic reasoning than the dominant arguments provide. *Cf.* Scott Hershovitz, *Harry Potter and the Trouble with Tort Theory*, 63 STAN. L. REV. 67, 78 (2010) ("[W]e must approach every assertion economists make about the efficiency of tort doctrine with a healthy skepticism .... I cannot demonstrate that any particular bit of received wisdom about the efficiency of tort doctrine is wrong, much less that all or even most of it is. Instead, what I can offer are possibility proofs that the standard economic analysis might be wrong ....").

sufficient to determine rules of law; it is that *even if* economic considerations were paramount, many prevailing arguments offered by law-and-economics scholars would still be insufficient to justify their conclusions about legal policy. Similarly, I take no particular issue in this Article with the goals of the behavioral economists or with other attacks on the formal economists' rational-actor models; critiques of the rational-actor model are often valid and important. My goal is simply to describe another salient flaw in the applicability of economic reasoning to law.

My argument proceeds in several stages. First, Part II identifies the general pattern of the flaw from which I believe many prominent legal-economic arguments suffer. It also shows how the problem is related to extremely strong assumptions that the law-and-economics movement needs to make, even in the context of private law, about the overall economic perfection of capital markets, credit markets, and other factor markets—assumptions that ought to be obviously implausible given the economic events of the last few years. Part III details this flaw in several foundational arguments prominent in tort law and contract law—particularly, the Hand Formula and the theory of efficient breach; it also compares this Article's central critique with "activity-levels" arguments in tort law. Part IV shows how the flaw extends further to more particular arguments in those disciplines and suggests the generality of the flaw. Part V concludes.

II. THE DISTINCTION BETWEEN OPTIMAL ACTIVITY AND ACTIVITY THAT IS BETTER THAN ITS ABSENCE

The general problem with much of the economic reasoning that this Article highlights is easy to state, but the problem raises a number of subtle issues that need careful exposition. The basic problem is that "efficiency" has multiple meanings, and it is easy to slide between them.

Consider, as an example, the following argument: (1) banking creates wealth; that is, it is socially productive;[6] (2) therefore, on

6. Of course, the global economy of the last few years has put this proposition into some doubt. *See* SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN (2010) (chronicling the financial crisis of the last several years); *see also The Cost of Repair*, ECONOMIST, Oct. 9, 2010, at 14, 17 ("Paul Volcker, a former Fed chairman, has caustically called the ATM cash dispenser the only worthwhile financial innovation of recent decades, a sentiment widely shared by venture capitalists and non-financial businesses."). But the extent to which it is in fact true is not relevant to the argument's use as an example.

grounds of efficiency, we ought to encourage college students to become bankers.

Of course, this argument needs a few modifications before it can even get off the ground. For one thing, we might not want to encourage college students to become bankers if the administrative costs of doing so were substantial. If it cost billions of dollars to wage a marketing campaign to encourage college students to become bankers, it would be inefficient to do so if the expected gains from encouraging more people to become bankers were more modest. Similarly, the argument assumes that encouraging college students to become bankers will increase the likelihood that they will in fact become bankers—rather than, say, increasing the chances that they will rebel against a heavy-handed advertising campaign and adopt a countercultural career path, becoming instead second-rate musicians who write songs about the evils of banking.

But there is a further flaw in the argument, and that flaw is the one with which I am concerned: encouraging someone to become a full-time banker necessarily discourages him or her from pursuing other full-time work. Even assuming that modern banking is a productive activity, other activities might be *more* productive.[7] Accordingly, it would be a mistake—even on grounds of efficiency alone—to say that just because something is wealth-producing, or "socially productive" in the narrow sense that the argument has in mind, it should be encouraged.[8]

In other words, the conclusion of the hypothetical argument we are considering is not just that students should become bankers; it is that students should become bankers *instead of choosing some*

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7. President Obama appears to have been motivated by this recognition when, in an interview on *The Tonight Show* in early 2009, he said:

> [W]hat we need is steady growth; we need young people, instead of—a smart kid coming out of school, instead of wanting to be an investment banker, we need them to decide they want to be an engineer, they want to be a scientist, they want to be a doctor or a teacher. And if we're rewarding those kinds of things that actually contribute to making things and making people's lives better, that's going to put our economy on solid footing. We won't have this kind of bubble-and-bust economy that we've gotten so caught up in for the last several years.

Interview of the President by Jay Leno on The Tonight Show (Mar. 19, 2009), http://www.whitehouse.gov/the-press-office/Interview-President-Jay-Leno-Tonight-Show-3-19-09.

8. Of course, we could define the terms "productive" or "wealth-producing" in ways that are absolute rather than relative—that is, we could choose not to describe banking as "productive" unless it were the *most* productive possible career for whatever person or people are in question. But my point is that in much legal-economic analysis, the terms are used more narrowly in ways that cause economic arguments to be insufficient to justify their conclusions.

alternative career. When the argument is put that way, its incompleteness is clear because the opportunity costs of encouraging people to become bankers are highlighted: those we are encouraging to become bankers might have become scientists, law professors, professional athletes, successful humorists, unsuccessful humorists, or any number of other types of professionals (or nonprofessionals) who might produce, or destroy, more or less wealth than bankers.

The same considerations apply, with perhaps surprising regularity, to many kinds of law-and-economics arguments. The general problem is that an activity may be "efficient," "productive," or "wealth-producing" in the narrow sense that it is better for it to occur than for it not to occur. Thus, for example, we might be asked whether it is efficient for a railroad to run (versus not to run) given the social value of the transportation it provides and the likelihood it will crash and cause injuries to passengers. In analyzing the efficiency of a railroad, we do not need to stop with those particular costs and benefits; indeed, we might, and often do,[9] consider a multitude of others: the harms that arise from the pollution caused by its engine; the indirect effects on the price of goods and the market for employment resulting from a more effective system of transport; the likelihood that sparks from the train will cause fires that affect nearby agricultural fields;[10] the effects on nearby residences of noise from the train; and so on. Even so, the analysis would necessarily be incomplete unless it incorporates one further consideration, too often neglected in these sorts of discussions: the activities prevented when capital, credit, labor, and other economic "production factors" are used to build and manage a railroad rather than to engage in entirely unrelated activities (such as organizing and operating sports teams, law schools, science labs, and so forth).

Suppose we try to analyze the efficiency of the railroad from the perspective of tort law's Hand Formula, which would determine that the railroad is efficient if its costs outweigh its benefits.[11] That is, a standard conclusion of law and economics is that if the railroad's operation generates $100,000 in social benefits (often manifested

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9. *E.g.*, Bayern, *Negligence*, *supra* note 5, at 712-13; *see also* Robert Cooter & Ariel Porat, *Does Risk to Oneself Increase the Care Owed to Others? Law and Economics in Conflict*, 29 J. LEGAL STUD. 19 (2000) (considering, additionally, risks of harm to injurers themselves).

10. *Cf.* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 29-31 (1960) (using a similar, now-famous, example); Bayern, *Negligence*, *supra* note 5, at 712.

11. For a more complete discussion of the details of the Hand Formula, see discussion *infra* Part III.A; *see also* Bayern, *Negligence*, *supra* note 5, at 712-19.

simply as private profits to the operator of the railroad) but causes $95,000 in unavoidable harms externalized to others (for example, because the railroad's unavoidable sparks burn down nearby cornfields, or because its unavoidable crashes cause property damage), then the railroad's operation is "efficient" and should be encouraged—or at least not discouraged. That is, the railroad, taken on its own, is said to produce wealth; it is better on instrumental economic grounds for the railroad to exist and to operate than for it not to exist or not to operate. Putting aside noneconomic concerns (such as those related to fairness and the distribution of wealth), and assuming the figures of $100,000 in gains and $95,000 in losses are accurate and complete, we would prefer that the railroad run rather than that it not run.[12] Of course, to be clear, I am assuming that the $95,000 in harms cannot be prevented by means of a simple and cheap precaution; this is what I mean when I call the harms "unavoidable."[13]

Compared to other ways of making $100,000, however, the railroad may be far worse for society than its alternatives. We would easily prefer someone to make $100,000 in a way that causes only $2000 of harm to others (or, of course, ideally no such harm) than in a way that causes $95,000 of harm to others, even putting aside fairness and considering grounds of allocative efficiency alone. That is, even though the operator of the railroad might earn $100,000, the railroad is worth only a net $5000 to society because of the harms that it causes. But another activity that earns its proprietor $100,000 may be worth far more than $5000 overall—indeed, up to $100,000, if it externalizes no harms.

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12. The activity may be undesirable, of course, for any number of other reasons, including concerns about fairness, rights, virtue, autonomy, and the overall social distribution of wealth. I do not mean to minimize these concerns, which are often central both in explaining and in justifying legal doctrines. *See generally* EISENBERG, *supra* note 3, at 14-42. As noted in the text, however, my argument proceeds by showing that even on economic grounds alone, many of the conclusions of the law-and-economics movement cannot be justified.

13. If the harms totaling $95,000 could be prevented by means of a $5 precaution on the part of the railroad—for example, if the $95,000 in harm reflects fires that sparks from the railroad cause, and these sparks could be prevented if the railroad installs a $5 spark arrestor—then clearly the operation of the railroad is unreasonable, even in purely economic terms. I am treating the $95,000 harms as a cost that can be avoided only if the railroad stops operating; that is, by hypothesis, the cheapest precaution that can prevent the $95,000 in expected harms, in my example, is the cessation of the railroad's operation. Because this would have a cost of $100,000 (in forgone benefits to the operator of the railroad), the Hand Formula would deem the railroad's operation as cost-justified and therefore reasonable (nonnegligent).

Asking only whether a railroad is better than no railroad may miss the point. The railroad may well be more efficient than its *absence* but significantly less efficient than its *alternatives*. Often, however, legal-economic modeling—such as the Hand Formula here, though the Hand Formula is just an illustration—focuses (sometimes just implicitly) on the comparison between an activity and its absence, rather than the comparison between an activity and its alternatives.

For example, while an economic argument may purport to show that *A*, a promisor in breach, and *B*, an injured promisee, together benefit ex ante from a rule based on the theory of efficient breach, the argument may fail to address the possibility that the proposed rule will encourage other parties to take steps to become like *A*, the promisor in breach, and to emulate his potentially opportunistic behavior.[14] The rule may provide incentives for people and businesses to arrange their affairs in order to have the opportunities that *A* has. Even supposing that a breach by *A* is better than *performance* by *A*, ex post, however[15]—that is, even supposing that *A* and *B* together benefit from breach, which is typically all that economic analyses purport to show—giving *A* the opportunity to breach may give parties too much of an incentive to be in the position of *A* rather than in the position of *C*, an entirely unrelated kind of party who does not benefit from the opportunity to breach a contract. Nonetheless, *C*'s activity may have more social utility than *A*'s, and as a result, the economic argument—even though motivated by efficiency—will in fact undermine efficiency.[16] Similar concerns apply to many kinds of economic arguments, from instrumental analyses of contract impossibility[17] to economic attacks on the contract doctrine of unconscionability.[18]

The same problem can be described in terms of opportunism. In the case of a promisor in putatively efficient breach, or a railroader who earns $100,000 but causes $95,000 in harms to others, the wrongdoers earn more—potentially much more—than their overall contribution to society. The railroader, if rational and selfish, will

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14. For a different but related observation about the theory of efficient breach and its broader effects, see Melvin A. Eisenberg, *Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law*, 93 CALIF. L. REV. 975, 1010-13 (2005) (arguing that the theory of efficient breach provides insufficient incentives for planning and would harm contract law by undermining social norms).

15. This supposition is incorrect far more often than most law-and-economics scholarship seems to realize. For a detailed analysis, see *id.* at 997-1013.

16. See discussion *infra* Part III.B for an analysis of the opportunity costs of encouraging breach of contract.

17. *See* discussion *infra* Part IV.B.

18. *See* discussion *infra* Part IV.A.

choose the $100,000 profit over an activity that earns him or her $90,000 but causes no social harms; the promisor will, again if rational and selfish, prefer entering into a contract that he or she may breach than one where the opportunity of breach may not arise, even if the latter contract creates more social value.[19] In other words, when an activity allows a private profit disproportionate to its social value, parties who are selfish and rational will have too much incentive to engage in it and not enough incentive to engage in more productive activities.[20]

Though the general form of the concern that I have described arises occasionally in the legal-economic literature,[21] legal economists overall are not sufficiently concerned with the problem. One reason is perhaps that the problem does not arise—that is, it is impossible as a matter of theoretical economics—if several deep assumptions are made about the perfection of certain kinds of markets. This Part proceeds by highlighting those assumptions and showing that, fairly obviously, they are not correct.

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19. For further discussion of this point, including a response to the Coasean objections that might oppose it, see discussion *infra* Part III.B.

20. It is important to stress, again, that both the "less productive" and the "more productive" activities are *efficient* in the sense that when considered in isolation, it is better (on grounds of efficiency alone) for them to occur than for them not to occur. The problem is not that wealth-destroying activity may occur in isolation; it is that wealth-promoting activity may occur with excessive frequency compared to activities that create even *more* wealth. Again, this is not an issue if activities' costs and benefits are evaluated with metrics that accommodate their alternatives—if, for instance, we consider opportunity costs in activities' valuations, as we might begin to do when fully considering the costs of capital and other production factors as transaction costs. My point again, however, is that arguments like the Hand Formula and the theory of efficient breach fail to do this appropriately.

21. If seen as a problem of opportunism, my critiques share features with those by other commentators concerned, ordinarily in somewhat more focused contexts, with the opportunism associated with wealth transfer rather than the social productivity associated with wealth production. *See, e.g.*, DAVID D. FRIEDMAN, PRICE THEORY: AN INTERMEDIATE TEXT 476 (2d ed. 1990) ("The analysis of rent seeking suggests that, at least under some circumstances, monopoly profit is not a transfer to the firm from its customers but a net loss. The higher the monopoly profit, the more resources the firm will burn up . . . in the process of getting it. If so, perhaps the best solution to the problem posed by monopoly is not regulation but taxation . . . ."); Ronald H. Coase, *Blackmail*, 74 VA. L. REV. 655, 674 (1988) ("Blackmail involves the expenditure of resources in the collection of information which, on payment of blackmail, will be suppressed. It would be better if this information were not collected and the resources were used to produce something of value."); Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978) (proposing a rule concerning disclosure of potentially valuable information in contract law that aims to encourage investment in productive rather than redistributive information gathering).

A. *The Hidden, False Assumption That All Activity That Is More Efficient than Its Absence Will Occur*

One central thesis of this Article is that many apparently freestanding economic arguments that purport to demand particular conclusions in the private law, such as the Hand Formula and the theory of efficient breach, depend in complex ways on broader economic assumptions that have little or nothing to do with the private law. These broader assumptions are varied, but they have a general conclusion in common: namely, the notion that all activity that is efficient on its own (compared in isolation to its absence) will occur. For example, assuming that a business opportunity like our hypothetical railroad that produces $100,000 in private profits while causing $95,000 in expenses to others exists, the structure of many economic arguments in the private law assumes, at least implicitly, that the opportunity will be fulfilled—that is, that the railroad will run, and that someone will make $100,000 in profits and cause $95,000 in harms.[22]

If this assumption were true, this Article's general concern with the alternatives and opportunity costs of activities would drop away. To see why, consider two hypothetical railroads, each "efficient" in isolation but one more efficient than the other: Railroad *A* nets its

22. There is a technical wrinkle threatening this point, which is that the example does not necessarily make clear the role of the transaction costs of organizing and operating the railroad. That is, economists might say that the railroad will run unless the transaction costs of organizing and continuing its operation exceed its profits. To put it differently, if the business opportunity of a $100,000 railroad exists but does not get taken up by some entrepreneur, the transaction costs must, tautologically, be greater than $100,000. (These transaction costs may come in the form of difficulties in determining that the business opportunity exists, evaluating its expected profits, bargaining in support of its organization and operation, and so on.) This evaluation of the transaction costs is just definitional, however; it is a tautological way of saying that if the railroad ends up operating, the transaction costs must not have been great enough to stop it, in view of its profits—and conversely that if the railroad does not operate, the transaction costs must have been too great.

This sort of transaction cost does not directly affect the Article's main argument. For the purposes of the main argument, we can assume that the $100,000 figure for the railroad's stated profits accommodates the sort of transaction-specific costs and benefits that law-and-economics arguments typically associate with the railroad's operation. The point of my main argument is that even after ordinary transaction costs are considered, profitable activity may not occur; that $100,000 in profits for the railroad is possible *after* the sort of transaction costs associated with searching for, identifying, evaluating, and bargaining about the railroad's business opportunities still does not imply that the railroad will run, because there are neither perfectly efficient factor markets nor unlimited factor resources. Of course, we might define the term "transaction costs" to include the inefficiencies in factor markets, but that does not change the analysis; it just leads me to restate my argument as one that shows that legal-economic arguments commonly fail, at least implicitly, to recognize particular kinds of transaction costs that prevent efficient activity from occurring.

owner $100,000 but externalizes $95,000 in harms, and Railroad *B* nets its owner $90,000 but externalizes $2000 in harms. This Article's general concern is that the law will encourage Railroad *A* over Railroad *B*, but if all activities that we might call *efficient in isolation* occur, then the concern does not appear: both Railroad *A* and Railroad *B* will run, so it does not matter that the law encouraged Railroad *A* to run.

To put it differently, if all activities efficient in isolation will occur, then from an instrumental perspective concerned with social wealth, encouraging Railroad *A* causes no harm; from such a perspective, we *want* Railroad *A* to run, and encouraging it has no effect on Railroad *B*'s chance of running, because all activity that is efficient in isolation will occur.

On the other hand, if the assumption that all activities efficient in isolation will occur is *not* correct, then there may of course be substantial harm in encouraging Railroad *A*, because doing so may divert resources away from Railroad *B*. It may also divert resources away from otherwise entirely unrelated activities, because in some sense all activities are economically interchangeable; for example, at least at some point in the life of the railroad's operator, he or she, at least theoretically, could have decided to choose an entirely different line of work, becoming a baseball player or a scientist. Accordingly, encouraging a railroad to operate tends to discourage other businesses from operating; the law cannot have its cake and eat it too.

The assumption that all activity will occur as long as it is efficient in isolation is, however, manifestly wrong in the real world. The general reason that the assumption is wrong is that markets for production factors, including very broad economic factors such as capital and credit, are imperfect.

B. The Reasons for Factor-Market Imperfection

That capital markets and credit markets[23] are imperfect should be evident from recent history.

A common, and fortunate, reaction to the global economic turmoil of the last several years has been a growing skepticism of the predictions of formal modeling and dogmatic economics. Stock

23. Occasionally the term "capital markets" refers to both equity markets and debt markets. *See, e.g.*, PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS 9, 160-65 (19th ed. 2010). I reserve the use of the term to the former unless the context indicates otherwise.

markets have swung wildly,[24] and credit necessary to fund economic activity has been threatened by weaknesses in banks.[25] One cause of these events, at least roughly, was an overreliance on predictive economic models.[26] Fittingly, public policy making and rhetoric has seemed to shift away—at least for a time—from abstract social-scientific theory and toward a kind of pragmatic intellectual pluralism, focusing on "what works" rather than on what predetermined reductionistic models conclude.[27] Richard Posner, widely credited with many of the early insights in law and economics,[28] has himself written a book in which he observes the "failure of the economics profession to have grasped the dangers that have now produced the first U.S. depression since the 1930s."[29]

But the appropriate conclusions to draw from newly prominent inefficiencies in capital and credit markets do not stop with a

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24. *See* Vikas Bajaj, *Another Afternoon Turns Dark as Worry Sends Stocks Plunging*, N.Y. TIMES, Oct. 10, 2008, at A1; Michael M. Grynbaum, *Cheer Fades as Stocks Plunge 9%*, N.Y. TIMES, Dec. 2, 2008, at B1; Jack Healy & David Jolly, *Once Again, Stocks Slide in Last Hour of Trading*, N.Y. TIMES, Nov. 18, 2008, at B4; Javier C. Hernandez, *As Confident Investors Race to Stocks, the Dollar Weakens Further*, N.Y. TIMES, Nov. 10, 2009, at B1; Javier C. Hernandez, *A Downward Spiral Continues as U.S. Stocks Fall Below 10,000 Benchmark*, N.Y. TIMES, Feb. 9, 2010, at B9; Steve Lohr & Jack Healy, *Glimmer of Hope Sets Off a Rally in Beaten Stocks*, N.Y. TIMES, Mar. 13, 2009, at A1; Gerry Shih, *Stocks & Bonds: Pessimism Still Grips Wall Street*, N.Y. TIMES, Aug. 18, 2009, at B1.

25. *See* Edmund L. Andrews & Mark Landler, *U.S. May Take Ownership Stake in Banks To Ease Credit Crisis*, N.Y. TIMES, Oct. 9, 2008, at A1; David Stout, *Geithner To Unveil Plan To Revive Credit Flow and Monitor Banks' Aid Use*, N.Y. TIMES, Feb. 1, 2009, at A18.

26. This overreliance arguably applied both narrowly and broadly. Narrowly, too much faith in formal analyses of the risks of mortgage-backed securities appears to have led to a misunderstanding among banks and other private businesses of the value of those assets. *See, e.g.*, JOHNSON & KWAK, *supra* note 6, at 124 ("As housing prices took off, it became easy to build models showing that [mortgage-backed securities and collateralized debt obligations] had virtually no risk . . . ."). More broadly, though admittedly more debatably, the regulatory environment that allowed for an increasing dependence on securities that turned out to be misvalued appears, itself, to have resulted in part from an overreliance on economic models that disfavored regulation. *See id.* at 68-87; *see also* Edmund L. Andrews, *Greenspan Concedes Flaws in Deregulatory Approach*, N.Y. TIMES, Oct. 24, 2008, at B1 ("Greenspan [the chair of the Federal Reserve of the United States from 1987 to 2006] admitted that he had put too much faith in the self-correcting power of free markets . . . .").

27. *See, e.g.*, Brian Knowlton, *Obama Promises Quick Relief for Governors*, N.Y. TIMES (Dec. 3, 2008), http://www.nytimes.com/2008/12/03/us/politics/03transition.html ("'We are not going to be hampered by ideology in trying to get this country back on track,' [said then President-elect Barack Obama.] 'We want to figure out what works.'"). The same article reports that Governor Arnold Schwarzenegger of California "urged lawmakers to 'get off of their rigid ideologies.'" *Id.*

28. *See, e.g.*, Lawrence A. Cunningham, *Traditional Versus Economic Analysis: Evidence from Cardozo and Posner Torts Opinions*, 62 FLA. L. REV. 667, 667-70 (2010).

29. RICHARD A. POSNER, A FAILURE OF CAPITALISM 328 (2009).

generalized caution in abstract modeling. Beyond broad lessons that placing too much faith in formal models can lead businesses and policy makers down dangerous paths, there are several important specific analytical conclusions to be drawn—in private law, perhaps surprisingly—from the increasing recognition that capital markets, credit markets, and other deep features of the economic landscape do not function with anything close to perfect efficiency.

A *factor market* is a market in which the factors (or inputs) of economic production, like money, equipment, and the services of workers, are bought and sold.[30] What ties together my concern for these markets, in analyzing the private law, is that scarcity and inefficiency in them prevent some otherwise productive activities from occurring. Because of factor-market limitations, even transactions for which the transaction-specific costs and benefits make an activity appear efficient may not be able to occur. For example, it might be privately and socially efficient for someone to attend an expensive law school when the tuition is compared against the benefits of going to the school, but that possibility may not be available if the prospective student cannot borrow money to pay tuition. Similarly, an otherwise efficient opportunity for a business to expand may be prevented by its inability to secure financing.

Technically speaking, factor limitations and factor-market inefficiencies could be regarded as ordinary transaction costs.[31] For example, we can interpret the inability to secure funding (either as equity or as debt) as a transaction cost that prevents a business from engaging in an activity that would otherwise be profitable. Similarly, we can say that a potential activity is not "efficient" or "wealth-producing" if it cannot occur because of factor-market limitations or inefficiencies. But law-and-economics arguments in contract law and tort law ordinarily do not consider this kind of cost when evaluating the transaction-specific costs and benefits (injury-causing behaviors, precautions against them, breach of contract, precaution against breach, and so on) of the kinds of activities with which economic arguments about the private law are concerned. For example, for many legal-economic conclusions like "contracting parties A and B can, together, achieve more contractual surplus under a rule of damages

30. *See* SAMUELSON & NORDHAUS, *supra* note 23, at 9 (classifying "factors of production" into "three broad categories: land, labor, and capital"). In their widely used textbook, Samuelson and Nordhaus provide an extended and appropriately cautious introduction to factor markets and general equilibrium theory. *Id.* at 229-98.

31. *Cf.* discussion *supra* note 22.

based on the theory of efficient breach than on an opposing rule," the supporting argument often, at least implicitly, attempts to accommodate transaction costs like bargaining costs in concluding that *A* and *B* both benefit from a particular legal rule.[32] But the same argument will often fail to accommodate the broader market effects of the rule in question under circumstances where factor markets are imperfect and factors to production are limited.

Recent history has highlighted the problematic assumption that factor markets operated with perfect efficiency, but market failures in factor markets should come as no surprise in general. For a credit market—that is, a market in which people can lend and borrow money—to operate perfectly, all the market participants would need to have perfect information about (1) which other parties were interested in borrowing or lending, (2) all the characteristics of potential counterparties that affected the likelihood of repayment (that is, of the *credit risk* or *default risk* of all counterparties), and (3) their own future tolerances for risk and desire for the return associated with lending or borrowing money. Moreover, all parties would need to be able to process this information perfectly and rationally. These prerequisites should, on their face, seem clearly quite strong; information and its processing are perfect in almost no contexts. But recent macroeconomic experience has shown that the assumptions characterize modern markets particularly poorly; for example, credit markets are so complicated that evaluating the counterparty risk associated with a particular instrument requires more than a straightforward analysis.[33]

Markets for equity rather than debt—such as stock markets—are imperfect for similar reasons related to informational incompleteness.[34] The public capital markets, such as the New York Stock Exchange, also suffer from swings that seem to result from traders' emotions,[35] from short-term planning and thinking,[36] and from market

32. *See* discussion *infra* Part III.B.

33. *See* Manuel A. Utset, *Complex Financial Institutions and Systemic Risk*, 45 GA. L. REV. 779 (2011).

34. *See* PAUL MILGROM & JOHN ROBERTS, ECONOMICS, ORGANIZATION & MANAGEMENT 467-73 (1992); *see also* Note, *Tort as a Debt Market: Agency Costs, Strategic Debt, and Borrowing Against the Future*, 115 HARV. L. REV. 2294, 2309 n.80 (2002) ("[C]apital markets often suffer from incomplete information and frequently fail to incorporate insider information." (citing MILGROM & ROBERTS, *supra*)).

35. *See generally* Henry T.C. Hu, *Faith and Magic: Investor Beliefs and Government Neutrality*, 78 TEX. L. REV. 777 (2000).

36. *See* Editorial, *Can You Trust the Market?*, N.Y. TIMES, Jan. 10, 2011, at A20 ("Long-term, buy-and-hold investors are still nursing losses because of reckless games played by big banks and short-term traders.").

manipulations[37]—as well as, apparently, from simple technical errors, including those that caused the Dow Jones Industrial Average to drop almost ten percent on May 6, 2010, for what amounted to no substantive economic reason.[38]

The upshot of all these imperfections is that many activities that, economically speaking, ought to proceed in view of their transaction-specific costs and benefits—that is, activities that are better than nothing, that produce wealth compared to their absence—end up being unable to occur. Consider a variation of the railroad example I have presented throughout: a railroad can make $100,000 while causing $95,000 of externalized harm, while a hotel might earn $90,000 while externalizing no harm at all. Conceive these two potential endeavors as rival business opportunities. That is, a hypothetical entrepreneur might have the opportunity to engage in them on their merits. The entrepreneur might decide to avoid both business opportunities, to pursue one or the other, or to pursue both.

If credit and capital markets were perfect and there were no other transaction-specific costs in the way (such as an irrational distaste for the business of hospitality on the part of the entrepreneur, a failure to understand the railroad's costs and benefits, or bargaining costs associated with organizing and operating a hotel or a railroad), there is indeed no reason to think the entrepreneur would not pursue both activities. Each is profitable (hypothetically, in view of their transaction-specific costs and benefits), so why would the entrepreneur want to avoid pursuing them? He can make $100,000 from the railroad and $90,000 from the hotel; the simple decision is to operate both. But unless the entrepreneur either has capital or can obtain financing, he may not be able to pursue both. For example, if the railroad and the hotel each requires a capital outlay of $50,000 to start up (for instance, to renovate a building for the hotel or to purchase an engine for the railroad), the entrepreneur will not be able to pursue both activities unless he can find $100,000 in financing, either by borrowing money or by convincing others to take equity stakes in his future companies. The imperfections of the capital and credit markets may prevent him from doing so. For example, even if the entrepreneur

37. *See id.*; *see also* Reuters, *S.E.C. To Study Rapid-Fire Stock Orders*, N.Y. TIMES, Sept. 8, 2010, at B9.

38. *See* Graham Bowley, *The Flash Crash, in Miniature*, N.Y. TIMES, Nov. 9, 2010, at B1 ("But even though regulators have identified the main source of the drop as a sale of a large block of futures contracts by a mutual fund in Kansas, some worry that today's fractured electronic stock market has become so unstable that another large sale or a simple error could incite a broader crash.").

is competent and creditworthy, and even if the future value of the businesses is clear, credit may simply be unavailable in a dysfunctional credit market; capital may not flow freely because of all the problems endemic to capital markets. As a result, the entrepreneur might only be able to obtain, say, $60,000 in financing. That is enough for only one activity. With that amount of financing, a legal regime based on the Hand Formula will cause the entrepreneur to pursue the railroad, in spite of its social costs, because the private profit of the railroad is greater than the private profit of the hotel. As a result, the Hand Formula will lead directly to inefficiency by promoting a less efficient activity over a better one. The Hand Formula's distortion matters precisely because only one of the candidate activities can proceed.

Of course, capital markets and credit markets are not the only kinds of factor markets. Factor markets are often taken to include labor markets as well, labor being a factor to production just as capital is—and indeed, a factor in a market that is probably far less perfect even than capital and credit markets.[39] The imperfections in labor markets, too, ensure that not all activity that is (otherwise) efficient can occur.

As a very simple example, building on the same one we have been using, suppose that in Newtown, there is just one unemployed worker who, for at least $35,000 a year, is willing to work serving a critical function in the operation either of a railroad or of a hotel. Suppose, for argument's sake, there is nobody else in the world willing to come to Newtown to earn $35,000 to work in the same roles.[40] A

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39. As Michael Trebilcock and Thomas Boddez put it:

> The economic assumption of perfect mobility in factor markets is less valid in the context of labor than it is in the context of capital. The transaction costs which accompany the flow of capital from one use to another tend to be small when contrasted with the financial and psychic costs borne by individuals forced to retrain or relocate in order to obtain alternate employment. In addition to the imperfect mobility of labor, a claim to compensation can be based on the inability to diversify investments in human capital. Particularly in cases of highly specialized human capital investments, the worker assumes a high degree of undiversified risk.

Michael J. Trebilcock & Thomas M. Boddez, *The Case for Liberalizing North American Trade Remedy Laws*, 4 MINN. J. GLOBAL TRADE 1, 12 (1995).

40. This is obviously too strong an assumption of labor-market imperfection, but it does not affect the form of the critique I am making; suppose what was at issue was not *whether* anyone would move but *how quickly* others could get up and running in a new job in Newtown. Or suppose the problem is analyzed at a broader level—say, 30,000 workers in a city are currently employed, and advertising for workers outside the city leads to greater costs and relocation expenses, and so on. The underlying and relatively straightforward point is the

national railroad line and a national hotel chain are both interested in expanding their business to Newtown. The railroad owner stands to earn $45,000 gross profits for the first year of its operation but expects to externalize $20,000 of harm (in the form of hard-to-avoid injuries, fires to nearby cornfields, or whatever else); the hotel owner stands to earn $44,000 for the first year of its operation with no externalized costs. Given the costs and other features of the bargaining landscape, suppose each proprietor is unwilling to engage his or her own time and other hard-to-quantify resources, or to accept the risk of business losses, to earn less than $10,000 in Newtown.[41] Thus, the owner of the railroad will pay the worker up to $36,000; the hotel chain will pay up to $35,000. Presumably, if he is aware of both offers and the working conditions are otherwise equally desirable, the worker will choose to work for the railroad; the hotel will not be able to take advantage of a business opportunity it would have had if the railroad did not exist or operate. Thus, a rule that encourages the railroad to operate—as the Hand Formula does in this case, because it lets the railroad cause $20,000 of harm without paying for it, thus allowing it to earn more than the hotel—works directly to *discourage* the hotel from operating, even though the hotel is more efficient from society's perspective than the railroad (because it leads to a net $44,000 in gains rather than the railroad's $45,000-$20,000, or $25,000, in gains).

As with capital and credit markets, the problem in this example would probably go away if labor markets were perfect; surely someone else in the world is willing to work for $35,000 at the hotel, but the unavailability of that person prevents an otherwise efficient transaction from occurring. Consequently, the Hand Formula's implicit disregard for the efficiency of alternatives leads to a directly inefficient outcome.

C. *Other Implicit Assumptions in Law-and-Economics Analysis in the Private Law*

A different way to conceive deeper assumptions that apparently freestanding economic arguments in tort law and contract law make is to frame the assumptions in terms of perfect competition within industries. Take, again, the example of the railroad and the hotel. The

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same in all these cases, which is that labor-market imperfection makes it impossible for activities that would otherwise be efficient to occur.

41. This again is a stylized assumption—really, a simplification that abstracts away more complicated underlying economic features of the problem—that does not matter. For example, the cost of capital in either case could be quantified, as could the risk aversion of the various parties, rather than my simply stating a $10,000 profit margin. But it does not matter.

railroad earns $100,000 but causes $95,000 of externalized harm; the hotel earns $90,000 while causing no externalized harm. My chief contention has been that in such a state of affairs, the Hand Formula directly encourages an inefficient choice between the railroad and the hotel.

A potential response to this contention, however, is that while that problem may arise in a static world, once we consider dynamic incentives to enter and exit industries the problem will not be significant. For example, because the railroad is worth more to society (gross) than the hotel, more actors will seek to run railroads than hotels, leading to less of a profit margin for railroads; eventually, a new marginal railroad will produce less than $95,000, meaning that it will not be efficient any longer because its costs will be greater than its benefits. Eventually, entrepreneurs will switch to the hotel over the railroad. In other words, the market will address the problem I have raised.

There are two problems with analysis of this type. First, it does not even get off the ground unless markets are perfectly competitive, and it would be just as odd and damaging for a purportedly freestanding argument in tort law or contract law to depend on the notion that markets in the control and operation of railroads and hotels are perfectly competitive as for them to assume that factor markets are perfect. Second, it does not, fundamentally, address my principal concern. It is true that activities that outperform will tend to attract more actors, but when that outperformance does not correspond to overall social benefit, there is no reason to assume the overall market dynamics are efficient from society's perspective. Thus, a world in which dozens of entrepreneurs have flocked to railroads, driving down the supernormal return associated with operating railroads, is still a world in which there is too much railroading, and not enough hotel operation, in view of the respective costs and benefits of the two activities.

To summarize, one way to understand the foundational problem with which this Article is concerned is to recognize the hidden assumptions in many legal-economic arguments that it exposes. There is at least one way to salvage economic reasoning from my critique in this Article, and that is to assume that capital markets, credit markets, and other so-called factor markets all operate perfectly. In other words, by assuming that such markets are perfect—and only by so assuming—economists can defeat my critique. Of course, however, the assumption is not correct.

It is important to recognize, again, that the assumptions regarding capital markets, credit markets, and so on are not obviously or intuitively related to the private law. My conclusion at this stage, in other words, is that law-and-economics arguments like the Hand Formula depend in subtle ways on significantly broad perfection in markets that, at first glance, have nothing to do directly with tort law. Focusing on conceptions of efficiency that are too limited, like "the cost of precaution and the cost of expected harm"[42] from accidents ignores broader efficiencies; as a result, reaching particular policy conclusions in law on the basis of economic reasoning that rests on limited premises tends not toward efficiency but toward inefficiency. To put it differently, economic arguments that assume the perfection of factor markets do not even *aim* to promote true, overall allocative efficiency; instead, they concern only efficiency in narrow circumstances that do not correspond to reality.[43]

At this stage, it is important to recognize that my argument is negative and critical: I am not constructing a basis, here, for deciding how to determine the correct pricing of activities, nor am I presenting a definitive solution to the problems I identify. My argument is, more modestly, simply that we need to be sensitive to the problem.

III. THE NEGLECT OF ALTERNATIVES IN FOUNDATIONAL TORT AND CONTRACT MODELS

This Article has already used the Hand Formula in tort law as a running example of the inefficiency of narrow economic argumentation that assumes the perfection of factor markets (and thus that all activity that is more efficient than its absence will occur). This Part spells out my concern with the Hand Formula in more detail; it then considers how the problem this Article has described manifests itself in the theory of efficient breach in contract law. Part IV considers further, more specific arguments in tort and contract law.

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42. ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 321 (4th ed. 2004). For the thorough theoretical introduction into the literature of the notion that tort law is concerned with the combination of costs from accidents and costs of precaution, see GUIDO CALABRESI, THE COSTS OF ACCIDENTS: A LEGAL AND ECONOMIC ANALYSIS (1970).

43. Indeed, in this sense, law-and-economics arguments are conceptualistic: they aim to derive legal rules from premises without regard, in the end, for the soundness of the conclusions.

A. *Tort Law: Opportunism, the Hand Formula, and Activity Levels*

Consider again, as probably the most fundamental example of a legal rule that suffers from the problem I am describing, a negligence rule based on what has come to be known as the Hand Formula in tort law. It is worth, at this stage, providing some background on the Hand Formula. Fundamentally, it analyzes precautions that potential injurers and victims might take in terms of their cost-effectiveness.[44] Judge Learned Hand, in one early description of the formula, stated it as follows: "[I]f the probability [of injury] be called P; the [amount of the] injury, L; and the burden [of precaution against the injury], B; liability depends upon whether B is less than L multiplied by P: i.e., whether B [is less than] PL."[45]

Judge Hand did not conceive the formula as something meant to be applied literally; he appears to have intended it as a loose guide for those making factual determinations about which behaviors are reasonable and which are not.[46] Nonetheless, his formulation is often taken literally and formally; for example, Richard Posner has built upon it by formalizing it, separating its absolute form from its marginal form, and so on.[47]

Perhaps even more significantly, the Restatement (Third) of Torts adopts the formula explicitly, essentially in its algebraic form:

> A person acts negligently if the person does not exercise reasonable care under all the circumstances. Primary factors to consider in ascertaining whether the person's conduct lacks reasonable care are the foreseeable likelihood that the person's conduct will result in harm, the

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44. *See* Bayern, *Negligence*, *supra* note 5, at 713-14.

45. United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947).

46. Judge Hand later wrote:

> It is indeed possible to state an equation for negligence in the form, C [equals] P [times] D, in which the C is the care required to avoid risk, D, the possible injuries, and P, the probability that the injuries will occur, if the requisite care is not taken. But of these factors care is the only one ever susceptible of quantitative estimate, and often that is not. The injuries are always a variable within limits, which do not admit of even approximate ascertainment; and, although probability might theoretically be estimated, if any statistics were available, they never are; and, besides, probability varies with the severity of the injuries. It follows that all such attempts are illusory, and, if serviceable at all, are so only to center attention upon which one of the factors may be determinative in any given situation.

Moisan v. Loftus, 178 F.2d 148, 149 (2d Cir. 1949); *see also* Stephen G. Gilles, United States v. Carroll Towing Co.: *The Hand Formula's Home Port*, *in* TORTS STORIES 11, 28 (Robert L. Rabin & Stephen D. Sugarman eds., 2003).

47. RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 168-69 (7th ed. 2007).

> foreseeable severity of any harm that may ensue, and the burden of precautions to eliminate or reduce the risk of harm.[48]

The comment to the Restatement adds:

> Conduct is negligent if its disadvantages outweigh its advantages, while conduct is not negligent if its advantages outweigh its disadvantages. The disadvantage in question is the magnitude of risk that the conduct occasions; as noted, the phrase "magnitude of the risk" includes both the foreseeable likelihood of harm and the foreseeable severity of harm that might ensue. The "advantages" of the conduct relate to the burden of risk prevention that is avoided when the actor declines to incorporate some precaution. The actor's conduct is hence negligent if the magnitude of the risk outweighs the burden of risk prevention.[49]

In prior work, I described theoretical economic shortcomings of negligence regimes based on the Hand Formula on its own terms,[50] and I began to describe some broader problems associated with the opportunism that it enables.[51] In this Part, I mount in more detail the critique that I outlined earlier in this Article.

The critique is essentially twofold. Its first part has already been telegraphed because I already used the Hand Formula (in my examples involving the choice between operating a railroad and operating a hotel) as my central example of a supposedly freestanding economic argument in tort law that nonetheless depends on broader economic perfection outside tort law. That is, the first part of the critique is that just because an activity is "efficient" in the sense that it produces wealth compared to its absence does not mean we want the activity to occur, even on instrumental grounds.

Recall that in my example, if a railroad were the only possible business opportunity (that is, if the hotel did not exist), society would, from the perspective of welfare maximization, want it to operate rather than not to operate. In other words, even given the harm it externalizes, the railroad is still socially valuable; its expected net present value, from society's perspective, is still positive. If the question were evaluated in isolation, as if it were the only possible business any entrepreneur could start, any rational and public-minded social planner concerned only with instrumental efficiency who had to answer the question, "Should there be a railroad here?" would answer

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48. RESTATEMENT (THIRD) OF TORTS: LIAB. FOR PHYSICAL & EMOTIONAL HARM § 3 (2005).

49. *Id.* § 3 cmt. e.

50. Bayern, *Negligence*, *supra* note 5, at 731-38.

51. *Id.* at 740-49.

"Yes." To state it more formally, as between operating a railroad and operating nothing, operating the railroad is Kaldor-Hicks efficient.[52]

But because there are business alternatives for the firm other than railroads, the danger of a negligence regime—that is, of a regime that allows the firm in our example to operate a railroad without paying for all its social costs—is that it gives activities that externalize costs an advantage. To be clear, my argument is not that strict liability would necessarily be more efficient than a negligence regime; which one is superior would be almost impossible to deduce without a sensitive look at the various costs and benefits of each business activity and also, for complex reasons I have discussed elsewhere,[53] of the activities that the people who suffer the railroad's harm engage in (such as owning houses or businesses in areas where the railroad might operate). My argument, instead, is just that the Hand Formula poses the danger I have described.

The second part of my critique concerns activity-levels arguments. A substantial and important body of prior economic work concerned with "activity levels" has suggested what might seem to be a way around the problem I have described; if it indeed were, my critique would not be against economic reasoning as a whole but just against a form of economic reasoning that had become outdated. However, though activity-levels arguments are significant, they are concerned with a problem different from the one I am describing.

Activity-levels arguments are due, originally, to Steven Shavell.[54] The principal contribution of such arguments is a recognition that if an actor does not bear the risk of injuries as long as he or she acts safely or reasonably, the actor may nonetheless engage in *too much* of an activity. For example, if I am sure that I can avoid all liability for car accidents by driving reasonably, then I might drive safely (to avoid liability), but I might still drive too often. I might, in other words, not take into account the costs that my safe driving imposes on others—even if it increases the likelihood of accidents (because even safe driving sometimes causes accidents). Shavell originally described the problem as follows:

> By definition, under the negligence rule all that an injurer needs to do to avoid the possibility of liability is to make sure to exercise due care if he engages in his activity. Consequently he will not be

52. *See* POSNER, *supra* note 47, at 13-15.

53. Bayern, *Negligence*, *supra* note 5, at 731-38.

54. *See* Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1, 1 (1980).

> motivated to consider the effect on accident losses of his choice of whether to engage in his activity or, more generally, of the level at which to engage in his activity; he will choose his level of activity in accordance only with the personal benefits so derived. But surely any increase in his level of activity will typically raise expected accident losses (holding constant the level of care). Thus he will be led to choose too high a level of activity; the negligence rule is not "efficient."[55]

Of course, if courts could directly judge whether people were driving too often, they could declare *that* decision to be negligent and thus impose liability for it.[56] But courts cannot easily judge whether someone drives too much; they do not have access to enough information to make that determination, and they do not have the expertise or institutional competence to make decisions like it.

Shavell, very early, recognized that the problem of activity levels makes it impossible to develop simply efficient rules in tort law. His argument is technical,[57] but at heart it presents a simple recognition: because an injurer and a victim in tort law cannot both bear the financial risk of the same accident (unless we were to radically restructure tort law to involve payments to the state or to third parties), the law can provide incentives for efficient levels of activity for only one of them. Thus, for example, as between a safely operated railroad and the nearby cornfields that its operation might nonetheless unavoidably burn down, the law can either assign (strict) liability to the railroad or make the cornfields' owner suffer the harm without a legal remedy (as it would under a rule of negligence). In the former case, there might be too much incentive to run railroads (albeit reasonably safely), whereas in the latter case there might be too much incentive to grow corn on fields near railroad tracks (albeit reasonably safely). The law cannot discourage both parties from engaging in their respective activities excessively.

This Article's central critique may sound at first blush merely like an activity-levels argument. That is, it may appear, in my example concerning the choice between railroads and hotels, that the problem is simply that there will be too much railroading and not enough hotel operation. The railroad is, after all, operating safely, as far as the legal-

55. *Id.* at 2 (footnotes omitted).

56. *See id.* at 22-23; Bayern, *Negligence*, *supra* note 5, at 726-27.

57. *See* Shavell, *supra* note 54, at 18-20; *see also* Bayern, *Negligence*, *supra* note 5, at 726-28.

economic analysis is concerned.[58] But it should not operate—that is, if it operates, we will see *too much* "safe" or "reasonable" railroading.

The difference between my critique and Shavell's understanding of activity levels is that my critique is concerned with factors that have nothing to do, directly, with tort law. The activity-levels argument, at bottom, addresses the notion that at some levels of engagement, some activities cause social harms that cannot be cost-justified. That is, Shavell is concerned with "any increase in . . . level of activity [that] will typically raise expected accident losses."[59] The problem with too much "safe" automobile driving is conceived, as far as traditional activity-levels arguments are concerned, in terms of the excess risk that such driving will cause to other drivers; it is not concerned directly with the motivation to drive rather than to engage in some other, entirely unrelated activity. Shavell observes that although a driver

> will choose to engage in the activity just up to the level at which the personal benefit from a marginal increase would equal zero, it would be best from society's viewpoint for him to engage in the activity only up to the level at which his benefit from a marginal increase would equal the (positive) social marginal cost in terms of accident losses.[60]

To put it differently, the frequency at which people drive is only important to traditional activity-levels arguments if there is some level at which too much driving is, on its own, socially inefficient—if it would be better, past some point, for the hypothetical driver to do nothing than to drive.[61]

My critique, however, is oriented differently; my argument is that the problem remains even if there is *no* level at which driving is, on its own terms, inefficient. To see the difference, consider the following stylized example: there are unlimited supplies of two materials (say, copper and coal) in the ground, waiting to be mined. To keep the example numerically simple, we can measure the value of copper and

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58. We know this from the terms of the hypothetical, which is that the railroad produces $100,000 in gains while causing only $95,000 in losses. Recall that I am assuming, in constructing the hypothetical, that there is no cheaper way to prevent the $95,000 externalized losses than the full cessation of the railroad's operations, at an opportunity cost to the railroad of $100,000. *See supra* note 13 and accompanying text.

59. Shavell, *supra* note 54, at 2.

60. *Id.* at 2 n.3.

61. There is, again, a wrinkle underlying this point, which is that if marginal costs and benefits of *all* activities are calculated correctly, and if a general economic equilibrium prevails, *see* SAMUELSON & NORDHAUS, *supra* note 23, at 160-65, the activity-levels arguments appear to approach my concern. But my chief point in the text is that general equilibria do *not* prevail—or, at least, that apparently freestanding arguments in tort law and contract law should not assume that they do.

coal against the number of hours it takes to extract them from their natural stores; we can say, hypothetically, that an hour's effort extracting coal yields $10 worth of coal and that an hour's effort extracting copper yields $8 worth of copper. Suppose, however, that mining coal causes $4 per hour in externalized harms (as health risks to employees, damage to land, or what not). Suppose, for our purposes, that we could not possibly mine either coal or copper fast enough to cause their values to fall anytime soon.

In this example, there is essentially no activity-levels concern, following the traditional economic understanding of activities levels. Because the price of copper and coal do not marginally decline with mining, there is no level at which is it *not* worthwhile to society, overall, to mine the copper or the coal. And, as with my example presenting the railroad versus the hotel, both coal mining and copper mining in this example are efficient; if both could occur, we would want both to occur. (The social value per hour of work mining coal is $10-$4, or $6; the social value per hour of mining copper is $8.) But because of limited capital, credit, labor, or other factors, we might have to choose between mining coal and mining copper. The Hand Formula will lead us, as in the railroad-and-hotel example, to make the wrong choice, and activity-levels arguments concerned only with tort-related incentives do not fix the problem; there is, again, no level in this example at which we do not want coal mining to occur, if coal mining is evaluated on its own.

Thus, in some sense, the orthodox understanding of activity levels has nothing to say here. Like the Hand Formula itself, it is concerned fundamentally with the rate of accidents. Posner drives that point home:

> Only when a class of activities can be identified in which activity-level changes by potential injurers are the most efficient method of accident prevention is there a compelling argument for imposing strict liability. Conversely, in a class of activities in which activity-level changes by potential victims are the most efficient method of accident prevention, there is a strong argument for a rule of no liability . . . .[62]

To reach social optimality, however, the efficiency of liability rules cannot be evaluated exclusively from the perspective of determining the optimal level of either the injurer's or the victim's activity in isolation. In isolation, the harm externalized by mining coal in my

62. POSNER, *supra* note 47, at 179.

example would not matter, because it is always efficient in isolation to continue to mine coal.

It is worthwhile to stress that Shavell has long recognized that activity-levels arguments on their own cannot lead to fully efficient results.[63] He observed in his original formulation of the arguments that "there is no conceivable liability rule that induces parties to act efficiently"; he continued: "[C]onsider any liability rule which may depend on any or all of the following variables: the victim's losses, the care he exercises, the care the injurer exercises. Then the liability rule is not efficient."[64] That conclusion, of course, agrees with my underlying observation that traditional analysis of tort-based economics does not lead to efficient results. But economists did not, over the last twenty years, take Shavell's conclusion as a call to engage in a broader kind of economic reasoning in tort law than one that concerned itself only with "the victim's losses, the care he exercises, [and] the care the injurer exercises."[65] Economic reasoning has remained fairly narrowly focused on those same goals.[66]

B. Contract Law: Rent Seeking and the Theory of Efficient Breach

1. The Theory in General

The theory of efficient breach is fundamental to the modern economic understanding of contract law. Posner outlines the theory as follows:[67]

> [I]n some cases a party is tempted to break his contract simply because his profit from breach would exceed his profit from completing performance. He will do so if the profit would also exceed the expected profit to the other party from completion of the contract, and hence the damages from breach. So in this case awarding damages will not deter a breach of contract. It should not. It is an efficient breach.[68]

Posner illustrates the theory with the following example:

> Suppose I sign a contract to deliver 100,000 custom-ground widgets at 10¢ apiece to A for use in his boiler factory. After I have delivered 10,000, B comes to me, explains that he desperately needs 25,000 custom-ground widgets at once since otherwise he will be forced to

63. *See supra* note 57 and accompanying text.

64. Shavell, *supra* note 54, at 19.

65. *Id.*

66. *Cf.* Hershovitz, *supra* note 5, at 77.

67. For a discussion of the changes in Posner's formulation of the theory over the years, and also of the origins of the theory, see Eisenberg, *supra* note 14, at 997-98.

68. POSNER, *supra* note 47, at 120.

> close his pianola factory at great cost, and offers me 15¢ apiece for them. I sell him the widgets and as a result do not complete timely delivery to A, causing him to lose $1,000 in profits. Having obtained an additional profit of $1,250 on the sale to B, I am better off even after reimbursing A for his loss, and B is also better off. The breach is therefore Pareto superior.[69]

The theory of efficient breach as thus outlined is severely misguided for several reasons, most of which Professor Melvin Eisenberg and others have detailed.[70] The most significant flaws are in fact relatively easy to describe once they are exposed: first, just because *B* is willing to bid more than *A* after *A* signs a contract does not mean that *B* values the goods more highly than *A*; *A* may simply have cut a better deal or negotiated at a better time. Second, as even Posner recognizes, breach is not the only way *B* (the user who putatively places a higher value on the goods) can get the goods; he could also buy them from *A*.[71] Posner claims that it will be cheaper (in terms of transaction costs) for the original seller to sell to *B*, but this is little more than an arbitrary supposition, and it seems unlikely in view of the extremely large transaction costs of the litigation that would result from breach. Third, *A*'s damages will not necessarily measure *A*'s costs for all the reasons that contract damages may fall short of the full subjective damages that would make promisees indifferent between performance and breach, such as rules concerning foreseeability and certainty.

2. Factor-Market Imperfection and Its Relationship to Contract Law

The view of factor-market imperfection that I have offered presents a further flaw. Specifically, the theory of efficient breach would provide incentives to adopt the business of the seller in Posner's example, or alternatively of *B*, the third-party buyer who asks for breach. The theory of efficient breach, in this sense, is an argument in favor of what Robert Nozick called "utility monsters";[72] that is, people who place a higher value on goods will, under the theory of efficient breach, be able to transfer wealth toward themselves and destroy rights of others in the name of efficiency. That alone does not lead to a conclusion that the theory of efficient breach is in fact inefficient, but it is strongly suggestive: if people can gain more rights simply by

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69. *Id.*
70. *E.g.*, Eisenberg, *supra* note 14, at 997-1016.
71. POSNER, *supra* note 47, at 120.
72. ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 41 (1974).

adjusting their preference, then most of the efficiencies of contract law (in terms of enabling value-creating bargains) would be lost, and the law would come to favor the preferences of people at the current instant rather than the interests of those who once bargained about their rights.

This problem with the theory of efficient breach interacts with this Article's argument about the effects of factor-market imperfections because it suggests that the theory provides too great an incentive to become like—that is, to engage in the activities of—the original seller or party *B* in Posner's example. That is, in Posner's example there will be too strong an incentive either to become a seller who can breach or to produce pianolas, and not enough of an incentive to produce boilers—or, importantly, to do *anything else*.[73]

The reasons for this conclusion, in a contractual setting, are perhaps not as obvious as this Article's conclusions in tort law. As noted, the central problem for our purposes is that the theory of efficient breach increases the incentive to become one of the parties that benefits from the contract that results from breach (the one between the original seller and *B* in Posner's example) and less of an incentive to become one of the parties that would benefit from a rule that encouraged performance of the original contract. I focus on the benefits to the parties of the respective contracts, collectively, because for either contract, bargaining may assign the gains of the contract in favor of either party—so we do not know, for instance, that the conclusion of the second contract at the expense of the first helps either the original seller or *B* individually, but we do have good reason to think it relatively helps the two collectively.[74] (Similarly, encouraging performance of the first contract helps the original seller and *A*, relatively speaking, but we do not know the individual gains of either the original seller or *A* individually.)

Accordingly, allowing a breach of the contract reflects a transfer of wealth from the group that is composed of *A* and the original seller to the group that is composed of *B* and the original seller. Of course, in theory this redistribution might be efficient rather than inefficient, and it may or may not accompany whatever gains or losses may otherwise be associated with the theory of efficient breach; my point

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73. As noted previously, Professor Eisenberg has made a similar point; his was in terms of incentives for planning rather than incentives to adopt lines of business, but the two points are consistent and mutually supportive. *See* Eisenberg, *supra* note 14, at 1010-13.

74. For an economic overview of bargaining, see COOTER & ULEN, *supra* note 42, at 32-42.

for now is only that there is a relative difference in the way that wealth is distributed between a remedial regime in contract law that applies the theory of efficient breach and one that rejects the theory. On balance, unless the bargaining power of the parties is systematically lopsided, we can expect the relevant redistribution will be from *A* to both the original seller and *B*.[75] Accordingly, under the theory of efficient breach, there will be more of an incentive to enter either the line of business of the original seller or the line of business of *B*. Or, to state the matter more generally, there will be more of an incentive to become either like (1) parties that have the opportunity to breach their contracts and resell goods or services to third parties, or (2) the third parties that benefit from such opportunities.

Of course, in the real world there may not be consistent or easily identifiable classes that correspond to groups (1) and (2) above. If there are not, then the theory of efficient breach may not be problematic in the way I am describing. But there are strong reasons to think that the theory of efficient breach will systematically hurt, and help, some identifiable classes of parties more than others. For one thing, those who have internalized a "moral norm of promise-keeping" will be systematically less likely to breach their contracts than those who have not, and thus will lose, relatively speaking, under a rule that encourages breach.[76] Moreover, those who are in a position to resell goods and services (that is, merchants) are likely to benefit from the theory of efficient breach more than those who are not (like typical consumers). Similarly, third parties in industries that present sudden, unexpected needs, with correspondingly high demand for goods and services, will tend to benefit from the theory more than those in industries with more predictable prices and preferences.[77]

Accordingly, it is likely that the theory of efficient breach does help some people and hurt others. It consequently provides a distorting economic incentive in favor of the people it helps and against those it hurts. In Posner's example, for instance, it probably

75. That is, *A* clearly loses on balance; *B* clearly wins; and the original seller can be presumed to win, under the theory of efficient breach, if only because the theory rests without penalty the perform-or-breach decision with him or her.

76. *See* Eisenberg, *supra* note 14, at 1012.

77. The reason for this is straightforward: parties like *B* (the third-party buyer after the original contract is breached) are more likely to be those that could not anticipate their needs in advance, whereas parties like *A* (who concluded a contract at a more favorable price) are more likely to be able to anticipate their needs in advance. Those who can anticipate needs in advance, in other words, are more likely to sign favorable contracts than those that cannot. The theory of efficient breach disserves the former category of promisees in favor of those with less stable or predictable preferences.

leads to a greater incentive to manufacture pianolas than there would otherwise be. Suppose the pianola factory owner would need to pay 16¢ instead of 15¢ for widgets without the theory of efficient breach; the theory of efficient breach makes it correspondingly more profitable to own a pianola factory.

As with all this Article's arguments, this distortion alone might not be problematic if all activity that is efficient in isolation (that is, again, better than its absence) can occur. Whether it costs 15¢ instead of 16¢ to buy widgets for a pianola factory does not matter if (1) producing pianolas is socially valuable, and (2) the consequent diversion of resources into pianola factories does not, because of factor-market imperfections, restrict activities that are even *more* socially valuable. Encouraging pianola factory owners solely on the basis of the former of these factors may, however, easily promote inefficiency.

To put the problem differently, the theory of efficient breach, as applied in Posner's example, rests implicitly on the premise that it is a good thing for pianola production to occur. We know at least, from the terms of Posner's example, that it is profitable for the pianola factory proprietor to be in the business of manufacturing pianolas, or else he would not be willing to bid for widgets in the first place. We do not, however, know enough to conclude that the business should be encouraged; to assume that it is socially valuable just because it is valuable when its costs and benefits are calculated without regard for the relative costs and benefits of other activities is to commit the fallacy that this Article has described. Just like assuming that banking should be encouraged because it is "productive," it may be wrong to favor pianola factories just because some people want to engage in that activity; their reasons for engaging in it can theoretically be more for reasons of redistribution than for reasons of overall social efficiency. And that becomes a problem when—but only when—factor-market imperfection makes it impossible for all activities that are efficient in isolation to occur.

To be clear, I am not suggesting that the theory of efficient breach *necessarily* leads to inefficiency for the reasons I am describing; I am only suggesting it is possible. My argument is that the theory of efficient breach is, in view of factor-market imperfection, insufficient to justify its conclusion; if factor markets are imperfect, the theory is fully consistent with a state of affairs in which the theory of efficient breach causes inefficiency because it encourages people to breach contracts more for redistributive than for productive reasons.

To determine whether the theory of efficient breach specifically promotes inefficiency in an individual case, on the particular grounds I am describing, we need, essentially, to evaluate the opportunism of the original promisor and the third-party buyer. The opportunism, which rests on an incentive to transfer wealth rather than to create it, leads to the distortion with which this Article is concerned. That is, if the theory of efficient breach is applied as a foundation for contract law's remedial regime, the result will be that some parties will either (1) seek breach when the result is that they profit but society profits less than they do or (2) less directly, seek to become like those parties who can benefit from such opportunistic breaches. As with this Article's tort law argument, the problem is not specifically, for our purposes, that actors will engage in socially harmful businesses; it is that they will choose one socially beneficial business over another that is *more* beneficial. For example, they may choose to become like the seller or the pianola factory owner in Posner's example rather than choosing something that does not externalize the costs (because of imperfect damage measures and so on) in ways that the theory of efficient breach permits. Thus, for example, the theory of efficient breach is likely to give parties too much of an incentive to be in lines of business that face unstable preferences and sudden, unpredictable needs.

3. Inefficiency in the Face of Bargaining

The ability of contractual parties to reallocate gains to one another through bargains may seem to undermine the point I have made so far. For example, if in Posner's example the original seller and *B* collectively profit at the expense of *A*, we should expect that the seller would offer *A*, or that *A* would demand, a lower price for the greater risk of breach. Alternatively, the parties might liquidate damages, specify in detail what does and does not count as breach, and so on, in order to protect *A*'s interests ex ante. Accordingly, it may not seem problematic if the seller and *B* collectively benefit at *A*'s expense, for it may seem that in a dynamic world, bargaining will simply address the problem.

This objection, of course, is correct to the extent that bargaining—where perfect—addresses *all* economic problems that may arise. That recognition is the heart of the Coase Theorem, which concludes that perfect bargaining makes legal rules irrelevant because parties can simply achieve allocative efficiency on their own.[78] More

78. *See generally* Coase, *supra* note 10.

than forty years ago, Guido Calabresi saw that when the premises of the Coase Theorem are accepted, even long-term inefficiencies that legal rules aim to address drop away.[79]

Even when considering the efficiency of rules in contract law, however, it is improper to assume that bargaining is perfect and fully costless. As noted, that assumption makes all legal rules irrelevant; in a world without any transaction costs, the theory of efficient breach is necessarily as efficient as any theory proposing its opposite. The question is, as usual, what rule is best in our world. If we think that the market is good enough that parties will expect breach at exactly the right levels and bargain in view of its possibility, the theory of efficient breach may not be inefficient, but it is precisely those cases in which it does not matter anyway. To say it differently, the theory of efficient breach could plausibly be efficient if parties bargained with it in mind. There are, however, strong reasons to suppose that parties do not bargain with it in mind.[80]

In any event, if economic arguments must assume that bargaining is perfect in order for them to justify their results, that is yet another deep and potentially flawed assumption that the arguments make without purporting to do so.[81] And it would be a particularly ironic assumption given that, as the Coase Theorem describes, perfect

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79. *See* Guido Calabresi, *Transaction Costs, Resource Allocation and Liability Rules—A Comment*, 11 J.L. & ECON. 67, 68 (1968) ("[I]f one assumes rationality, no transaction costs, and no legal impediments to bargaining, *all* misallocations of resources would be fully cured in the market by bargains. Far from being surprising, this statement is tautological, at least if one accepts any of the various classic definitions of misallocation." (footnote omitted)).

80. The details of those reasons are beyond the scope of this Article, but see Eisenberg, *supra* note 14, at 1007-08, for an outline of them.

81. The assumption that parties can reassign contractual surplus with perfection and ease appears to be so embedded in the contract literature that it is difficult to find examples where the assumption is disputed, even though, of course, real-world experience suggests that bargaining is not in fact perfect and that prices and other redistributive terms are often constructed with economic imperfection. Professor Eisenberg is one of the few commentators who recognizes this imperfection directly; for example, in suggesting that a profit margin may be fixed in a particular practical context, he writes:

> Nor is it true . . . that there is no good economic reason for the notion that the percentage markup is fixed. Based on observation, sellers often price by applying a rule-of-thumb markup. Furthermore, there is a good economic reason for pricing that way—it saves the administrative costs of one-by-one pricing decisions, and allows pricing decisions to be made lower down the food chain.

Melvin A. Eisenberg, *Impossibility, Impracticability, and Frustration—Professor Goldberg Constructs an Imaginary Article, Attributes It to Me, and Then Criticizes It*, 2 J. LEGAL ANALYSIS 383, 392-93 (2010) (internal quotation marks omitted).

bargaining makes models like the theory of efficient breach essentially pointless to begin with.

IV. THE NEGLECT OF ALTERNATIVES IN OTHER TORT AND CONTRACT MODELS

A. *Contract-Limiting Rules: Unconscionability, Minimum Wage, and Rent Control*

1. The Form of the Problem

Classic economic understanding counsels against rules that prevent private parties from entering into some bargains;[82] these include rules that strike down some contracts as unconscionable and those that (often by statute) prevent contracts from adopting particular terms, such as wages below a certain dollar figure or residential rent above a calculated amount. These economic arguments, like the more foundational models that Part III addressed, appear to assume implicitly that factor markets are perfect; once factor-market imperfection is recognized, it becomes clear that these arguments' sweeping conclusions should be replaced by a more nuanced analysis. Indeed, factor-market imperfection may point the way toward a clearer analysis of contract-limiting rules than the one that the law currently provides.

Consider, as an example, the debate about whether contract law should prevent one party from extracting a large and "unfair" amount of the contractual surplus.[83] Suppose there is a factory owner that

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82. *See* COOTER & ULEN, *supra* note 42, at 290-92; *see also infra* note 92 and accompanying text.

83. Extracting an unfair amount of the contractual surplus is known as *substantive unconscionability* in contract law. *See* 1 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 4.28, at 585 (3d ed. 2004). Rules prohibiting substantive unconscionability are different from, and generally more controversial than, rules that protect parties against *procedural unconscionability*, which reflects a simple breakdown in the bargaining process as a result of factors like information asymmetries or the use of form contracts. *See id.* at 588-89. For recent discussions of the merits of rules concerning unconscionability, see Larry A. DiMatteo & Bruce Louis Rich, *A Consent Theory of Unconscionability: An Empirical Study of Law in Action*, 33 FLA. ST. U. L. REV. 1067 (2006); Melvin Aron Eisenberg, *The Role of Fault in Contract Law: Unconscionability, Unexpected Circumstances, Interpretation, Mistake, and Nonperformance*, 107 MICH. L. REV. 1413, 1415-18 (2009). For a leading legal-economic view on substantive unconscionability, see Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1, 20-29 (1993).

When I refer to unconscionability in this Article, I mean to indicate substantive unconscionability unless the context suggests otherwise. Rules preventing procedurally unconscionable contracts are generally as easy to defend as rules concerning fraud and

would be able to pay his workers up to forty dollars a day because the potential workers produce that much value for the factory. But the potential workers have no better options in their locale and cannot easily move, so they would accept wages as low as approximately fifty cents a day to work. The factory owner knows this, so he offers fifty cents a day for the work. Suppose the workers, being plentiful and disorganized, accept the offer.

A basic economic argument against an unconscionability doctrine—or a minimum-wage law—that would prevent this kind of contract would be that the parties will not enter the contract unless they both benefit from it, and therefore the contract is wealth-producing and should be permitted or even encouraged.[84] The workers would not accept fifty cents a day if they had better alternatives. Accordingly, the reasoning proceeds, preventing the contract would make at least one of the parties, and probably both of them, worse off. The contract should therefore be allowed. Maybe there are other reasons in favor of an unconscionability doctrine or a minimum-wage law, an economist might say—such as notions of fairness or broad social concerns about the distribution of income and wealth. But efficiency, he or she would continue, is not among them.[85]

I should note that my goal is not specifically to defend the efficiency of substantive-unconscionability rules in all contexts. My aim is, as it has been before, to show that the sweeping conclusions of legal-economic arguments are unfounded unless they assume factor-market perfection.

The flaw, a variation of the one we have been discussing throughout this Article, is as follows: systematically being able to extract a large share of contractual surplus may give rise to what is essentially an externality worth preventing. Suppose *A* can contract with either *B* or *C*, but not both. To maximize social welfare, we want the transaction that is most valuable to occur. But *A* wants the contract that is privately more valuable to her, alone. If the contract with *B* has a total surplus of $200 and the contract with *C* has a total surplus of $250, but *A* can extract 98% of the surplus in the case of *B* and only 72% of the surplus in the case of *C*, she will choose *B* (and get 98% of $200, or $196) rather than *C* (and get 72% of $250, or $180).

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duress, because when the bargaining mechanism breaks down, it is hard to say that there is a contract that is either fair or efficient to enforce.

84. *See infra* note 92 and accompanying text.

85. *See infra* note 92 and accompanying text.

If *A* can contract with both of the parties, or if other parties like *A* can contract with both of them, then it does not really matter which contract *A* chooses, at least in terms of economic considerations. But we can be sure that contracts with both *B* and *C* will proceed only if we are sure that there are enough parties available to contract with both of them—that is, if the relevant markets are thick enough. To put it differently, we can be sure that the contracts will proceed only if capital markets, credit markets, and other factor markets are all perfect, because that is the only way to ensure that enough parties will be available to contract with both *B* and *C*. In the absence of that perfection—in other words, in the real world—it may be less socially efficient for *A* to pick *B* (a contract worth $200 in total, but where *A* gets 98% of the surplus) over *C* (a contract worth $250 in total, but where *A* gets only 72% of the surplus). That choice would be better for *A*, but worse for overall efficiency.

Addressing a few potential complications may be in order at this stage. For one thing, under typical economic theory, surpluses are not fixed beforehand; the parties can bargain over them.[86] If the contract with *C* is really more valuable (to both parties, together) than the contract with *B*, why would *C* not simply offer a better deal to induce *A* to make the more efficient contract?[87] For example, why would *A* be able to extract only 72% (or $144) of the contract with *B* rather than 82% (or $205), which would be enough to entice *A* to choose *C* over *B* (because 98% of $200 is only $196, which is less than $205)? Surely *C* would prefer getting *some* surplus rather than *no* surplus, assuming *C* were rational and perfectly informed; therefore, *C* would allow *A* to extract this greater portion of the surplus.

Bargaining costs, however, may intervene and prevent the contract with *C* from going forward. Though it is, of course, correct that divisions of surpluses are not necessarily fixed in advance of contract negotiations, they may reflect typical bargaining patterns in industries, and it may be hard or expensive to vary far from those patterns.[88]

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86. *But see* Eisenberg, *supra* note 81, at 392-93 (suggesting that there could be practical reasons that surpluses are indeed fixed in advance).

87. This is, again, just a restatement of the Coase Theorem. *See generally* Coase, *supra* note 10.

88. *Cf.* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 554 (2003) ("[W]hen bargaining power is determined prior to contract formation, as is common in business contexts, ... [p]arties jointly choose the contract terms so as to maximize the surplus, which the price may then divide unequally.").

Perhaps more importantly, in the real world, we cannot be sure that it will be worthwhile for *A* to continue to search for alternatives once finding her privately good deal with *B*. In other words, the mere availability of a contract with one party can crowd out better contracts, because parties do not have unlimited resources to spend searching for contracting partners and then bargaining over contracts.[89] As long as *A* can contract with only one party, and as long as nobody else will be around to contract with the other party, simply providing the *option* of contracting with *B* makes it less likely, in the real world, that the more socially profitable contract with *C* will be concluded. But if the contract with *B* is barely socially valuable compared to its alternatives, it could be a mistake to allow it, particularly where it is so good for *A* privately that *A* may stop searching once she finds it.[90]

Moreover, to emphasize the parties' ability to bargain further here would again engage in a kind of Coasean bait-and-switch.[91] If bargaining is perfect, minimum-wage laws and unconscionability doctrines have no negative effects: if parties can get around transaction costs in general, then parties can get around a minimum-wage law by adjusting other terms. The goal of the legal rules at stake should be to do what makes sense in view of the transaction costs that we know from experience or empirical research are familiar, and if that is the starting point, then it becomes difficult to say *without more* that minimum-wage laws are inefficient without looking at the potentially redistributive activity they prevent—that is, activity that is more redistributive than other alternatives available to the contracting parties.

The observation that the contract between *A* and *B* is, on its own terms, an efficient contract (because it has a surplus) is, then, insufficient if the goal is to evaluate the normative instrumental justifications for a rule about unconscionability. This, however, has not stopped economists from creating the impression that minimum-wage

89. *See* Peter A. Diamond & Eric Maskin, *An Equilibrium Analysis of Search and Breach of Contract, I: Steady States*, 10 BELL J. ECON. 282 (1979); P.A. Diamond & Eric Maskin, *An Equilibrium Analysis of Search and Breach of Contract, II. A Non-Steady State Example*, 25 J. ECON. THEORY 165 (1981); George J. Stigler, *The Economics of Information*, 69 J. POL. ECON. 213 (1961); Shawn J. Bayern & Melvin A. Eisenberg, *The Expectation Measure and Its Discontents* (Mar. 5, 2011) (unpublished manuscript) (on file with author).

90. In the more general case, putting aside features specific to contract law, unconscionability, and minimum-wage laws, there is no reason to believe that parties will always be able to reach the most efficient result through private bargaining, regardless of the state of the law. To assume that would be to assume that there are never transaction costs great enough to prevent one potentially efficient bargain from proceeding.

91. *Cf.* discussion *supra* Part III.B.3.

rules, or those preventing unconscionability, are inefficient in broad, almost incontrovertible terms.[92]

In other words, it is clear that there can be simple efficiency-motivated reasons for a substantive-unconscionability doctrine in contract law. It is incomplete to attack unconscionability doctrines and minimum-wage laws on the ground that the contract between *A* and *B* should be permitted or encouraged because it makes *A* and *B* better off. The absence of a rule preventing unconscionability encourages *A* to choose *B* (or at least makes it more likely that *A* will choose *B*) as a contracting partner instead of *C*. Because the contract with *C* could benefit society more, the increased likelihood of a contract with *B* reflects a deadweight social loss.

Note, as before, that if all otherwise efficient transactions could be completed because factor markets were perfect, then there would be no inefficiency at stake here from *A*'s opportunism: *A* could contract with both *B* and *C*. Or if *A* contracted with *B*, someone else could contract with *C*. But because factor markets are imperfect (for example, *A* cannot get credit to contract with both *B* and *C*, and not everyone can become like *A* merely because there is some value to his position), society loses, overall, from *A*'s "unfair" contract with *B*.

In other words, allowing a factory owner to contract with disorganized low-wage laborers under harsh conditions might improve (at least in a narrow sense) the position of both the owner and the laborers, but it is difficult to know whether, in the abstract, allowing the contract to proceed is more efficient than its alternatives. Perhaps it would be more efficient for society if the owner were in a different business or if the factory were put to a different use—possibilities that might not even arise without an unconscionability rule or minimum-wage doctrine, because of the redistributive potential of the particular

92. *See* Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 306 (1975) ("[T]he problem with substantive unconscionability is further increased because the clauses so attacked are, at the time of formation, arguably in the interests of both parties to the agreement."); Mark A. Graber, *Does It Really Matter? Conservative Courts in a Conservative Era*, 75 FORDHAM L. REV. 675, 685 (2006) ("Most conservatives oppose minimum wage laws as economically inefficient."); Kent Greenfield, *Reclaiming Corporate Law in a New Gilded Age*, 2 HARV. L. & POL'Y REV. 1, 25 (2008) ("Current public policy tools that redistribute wealth and income tend to either take effect after the initial distribution of financial wealth (e.g., taxes, welfare policy) or benefit only those at the lowest rung of the economic ladder (e.g., the minimum wage). These mechanisms are notoriously inefficient."); Herbert Hovenkamp, *Legislation, Well-Being, and Public Choice*, 57 U. CHI. L. REV. 63, 82 (1990) (noting that "[t]he minimum wage statute is clearly inefficient under traditional neoclassical criteria for allocative efficiency" but discussing the possibility that people might draw "social utility" from fairer rules).

use the factory owner proposes. If a significant motivation of those who engage in activities that these laws prevent are systematically redistributing wealth to themselves and away from others, the absence of these laws encourages more of that activity. That is not necessarily efficient, even if the activity does produce wealth compared to its absence, because it may prevent *more* efficient activity from occurring.

2. Constructing Unconscionability in View of Factor-Market Imperfection

The particular potential inefficiency I have outlined of uncritically permitting parties to make all contracts they desire to make, including substantively unconscionable ones, points the way toward what is perhaps a conceptually clearer view of the unconscionability doctrine. As it stands, the doctrine is vague and potentially undertheorized.[93] But the problem I have identified rests on opportunism and on the suspicion that a party is engaging in excessive surplus extraction in ways that divert his or her attention away from more productive activities. Accordingly, an important test in understanding unconscionability doctrine is whether the allegedly unconscionable party, without the availability of the unconscionable transaction, would have engaged in an activity that is *more* socially productive than the (admittedly socially productive)[94] unconscionable contract. For instance, in my example, would the factory owner have chosen some other activity that is more productive for society if the law—either a judicially enforced doctrine of unconscionability or something like a statutory minimum-wage or rent-control law—did not permit the particular fifty cents an hour wage contract that the factory adopted?

On this view, the focus of analysis for a court considering an allegedly unconscionable contract is on the state of the allegedly unconscionable party, not the party that the doctrine would protect.[95] In other words, based on the potential economic problem I am identifying, a court considering whether a contract is unconscionable

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93. *See* 1 FARNSWORTH, *supra* note 83, § 4.28, at 581 ("Nowhere among the [UCC's] many definitions is there one of unconscionability. That the term is incapable of precise definition is a source of both strength and weakness. The comments to UCC 2-302 give only the most general guidance on the meaning of the term." (emphasis omitted)).

94. Again, I make this concession just for the purposes of considering economic arguments on their own terms.

95. *Contra* COOTER & ULEN, *supra* note 42, at 290-92.

should not especially focus on the hardship suffered by the weaker or poorer party. In some sense, this makes sense purely on grounds of efficiency—again putting aside concerns of fairness, other moral considerations, the overall social distribution of wealth, and so on—because on such grounds both parties are better off if the contract is permitted than if it is not; the question is not whether the *parties* suffer but whether society overall suffers because of the contract's crowding-out effect on other, potentially more efficient contracts. This requires that we look to the nature and condition of the allegedly unconscionable party, the one that threatens to extract a large amount of the contractual surplus; the danger is that that party's focus on redistribution rather than social efficiency is leading in fact to social inefficiency.

This view, though perhaps counterintuitive as a whole, is consistent with several intuitions that lawyers and law students seem to have about unconscionability doctrine. For example, Fuller & Eisenberg's popular casebook *Basic Contract Law* includes a note that a report by the Federal Trade Commission[96] found, on limited data, that though retailers in low-income areas charged their customers greater prices and interest, their profit margins were not significantly greater than those of mainstream retailers.[97] To the extent this finding is true, my sense is that it would tend to make people more, rather than less, accepting of the practices of low-income retailers. That response is consistent with an intuition that the position of the allegedly unconscionable party matters. An economic reason for it to matter is that if the low-income retailers were indeed making supernormal profits by charging extreme prices, those profits would suggest that their activities were chosen in lieu of something more socially efficient: the reason they were low-income retailers, in other words, was that there was a special opportunity (likely monopolistic or oligopolistic) to appropriate the money of people with low incomes, not that there was a commensurately productive opportunity from society's perspective in the business of low-income retail.

The same line of reasoning applies, of course, to minimum-wage laws and to rent-control laws. In short, allocative concerns cannot cleanly be separated from distributive concerns, because the opportunity to distribute wealth toward oneself affects choices that

96. U.S. FED. TRADE COMM'N, ECONOMIC REPORT ON INSTALLMENT CREDIT AND RETAIL SALES PRACTICES OF DISTRICT OF COLUMBIA RETAILERS (1968).

97. LON L. FULLER & MELVIN ARON EISENBERG, BASIC CONTRACT LAW 69-70 (8th ed. 2006).

have allocative consequences. Thus, if landlords are able to receive supernormal profits by charging high prices to low-income people, their efforts will be inefficiently concentrated in the low-income-housing market.

Indeed, this reasoning overall can explain the law's general distaste for windfalls.[98] A true windfall, if unexpected, may not raise the problems I am discussing.[99] But those large and apparently unfair profits that can be sought or invested in lead to exactly the sort of distortions I have described throughout this Article.

Interestingly, then, we seem to reach a sort of convergence between long-term efficiency and fairness. Fairness is particularly concerned with the undeserved appropriation of supernormal profits. Perhaps intuitions that underlie fairness recognize the economically distortive effects of such appropriation. Nicely, notions of fairness, which economists often diminish in private law analysis,[100] seem to capture intuitions that would address some of the worst potential *efficiency-related* excesses of a narrower economic regime.

B. Least-Cost Avoider Arguments

A theme that recurs in the law-and-economics literature is the notion of the *least-cost avoider*, the party who can take precautions or insure against an accident at the lowest cost.[101]

For example, as between an injurer and a victim, we might assign liability to the party who could have most cheaply avoided the accident. If the injurer would need to stop her activity entirely to avoid the accident and the victim can avoid being injured by engaging in a $2 precaution, the rule would force the victim to bear the costs of the injury.

On the surface, the least-cost avoider principle seems sensible enough, but it provides a perverse long-term incentive to avoid *becoming* the least-cost avoider in order to take advantage,

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98. *See* Christine Hurt, *The Windfall Myth*, 8 GEO. J.L. & PUB. POL'Y 339, 341 (2010) ("[I]n court, once a judge classifies an economic gain as a windfall, that gain is then unlawful and will be prohibited.").

99. *See* 20 OXFORD ENGLISH DICTIONARY 378 (James A.H. Murray et al. eds., 2d ed. 1989) (defining "windfall" as a "casual or *unexpected* acquisition or advantage" (emphasis added)).

100. COOTER & ULEN, *supra* note 42, at 7-10.

101. The concept is ordinarily associated with Guido Calabresi. *See* CALABRESI, *supra* note 42; Guido Calabresi & Jon T. Hirschoff, *Toward a Test for Strict Liability in Torts*, 81 YALE L.J. 1055, 1060 n.19 (1972); *see also* Stephen G. Gilles, *Negligence, Strict Liability, and the Cheapest Cost-Avoider*, 78 VA. L. REV. 1291 (1992) (offering a more recent broad defense of the least-cost avoider principle).

opportunistically, of the ability to externalize costs under the principle. The principle might work in theory if courts could evaluate all motivations over all time periods. Because they cannot, the principle yields a perverse incentive to engage in activities mostly or solely because they cause a redistribution of wealth; the activities particularly encouraged are those that prevent a party from becoming the least-cost avoider in contexts where the party expects liability to be significant.

Indeed, this problematic incentive seems to be somewhat broader than the rest of the concerns this Article has raised; that is, it might apply even if factor markets were perfect.[102] But the problem is particularly salient in this Article's context because it encourages a kind of long-term opportunistic redistribution to which law-and-economics arguments are characteristically insensitive. To put it differently, the problem with the least-cost avoider approach is particularly significant when not all efficient activity can occur, because there is not just the inefficiency associated with perverse long-term incentives but the deadweight loss from the absence of the activities that those incentives crowd out.

In other words, even beyond this Article's context, it would be problematic for the law to encourage actors to externalize costs by avoiding becoming the least-cost avoider. (I am tempted to call such actors *least-cost-avoider avoiders*.) With factor-market imperfection, there is a further, second-order result: the activity in which actors engage to avoid liability under the least-cost avoider rule may prevent even more efficient activity from occurring.

As an example of an economic argument that suffers from the problem, one leading understanding of impossibility, impracticability, frustration, and related contract doctrines comes from Richard Posner and Andrew Rosenfield.[103] The basic premise of their argument is the party who is in a better position either to reduce or to insure against the risk of unexpected circumstances that develop after a contract is made should be the one to bear the costs of those unexpected circumstances.[104] But a problem with this argument is that it can encourage parties to put themselves into the position of actors who can only

102. That is, even if factor markets were perfect and thus all activity that is efficient in isolation can occur, the incentives to avoid becoming the least-cost avoider of injuries could distort behavior.

103. Richard A. Posner & Andrew M. Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83 (1977).

104. *Id.* at 88-92.

reduce or bear the costs of unexpected circumstances at large cost.[105] Factor-market imperfection exacerbates the problem by allowing whatever that activity is to crowd out more efficient activity.

The least-cost avoider principle arises often in law-and-economics literature. For example, it has been applied to legal rules concerning offer and acceptance, and damages for reliance, in contract law;[106] civil-procedural rules concerning sanctions for frivolous claims;[107] and even tax law.[108] In all those contexts, the potential problem is the same: favoring one who has high costs encourages people to avoid being in a situation where their costs are low, even if having low costs is better for society.

V. CONCLUSION

If factor markets were perfect, arguments that permit opportunistic redistribution of wealth, like the Hand Formula and the theory of efficient breach, would have more plausible claims to efficiency than they do. At the very least, they would be efficient if the activities that they encourage are "efficient" or "wealth-producing" in the sense that the activities should occur rather than not occur, because we would not have to worry about potentially *more* efficient alternatives: *both* the more socially expensive activity and its cheaper alternative could occur. As noted throughout, when we speak purely in terms of economic efficiency, we *do*—all else equal—want an activity that generates $100,000 in profits by causing $95,000 in harms to a third party to occur, rather than not to occur. But if factor markets are imperfect, law and policy may need to choose a more efficient activity over one that is so minimally productive, relative to its redistributive potential. What has come to be thought of as "law-and-economics reasoning" too often encourages more expensive activities over cheaper ones. For example, it may, through the Hand Formula, encourage potential injurers to engage in selfish activity that is more socially harmful than its alternatives would be; it may similarly, through the theory of efficient breach, directly undermine efficiency

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105. Professor Eisenberg has noted, similarly, that Posner and Rosenfield's rule would discourage parties from attaining "diversification and scale." Melvin A. Eisenberg, *Impossibility, Impracticability, and Frustration*, 1 J. LEGAL ANALYSIS 207, 253-54 (2009).

106. *See* Avery Katz, *When Should an Offer Stick? The Economics of Promissory Estoppel in Preliminary Negotiations*, 105 YALE L.J. 1249 (1996).

107. *See* James E. Ward IV, Note, *Rule 11 and Factually Frivolous Claims—The Goal of Cost Minimization and the Client's Duty To Investigate*, 44 VAND. L. REV. 1165 (1991).

108. *See* Kyle D. Logue & Joel Slemrod, *Of Coase, Calabresi, and Optimal Tax Liability*, 63 TAX L. REV. 797 (2010).

by encouraging rates of redistributive breach far in excess of those that are optimal.

Many prominent law-and-economics arguments in subjects like contract law and tort law become significantly less forceful when factor-market perfection does not hold; that is, they are less forceful in the real world than in a world constructed solely from theory. Law-and-economic analysis tends to focus on one particular good (or set of goods) at a time—for example, on the costs of precautions and accidents in tort law. In limiting its focus in this way, traditional legal-economic analysis promotes rules that, if adopted, would cause many activities to be mispriced. This mispricing might not matter if capital and credit markets (and other factor markets) were perfect, for efficient factor availability would still allow all marginally desirable activities to proceed. For example, with factor-market perfection and no transaction costs, it would not matter (from a standpoint of economic efficiency) whether the law encouraged one wealth-promoting activity over another, because all such activities would nonetheless occur.[109] In the real world, however, merely knowing that one activity promotes wealth on its own is not enough for the law to encourage it—even on purely instrumental, efficiency-oriented grounds. In short, the law cannot properly make allocatively optimal decisions by focusing on only a few narrow optimands at once.

This is not, or at least should not be, news to academic economists.[110] Economic theory has long understood that a variety of assumptions are necessary for society to reach "general equilibrium," rather than just equilibrium in particular markets.[111] Economic analyses in law, such as arguments about activity levels in tort law,[112] are even sometimes sensitive to the broad kind of cost-externalization associated with the problems I am describing, though in ways that I have argued are incomplete because they still restrict their goals to one

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109. This is just an adaptation of the Coase Theorem. *See generally* Coase, *supra* note 10.

110. In that sense, this Article is part of a long tradition of using fundamental economic points to undermine narrower policy conclusions made by legal-academic scholars. *See* Calabresi, *supra* note 79, at 68-69 ("It may be that [a generalization of the Coase Theorem that Calabresi offered] has always been quite obvious to economists, although if it has its relevance has too frequently been ignored. In any event, lawyers who use economics have in virtually every case been hopelessly confused on the subject."); *see also* Bayern, *Negligence*, *supra* note 5, at 719 n.38 (observing that the economist on whose work later legal reasoning rested "recognized, interestingly, some features of the fragility of his model" that later legal commentators tended to disregard or at least deemphasize).

111. SAMUELSON & NORDHAUS, *supra* note 23, at 160-65.

112. *See* Shavell, *supra* note 54.

optimand at once (or at best a handful at once). This recognition, unfortunately, is routinely ignored in legal-economic scholarship, and as a result, legal commentary is too trusting of abstract economic modeling and insufficiently insensitive to the significant negative potential consequences of activity mispricing, opportunistic behavior, and similar broad distortions. To frame the problem in simple terms of transaction costs, the costs associated with the imperfections in capital markets, credit markets, and other factor markets—imperfections that should be all too obvious given recent history—need to be emphasized more for legal-economic arguments to promote truly efficient outcomes.

In systematically criticizing legal rules based on fairness and other noneconomic considerations, the law-and-economics movement has ironically promoted inefficiency. It has also resurrected conceptualism, or the notion that law can be algorithmically derived from a series of axioms whose social goals are severely limited. As it turns out, rules based on considerations other than narrow economic reasoning are often more likely, rather than less, to promote efficiency, at least in a world where not all fundamental economic assumptions can be accepted at face value.

To the extent this is true, the reasoning offered in typical law-and-economics arguments in the private law fairly obviously cannot be treated as *determinative* because the arguments have explicitly narrowed their scope to a subset of all possibly significant instrumental goals. This is not a criticism of the entire legal-economic research agenda, but it is important to realize that it serves as a caveat for almost all legal-economic conclusions and that those arguments' force needs to be appropriately limited when considering how they ought to affect legal policy.

It is important to conclude with a note of modesty and to reiterate that the fallacy in economic reasoning that I am describing does not necessarily lead to inefficiency in all cases. My argument has been far more cautious and more modest than one that would suggest such a broad conclusion. This Article has observed that a common form of legal-economic reasoning is, perhaps surprisingly, entirely insufficient to justify its results. Particular results of the arguments I have discussed may still be efficient in particular domains; the thesis of this

Article has been only that they might not be, and that classic economic arguments provide insufficient reasons to conclude that they are.[113]

113. Clearly, then, something broader is needed. I am inclined to think that what is needed is a more direct, less formal analysis of the factual contexts at stake. *Cf.* Mark Kelman, *The Necessary Myth of Objective Causation Judgments in Liberal Political Theory*, 63 CHI.-KENT L. REV. 579, 586 (1987) (noting that while "[s]traightforward dialogue about morally preferred desires and values is needed[,] straightforward dialogue about desires and values is precisely what [classical] liberalism"—and, as it happens, the law-and-economics movement—"believes impossible").

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