

2018

## **Methodological Failures in Leading American Economic Analyses of the Private Law**

Shawn Bayern  
*Florida State University*

Follow this and additional works at: <https://ir.law.fsu.edu/articles>

---

### **Recommended Citation**

Shawn Bayern, *Methodological Failures in Leading American Economic Analyses of the Private Law*, 5 *Critical Analysis of Law: An International & Interdisciplinary Law Review* 19 (2018),  
Available at: <https://ir.law.fsu.edu/articles/787>

This Article is brought to you for free and open access by Scholarship Repository. It has been accepted for inclusion in Scholarly Publications by an authorized administrator of Scholarship Repository. For more information, please contact [efarrell@law.fsu.edu](mailto:efarrell@law.fsu.edu).

# Methodological Failures in Leading American Economic Analyses of the Private Law

---

Shawn Bayern\*

## Abstract

Critics of the American law and economics movement normally sidestep its analysis by emphasizing noninstrumental goals for legal rules or challenging the fundamental assumptions (like the rational-actor model) of legal-economic arguments. These critiques are often valid, but they neglect an equally important problem with much legal-economic reasoning, which is that it is often simply incorrect on its own terms. Too often, legal-economic analyses amount to elaborate restatements of particular disputed legal propositions, depend on an artificial scope of analysis, smuggle in various factual assumptions, and so on. This article demonstrates these problems using a series of examples in American private law.

\* \* \*

The law and economics movement still dominates academic discussions of American private law, but it suffers from several excesses. This article highlights one such excess—one that I think of informally as overenthusiasm. As the result of a strong push by eager and dedicated scholars, many commentators today still assume that legal problems have simple economic solutions; the rough common wisdom among many in the legal academy still seems to be that there are clear economic answers to most legal problems and that the only reasons not to follow those answers wherever they lead are noneconomic concerns (such as propositions about fairness, morality, autonomy, and so on). This common wisdom is wrong for at least two reasons. First, “economics” is often indeterminate. Second, much of what’s presented as “economic” simply is not economic, rather than conceptually obscured but conventional legal reasoning; it is seen as economic only because of the rhetorical successes of the proponents of the movement. For example, it is simply untrue that legal reasoning before the Chicago School came along was insensitive to such concerns as social costs, the incentives provided by legal rules, and the allocation of resources.

One cause of these problems is that legal economists often present conclusions as if they are scientifically or logically mandated when in fact their arguments often assume their own conclusions or suffer from internal analytical problems. Despite decades of

---

\* Larry & Joyce Beltz Professor, Florida State University College of Law. Thanks to Frank Pasquale and the editors for very useful comments.

critique of legal-economic methods, there has been very little attempt to offer “internal” critiques of legal-economic arguments—that is, to meet the arguments on as nearly their own terms as is possible, and then to demonstrate flaws in the purportedly economic arguments themselves.

This article explains this problem and gives several examples of analytical flaws in popular economic arguments. The fairly consistent upshot of this sort of analysis is that legal-economic arguments often mirror legal reasoning, but they do so incompletely or one-sidedly. To put it more simply, a “law and economics” argument, at least to many private law scholars in the U.S., is often just an elaborate (and often politically motivated) dressing over one particular legal argument—and just one argument among many rather than a decisive one.

### I. Why Critique Legal-Economic Arguments Analytically?

Many critics of the American law-and-economics movement simply dismiss it as irrelevant. Indeed, in the common law world outside the U.S., even mild, largely uncontroversial economic explanations for certain rules may be seen as “non-legal,” roughly as Lon Fuller’s caricature of a fictional hyper-realist judge sounds ridiculous to us all when the judge relies on features of the procedural history in a precedential case that he learned from his “wife’s cousin.”<sup>1</sup> In all familiar legal systems, such information is simply legally irrelevant in analyzing the precedent of an authoritative case. So too, perhaps to many commentators, is economic reasoning about such things as the hypothetical incentives imposed by common law rules or the allocative efficiency of a principle of contract damages. That is, the efficiency of a legal rule is simply irrelevant to those who value legal doctrine for its own sake. In the more realistic U.S. legal tradition, the movement is not treated as irrelevant, but the typical response of the movement’s critics is that economic considerations should not drive the law, or that the movement analyzes hypothetical rational actors who do not exist in the real world.

I am sympathetic to most of those criticisms, but I think it is fair to say they have been unsuccessful in slowing down the American law-and-economics movement. The reason is presumably that even if the critiques are valid, to economists they are question-begging. And even those outside the Chicago School believe it is normatively appropriate for law to be at least somewhat instrumental; *fiat justitia ruat caelum* may serve as an important moral reminder when weighing the rights of a criminal defendant against the political convenience of an improper determination of guilt, but it takes a particularly committed modern formalist to apply that notion to defend a rule of contract law that is

---

<sup>1</sup> Lon L. Fuller, *The Case of the Contract Signed on Book Day*, in Lon L. Fuller, *The Problems of Jurisprudence*, at 71, 81 (temp. ed. 1949) (“I should like to add a fact, however, of which my brothers are probably ignorant. It happens that my wife’s cousin was attorney for Pressman in that litigation, and I have learned through him that the case was argued before the Magistrate on grounds that had nothing to do with [the matter understood to be before the court].”).

clearly unsatisfactory to the vast majority of commercial parties upholding modern commercial norms. The history of common law has shown, time and again, that useless and counterproductive doctrines are either eroded or overruled once there is a consensus against them.<sup>2</sup> So, doctrinalism on its own is not a sufficient response to legal economics.

Still, the rejection of much legal-economic reasoning is justified. I believe the instinct to reject it is tied at least in part to an intuitive understanding of some of the movement's analytical failures—and indeed that that latent understanding is a more important obstacle for the legal-economic movement than a rejection of its consequentialist or other “non-legal” goals. If there were truly a group of legal scholars who could show convincingly that a particular legal rule would lead, better than all its alternatives, to happiness and human flourishing—indeed, to all desirable consequences—then most practical arguments against that group would diminish if not fall away entirely. It would take a particularly arid conceptualism to insist on doctrinal tradition in the face of an overwhelmingly persuasive, comprehensive consequentialist argument on an important matter—particularly those where fundamental human rights are not at issue and where consequentialist goals are not morally unpalatable. To be clear, I mean this statement to apply to cases of consequential reasoning that are not controversial on nonconsequentialist moral grounds—say, a detail concerning the application of principles of restitution to disgorgement of profits in the case of intentional breach of contract, rather than the use of torture to coerce information from suspected terrorists. My point is simply that in the absence of strong countervailing reasons, insisting on a historical doctrinal principle merely because it has been used in the past provides little argument against a comprehensive consequentialist analysis. It is often said that “the rule of law” prevents doctrinal development, but that argument seems entirely circular.<sup>3</sup>

A minor elaboration of this point is needed: perhaps there are cases where parties' reliance on existing doctrine is itself a reason in favor of insisting on historical doctrine, and similarly perhaps a sort of precautionary principle argues against certain changes. I have addressed this sort of argument in favor of doctrinal propositions in prior work.<sup>4</sup> For present purposes, I believe it suffices to say merely that in positing a persuasive consequentialist argument in favor of a novel rule, I mean the argument to include responses to such issues as private parties' reliance on the old rule; if the consequentialist argument fails to do that, it is not persuasive in the sense I am describing.<sup>5</sup>

---

<sup>2</sup> See Shawn J. Bayern, *Against Certainty*, 41 Hofstra L. Rev. 53 (2012); Melvin A. Eisenberg, *The Nature of the Common Law* 117-18, 155-56 (1988).

<sup>3</sup> See Bayern, *supra* note 2, at 84-87.

<sup>4</sup> See *id.* at 61-69.

<sup>5</sup> Perhaps what I am suggesting is that “legal economics” suffers from a marketing problem. If economists presented arguments that particular legal rules would promote human flourishing in all its forms—which is at least what the better economists aim to do—I think we would be more open to the sort of analysis I propose in the text. Economists usually don't get that far precisely because they limit their goals and adopt implausible assumptions that defy the experience and ignore the nuance of legal analysis.

If the argument in favor of a rule were purely utilitarian, there could be concerns about its distributive consequences, or its effects on particular marginalized groups—or, broadly speaking, any other relevant consequences—but those arguments are not available against a persuasive, comprehensive consequentialist. And apart from such arguments, the remaining responses seem hollow—an insistence on tradition or on an academic conception of morality or justice that is potentially insensitive to real-world conditions. I say this not to defend legal-economic reasoning or insist on the assumptions that its analysts commonly make but instead to suggest that skeptical responses to the American legal-economic movement are, at least in significant part, contextual; they are contingent on the failure of legal-economic reasoning to persuade us that its reasoning in fact meets its goals. So, for example, my suggestion is that a typical positivistic, amoral argument seems jarring to most common law commentators precisely because, at least in part, the morality missing from the argument captures considerations that are important to human happiness or other socially relevant consequences. Or, as another example, an economist's assertion that a particular rule will produce certain incentives may properly be discounted because the posited incentives seem implausible, or at least have not been convincingly demonstrated.

The reason I have made this point is that I think American legal economics does raise at least a *prima facie* challenge to classical doctrinal rules. In other words, the challenge is not irrelevant. It needs a response. My suggestion is that the appropriate response is at least in significant part analytical rather than normative: it is to refute economic arguments on their own terms, using the breadth and fact-sensitivity of common law methods. This sort of response is surprisingly rare. It is far more common to reject the conclusions of the legal-economic movement on intuitive grounds by disputing the relevance of the movement's goals. This failure to engage its methods seems to have permitted the movement to blossom, largely unchallenged on the specifics, as the chief academic force in American private law.

The remainder of this paper tries to highlight and organize the sort of analytical failures that I believe limit the appropriate force of legal economics. In particular, I aim to draw out three (admittedly very general) types of problems that I believe are systematic: (a) a misleading narrowing of scope that permits the legal-economists to smuggle clearly implausible assumptions into their analysis, well beyond the general ones about human rationality and so on; (b) equivocation about the notion of "efficiency"; and (c) increasingly technical arguments that tend to obscure rather than enlighten.

## **II. Some Systematic Analytical Failures of Legal Economics in Private Law**

### *A. Problems of Scope*

This section surveys two prominent legal-economic arguments in contract law to demonstrate how setting the scope of a legal-economic argument can permit its proponents to reach a specific conclusion that would otherwise be unjustified. The two

arguments concern the general law of unexpected circumstances (which includes such defenses as impossibility, impracticability, and frustration) and the law of disclosure (that is, when must one party to a contract reveal privately known information to the other party?).

The leading general economic argument about doctrines that concern excuses to contractual performance in the event of unexpected circumstances is due to Richard Posner and Andrew Rosenfeld;<sup>6</sup> the argument is quite old and has been criticized in a number of technical ways, but my concern with the argument here is more as a general demonstration of the rhetorical uses of legal-economic reasoning and of the flaws in those uses.

The core of the economic argument is relatively simple to state: of the two parties to a contract, one can bear (i.e., prevent or insure against) the risk of any particular unexpected circumstances at lower cost than the other, and so as “an aid to interpretation”<sup>7</sup> contracts should be read as if they assign the risks to the party able to bear them at lower cost. Economists believe this principle is justified not just on general grounds of allocative efficiency but because it is what rational contracting parties would supposedly prefer.<sup>8</sup> That is, if a draft of a contract assigns a risk to the party less prepared to prevent it or to insure against it, there is room for further negotiation; self-interested parties ought to reassign the risk and adjust the contract price, or other terms, as appropriate.

There are a variety of ways to criticize this argument. For me, the most important is probably that it’s impossible to administer in any sensible way; for example, governments are better insurers than almost any other parties, and they have the power to prevent more harms, so should governments lose every dispute about contractual impossibility, impracticability, or frustration?<sup>9</sup> I have also previously argued that Posner and Rosenfeld’s rule imposes perverse redistributive incentives.<sup>10</sup> But the argument suffers from a different sort of fault, one concerned with its choice of what to analyze. That problem, simply put, is that there are any number of reasons why even “rational,” self-interested parties would *not* adopt a contract that, taken in isolation as a single transaction, is maximally efficient—and once that perfection cannot be assured, we have

---

<sup>6</sup> Richard A. Posner & Andrew M. Rosenfeld, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 *J. Legal Stud.* 83 (1977).

<sup>7</sup> *Id.* at 90.

<sup>8</sup> See *id.* at 89 (“Since the object of most voluntary exchanges is to increase value or efficiency, contracting parties may be assumed to desire a set of contract terms that will maximize the value of the exchange.”).

<sup>9</sup> I owe this observation to discussions with Mel Eisenberg.

<sup>10</sup> See Shawn J. Bayern, *False Efficiency and Missed Opportunities in Law and Economics*, 86 *Tul. L. Rev.* 135, 175 (2011) (“[I]t 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*.”) (parentheses removed).

no basis for using a general “interpretive aid” in favor of the one economic effect that Posner and Rosenfield have identified.

There are many reasons why real-world contract parties do not allocate all risks “efficiently” in their contracts and then simply shift the contract price to accommodate the optimal division of risks. One of the most important, in the real world, is that nearly any firm of appreciable size adopts risk-management policies that prevent their agents from exposing the firm to catastrophic losses. For example, company policies routinely prohibit individual agents from signing contracts that individually or in the aggregate expose the company to more than a certain amount of financial risk. This type of management of agents is unremarkable; it is easily susceptible to a classical sort of economic analysis of its own, and Richard Posner would almost surely agree that a rational firm would adopt policies that aim to reduce the sum of its costs of monitoring agents, incurring losses from agents’ errors, and so on. But that understanding doesn’t appear in the typical legal-economist’s analysis of impossibility. The two analyses proceed separately, one not affecting the other.

Given this reality, a court that followed Posner and Rosenfield’s recommendations would simply be rewriting contracts with one particular economic consideration in mind—the one Posner and Rosenfield happen to be thinking about in presenting this argument. There is, however, simply no reason to assume that the rationality of a business firm is focused on individual contract terms addressing impossibility, impracticability, or frustration rather than on other organizational goals, like reducing agency costs. Even the possibility of other considerations makes Posner and Rosenfield’s argument impossible to apply. And this is no surprise, because any lawyer understands that ordinary interpretive principles do better, in practice, than attempts to reverse-engineer the rationality behind a constrained decision that exists in a rich, irreducible commercial context.

The problem with the arbitrary scope of Posner and Rosenfield’s legal-economic argument, then, is that it may make sense on its own terms but it is impossible to integrate into a broader analysis of efficiency. Once we recognize that we cannot assume each individual contract is meant to maximize the joint wealth of the contractual parties in a manner limited to the individual transaction in question, there is no basis on which to assume that any specific assignment of risks matches the preferences of the parties. To determine those preferences, we would need to look at the whole situation—something that Posner and Rosenfield specifically don’t want us to do.<sup>11</sup>

Of course, all this might be done without economic reasoning in particular. For example, well before the Chicago School, common law courts recognized many of the features of these cases that would matter to economists. Even the standard, famous cases

---

<sup>11</sup> E.g., Posner & Rosenfield, *supra* note 6, at 84 (criticizing those who believe that “no general theory is possible” in this area).

raise these points. It is possible to read *Taylor v. Caldwell*,<sup>12</sup> in which the court excuses both sides from a contract to rent out real property for use as a concert hall after the relevant building is destroyed by a fire, as applying an approach grounded in what the parties likely would have wanted given their relative costs. *Transatlantic Financing Corporation v. United States*<sup>13</sup> explicitly addresses the parties' relative abilities to predict and insure against the event causing the alleged commercial impracticability. But importantly, it does so sensitively, with attention to context—not using a single economic point to trump everything else but determining the important features of a case based on all the circumstances. Economic reasoning might shed light on what the court is doing, but it doesn't dictate one result over the others.

A related problem with arbitrariness of scope arises when a legal-economic argument (1) identifies a desirable result, and (2) connects the result to a legal rule that could achieve it, but (3) fails to consider whether the legal rule is needed to reach the result in the first place. In this pattern, arguments confuse necessary with sufficient conditions.

As an example, consider rules concerning disclosure in contract law—that is, rules that address the problem of when one party needs to disclose privately held information to the other party (for example, a material hidden defect in a good or real estate). The leading American legal-economic analysis of contract disclosure dates to work by Anthony Kronman.<sup>14</sup> Dean Kronman's argument differentiated between information that was acquired accidentally and information that was acquired as a product of investment. In short, his argument was that contracting parties should be under a duty to disclose accidentally acquired information—something overheard on a subway, for example—but should be able to profit if they have invested in information.

Consider a paradigmatic type of case in this area, described originally by Michael Trebilcock:

that of a prospector who through research of various kinds, including flying over vast expanses of farmland taking magnetic soundings, develops a well-informed hunch that a particular block of farmland may have serious potential as a mineral reserve or an oil-drilling site, and does not disclose this fact to the incumbent farmer before purchasing the land at a price that reflects only agricultural uses. Although welfare considerations seem fairly unambiguously to militate in favor of non-disclosure by the buyer, . . . the deliberate exploitation by the buyer of the farmer's ignorance of a crucially important fact bearing on the real value of his property seems to involve the taking of advantage of a less than fully autonomous choice by the farmer if one views as pre-conditions for fully autonomous choices, as even Milton Friedman does, lack of coercion and full information. It may be plausible to argue that the buyer's conduct violates the Kantian categorical imperative of equal concern and respect in that if roles were reversed . . . the buyer would not wish his ignorance to be exploited by the seller in this fashion, even

---

<sup>12</sup> [1863] EWHC QB J1.

<sup>13</sup> 363 F.2d 312 (D.C. Cir. 1966) (Skelly Wright, J.).

<sup>14</sup> Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts*, 7 *J. Legal Stud.* 1 (1978).

though such a precept may come at a cost in terms of long-run community welfare . . . . The farmer might reasonably ask why his interests should be sacrificed to this greater social end (without his informed consent); that is, why should he be used as a means to the ends of others?<sup>15</sup>

Kronman would argue that in this situation, economic efficiency requires the legal system to permit the buyer to profit from the seller's ignorance.

Kronman's argument has been refined over the years. In particular, leading legal economists now recognize that a privilege not to disclose information in all cases where one party has invested in acquiring information would be too broad. Instead, as these leading legal economists have observed,<sup>16</sup> the privilege not to disclose information is efficient (even under a simple analysis) only when the information itself increases productive capacity, rather than merely redistributing wealth. As an example, someone should not be able to profit only by learning information that everyone else is about to learn, merely to anticipate a market movement; the investment in information should instead yield new wealth for society overall. The information obtained by the oil prospector in Professor Trebilcock's example fits into this category, and so the leading legal economists would support a privilege not to disclose the information in that setting.

In this argument, the principal motivation for a rule permitting nondisclosure is, of course, to encourage productive information to be developed or discovered. But the legal economists appear not to have recognized that while such a rule may be *sufficient* to encourage investment in productive information, it is not *necessary*. For example, in Trebilcock's oil example, while requiring disclosure of private information about the value of land might prevent ExxonMobil from flying over the land to see if there's oil in order to buy it up cheaply, it doesn't prevent farmers from doing so, nor does it prevent ExxonMobil from contracting with farmers (in advance of a flyover) for an option to purchase their land if they find oil. Indeed, this latter possibility is in effect what ordinarily occurs in practice in most U.S. states, in the form of the purchase and sale of oil-and-gas leases.

To generalize somewhat, the economic analysis here proceeds by identifying a particular incentive that the law might create and then analyzing the effects of that incentive. But there is no attempt to weigh that incentive against others, to determine whether the incentive will do any good in the real world or will simply be redundant with other incentives, and so on. Legal rules do not operate in vacuums, and attention to just one strand of incentives tends to be unpersuasive to those setting legal policy precisely because they do not give any measure of effects outside their field of view.

---

<sup>15</sup> Melvin A. Eisenberg, Disclosure in Contract Law, 91 Cal. L. Rev. 1645 (2003) (quoting Michael J. Trebilcock, The Limits of Freedom of Contract 117-18 (1993) (brackets and internal quotation marks removed)).

<sup>16</sup> See, e.g., Robert Cooter & Thomas Ulen, Law and Economics 270-75 (3d ed. 2000); Steven Shavell, Acquisition and Disclosure of Information Prior to Sale, 25 RAND J. Econ. 20 (1994).

The problem here is not so much that the economists' conclusions are wrong; indeed, I am not clear that a rule requiring broader disclosure of private information than the law now requires is generally undesirable. But in considering the question, analyzing one type of incentive (specifically, the incentive to invest in productive information) may be helpful but cannot be dispositive. There are clearly other considerations even if our only motivations in fashioning a novel legal regime are instrumental. One is, as I have pointed out above, the necessity of a particular intervention in view of other ways of achieving the goals that the economists desire. Another involves entirely separate efficiencies. For example, if the rule encourages buyers rather than sellers of homes to hire independent inspectors, the law may promote needless duplication of effort.

The more we bear down on the particular economic reasoning that has been offered, the less applicable it seems if our goal is to determine the best rule, all things considered. In setting requirements to disclose information (as well as related areas, like default warranties in sales law), surely commercial norms and the expectations of parties are more important than artificial constructions of abstract incentives. The rest of the contract, including the price, is negotiated with these norms at least tacitly in mind. Furthermore, a lawyer used to paying attention to transactional context might well distinguish transactions along other dimensions than those the economists have noted; for example, U.S. states more readily have introduced a requirement to disclose private information in the context of home sales (perhaps because of the buyers' expectations and the stakes that they personally face in the transaction) than in the general case of sales of goods (where standardized warranties already seem to give effect to modern commercial norms). Despite the prominence of these economic arguments in U.S. academic circles, common lawyers are probably right not to pay them much attention—not because efficiency isn't important in contract law but because the analysis is not a persuasive path to real-world efficiency.

### *B. Equivocation About "Efficiency" and the Neglect of Alternatives*

The legal-economic confusion that this section highlights is easy to state, but it raises a number of subtle issues that need careful exposition. The basic analytical error discussed here is that "efficiency" has multiple meanings, and it is easy to slide between them. An alternative, possibly more helpful way to state this difficulty is that many economic arguments state their microeconomic assumptions (e.g., that the parties subject to contract and tort law are rational) but also have significant, unstated macroeconomic assumptions about the overall economic state of the world; exposing these assumptions invalidates the "logic" of the legal-economic arguments, requiring at the very least that they introduce more context-specific assumptions.<sup>17</sup>

---

<sup>17</sup> This section is drawn from Bayern, *supra* note 10.

To begin, consider 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 don’t need to stop with those particular costs and benefits; indeed, we might, and often do,<sup>18</sup> 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,<sup>19</sup> the effects on nearby residences of noise from the train, and so on. Even so, the analysis will necessarily be incomplete unless it incorporates one further consideration that is 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.<sup>20</sup> That is, a standard conclusion of law and economics is that if the railroad’s operation generates \$100,000 in social benefits (often manifested simply as private profits to the operator of the railroad) but causes \$95,000 in unavoidable harms externalized to others (e.g., 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’s 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, the railroad does produce wealth.<sup>21</sup> Of course, to be

---

<sup>18</sup> E.g., Shawn J. Bayern, *The Limits of Formal Economics in Tort Law: The Puzzle of Negligence*, 75 *Brook. L. Rev.* 707, 712-13 (2010) (calling for “a kind of economic analysis that has not yet been done” in analyzing activity levels in tort law).

<sup>19</sup> Cf. R.H. Coase, *The Problem of Social Cost*, 3 *J.L. & Econ.* 1, 29-31 (1960) (using a similar, now-famous example); Bayern, *supra* note 18, at 711.

<sup>20</sup> For a more complete critical discussion of the details of the Hand Formula, see Bayern, *supra* note 18, at 719-49.

<sup>21</sup> 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 2, 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.

clear, I'm assuming that the \$95,000 in harms can't be prevented by means of a simple and cheap precaution; this is what I mean when I call the harms "unavoidable."<sup>22</sup>

Compared to other ways of making \$100,000, however, the railroad may be far worse for society than its alternatives. We'd easily prefer someone to make \$100,000 in a way that causes only \$2,000 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 \$5,000 to society because of the harms that it causes. But another activity that earns its proprietor \$100,000 may be worth far more than \$5,000 overall—indeed, up to \$100,000, if it externalizes no harms.

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. If macroeconomic conditions are perfect and all narrowly "efficient" activity can occur, then the standard legal-economic analysis might be correct. But if factor markets are imperfect, then encouraging activity merely because it is more efficient than its absence threatens to miss the mark drastically.

Consider, as another significant example, the debate about whether contract law (or other sources of law) should prevent one party from extracting a large and "unfair" amount of the contractual surplus. Suppose there's a factory owner who would be able to pay their workers up to forty dollars per day because the potential workers would 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 fifty cents a day to work. The factory knows this, so it offers fifty cents per day for the work. Suppose the workers—being plentiful and disorganized—accept the offer.

The textbook microeconomic argument against an unconscionability doctrine—or a minimum-wage law—that would prevent this kind of contract would be that the parties won't enter the contract unless they both benefit from it, and therefore the contract is wealth-producing and should be permitted or even encouraged. The workers wouldn't accept fifty cents a day if they had better alternatives. Accordingly, as the reasoning proceeds, preventing the contract would make at least one of the parties, and probably

---

<sup>22</sup> 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).

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.

The flaw in this traditional logic 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's 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'll choose B (and get 98% of \$200, or \$196) rather than C (and get 72% of \$250, or \$180).

If A can contract with both parties, or if other parties like A can contract with both of them, then it doesn't 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're 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's the only way to ensure that all genuinely efficient opportunities will be taken. In the absence of that macroeconomic 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 aren't fixed beforehand; the parties can bargain over them. If the contract with C is really more valuable to both parties than the contract with B, why wouldn't C simply offer a better deal to induce A to make the more efficient contract? 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.

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 don't have unlimited resources to spend searching for

contracting partners and then bargaining over contracts. As long as A can contract with only one party, and as long as nobody else will be around to contract with the other, 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 he or she finds it.

Moreover, to emphasize the parties' ability to bargain further here would again be to engage in a kind of bait-and-switch. 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 are familiar. 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, hasn't stopped economists from creating the impression that minimum-wage rules, or those preventing unconscionability, are inefficient in broad, almost incontrovertible terms.

In other words, it is unjustified 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 would 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 of an assumption of macroeconomic perfection, 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 (e.g., A can't get credit to contract with both B and C, and not everyone can become like A merely because there's some value to his position), society loses, overall, from A's "unfair" contract with B.

To put it differently, 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 the 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 factory in favor of the factory owner. If a significant motivation of those who engage in activities that these laws would prevent is to redistribute wealth to themselves and away from others, the absence of these laws encourages more of that redistribution. 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.

### *C. Overcomplexity*

Shifting to a more casual mode of analysis, focused on rhetoric rather than specific analytical fault, a significant pattern in legal economics is simply the overcomplication of analysis—bedazzlement by technical detail. Contract interpretation serves as a good example of this type of problem.

In the area of contract interpretation, the prevailing economic wisdom is that literalism, or “textualism,” is a more efficient mode of interpretation than “contextualism,” or a rule that looks beyond the text of contracts to such sources of information as trade usage, prior dealings, and so on. Oddly, as an aside, legal economists (and economically minded legal scholars) have offered numerous, often contradictory arguments in favor of a rule of textualism. To put it bluntly, legal-economic thinking on this subject seems to be motivated by the belief that the common law plain meaning and parol evidence rules—rules that rely on written text of contracts to the exclusion of contextual information, such as commercial practices and inferred purposes of the contracting parties—must be efficient, but there is surprising disagreement about precisely why they are efficient.<sup>23</sup>

Historically, the chief economic argument in this area was that textualism promoted more certain legal entitlements, thereby reducing transaction costs. Thus, for example, Robert Scott wrote in 2000: “A rigorous application of the common-law plain meaning and parol evidence rules would preserve the value of predictable interpretation and encourage parties to take precautions in selecting terms with well-defined meanings.”<sup>24</sup>

In the early 2000s, however, leading legal-economic thought in American contract-interpretation theory began to take a position that almost ironically opposed the classical economic one: specifically, law-and-economic scholars began to argue that textualism produces outcomes that are *less* reliable but that this does not matter for most contracting parties, who would happily accept less reliability from the legal system in exchange for the hope of reduced litigation costs that a textualist regime would offer.

---

<sup>23</sup> Material in this section is drawn from Shawn Bayern, *Contract Meta-Interpretation*, 49 U.C. Davis L. Rev. 1097 (2016).

<sup>24</sup> Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 Nw. U. L. Rev. 847, 848 (2000).

Alan Schwartz and Robert Scott advanced the leading argument of this form in an extremely influential 2003 article entitled *Contract Theory and the Limits of Contract Law*.<sup>25</sup>

The essential insight of Schwartz and Scott's model, which is quite intuitively appealing at first, is that a risk-neutral party will be a contract textualist because admitting more evidence increases the costs of litigation without changing the expected value of the court's interpretive result.<sup>26</sup> This conclusion depends on a model of interpretive results as (1) reducible to scalar values that (2) have a mean value that is invariant to the amount of evidence used during the interpretive process.<sup>27</sup> Moreover, their model of the difference between textualism and contextualism is also essentially scalar; the different interpretive modes simply allow a court to use a larger or smaller "evidentiary base"<sup>28</sup> to carry out its interpretive process. On one end of the spectrum, a court might flip a coin (using no evidence at all). On the other, a court might use all relevant evidence that the parties submit. Schwartz and Scott's argument for textualism is an argument for what they call the "minimum evidentiary base," which includes specifically "the parties' contract, a narrative concerning whether the parties performed the obligations that the contract appears to require, a standard English language dictionary, and the interpreter's experience and understanding of the world."<sup>29</sup>

I have previously given an example of how I understand the way in which Schwartz and Scott intend for their model to work:

Suppose my contracting partner and I agreed on the number fifty. Schwartz and Scott's central conclusion is that even if the larger base of information reduces my risk (say, makes it nearly certain that the court will decide on the number fifty, rather than something between thirty and seventy), using this larger base of information will not be worthwhile because of its costs: I'll have to introduce more evidence, contest more evidence, go through a longer trial, and pay my lawyers more. Given that I didn't care about the risk (formally, the variance) in the court's result in the first place, I would prefer not to pay to reduce it.<sup>30</sup>

---

<sup>25</sup> Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 *Yale L.J.* 541 (2003).

<sup>26</sup> *Id.* at 574-77 ("Thus, courts that interpret contracts as typical parties prefer would be indifferent to variance as well, and sensitive only to the costs of administering their evidentiary standard."). I of course mean "expected value" in the literal technical sense as defined in the analysis of random variables. See generally Christiaan Huygens, *De Ratiociniis in Ludo Aleæ* (1657) (introducing the basic notion underlying the modern understanding of random variables).

<sup>27</sup> Schwartz & Scott, *supra* note 25, at 575-76 ("In other words, the court is as likely to make an interpretation that is more favorable to the buyer (less favorable to the seller) than the correct answer as the court is likely to make a less favorable interpretation. Judicial errors therefore cancel, in expectation.").

<sup>28</sup> *Id.* at 575.

<sup>29</sup> *Id.* at 572.

<sup>30</sup> Shawn Bayern, *Rational Ignorance, Rational Closed-Mindedness, and Modern Economic Formalism*, 97 *Calif. L. Rev.* 943, 954 (2009).

In earlier work I developed in some detail a technical objection to Schwartz and Scott's argument that depended on the distinction between risk and uncertainty.<sup>31</sup> In short, my objection was that asserting that courts' interpretations of contracts lacks bias is different from asserting that there is a definite mean numeric value around which the courts' interpretations will fall.<sup>32</sup> If there is no definite mean, then there is no reason for parties to trust that courts will, on average, reach the "correct" result.<sup>33</sup> There is, however, a way to state a broader objection more generally and with less technical language.

Recall that Schwartz and Scott's argument depends on the notion that courts, on average, will reach the right interpretive result even if, in individual cases, they will diverge from the parties' initial expectations.<sup>34</sup> This is, after all, what makes their assumption of risk-neutrality relevant; they conclude that risk-neutral parties prefer textualism specifically because they would prefer not to pay for more precise interpretation in individual cases.<sup>35</sup> Under Schwartz and Scott's model, the parties initially contract and have a shared idea of what they have agreed to do, but it is too expensive to draft a contract that covers every possible contingency.<sup>36</sup> A question later arises about the rights and duties of the parties. The parties' original conception could answer this problem in theory, but because of the limitations of the drafting process, this original conception is not verifiable to the court.<sup>37</sup> If the parties are textualists, they commit the question to the court knowing that the expected value of the court's interpretive distribution is the parties' original conception.<sup>38</sup>

The difficulty with conceiving information and communication in this way is that it assumes that the parties can use, at the time when they produce their contract, language that produces a distribution with a known "average" value but is nonetheless ambiguous and leads to different outcomes in courts. Though this is potentially conceivable in theory, it is implausible in practice. I believe the difficulty lies specifically in the translation of Schwartz and Scott's admittedly insightful formal model to real cases. It is one thing, in other words, to talk of a mean interpretive result; it is another to make the concept operational and tie it to real contract language. Schwartz and Scott never make clear the paradigmatic contract language they have in mind, nor do they argue that such paradigmatic cases are an appropriate basis on which to construct default legal rules. This abstraction ends up undermining their argument.

---

<sup>31</sup> See *id.*

<sup>32</sup> See *id.*

<sup>33</sup> *Id.* at 960 n.53.

<sup>34</sup> Schwartz & Scott, *supra* note 25, at 605-10.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

<sup>37</sup> "Verifiability" is a term of art in economic contract theory. See *id.* at 605-07.

<sup>38</sup> *Id.*

Consider more specifically: if the parties can use language that leads to a known and agreed-upon interpretive mean, why does any ambiguity remain? Schwartz and Scott describe the language that generates a known mean as follows:

It is optimal for risk-neutral firms to invest resources in drafting until the writing is sufficiently clear, in an objective sense, so that the mean of the distribution of possible judicial interpretations is the correct interpretation  $i^*$  [i.e., a scalar value corresponding to the correct interpretation]. Contracts sketched out in less detail than this would generate interpretation distributions whose mean could be anywhere.<sup>39</sup>

But if the parties are confident that the language they use will produce a definite mean result—a particular value  $i^*$ —why does any ambiguity remain in the language they have used? Why can't the courts settle uniformly on the mean interpretive result, which is evidently public knowledge anyway? In other words, what room in the real world remains for specific purposive language that that is characterized by two propositions: (1) there is general agreement on the “mean” interpretation, but (2) there is nonetheless symmetrical variance around this mean resulting from uncertainty?

With respect, it seems that Schwartz and Scott's model permits a much narrower conclusion than they intend. They wish to show that all risk-neutral parties prefer textualism, but it appears they have shown, at most, that such parties prefer textualism specifically for terms about which there is no possible real-world dispute. This is because, for language with an uncontroversial mean interpretive result that has symmetric variance, no ambiguity remains; there would be little reason for anyone, including courts, to adopt a meaning other than the known mean value.

To put it differently, how can a legitimate dispute arise out of a publicly known distribution? If there is a legitimate dispute about language, why would there be an agreement about the mean interpretive result *ex ante*, conversely, if there were a general agreement, why would ambiguity remain? Note that this is not simply a case where the parties have a private understanding of terms that they cannot prove to courts,<sup>40</sup> because under Schwartz and Scott's model, their expectation is specifically that the *courts* will reach a mean interpretive result (with some expected variance).

Even putting this problem aside, it is hard to discern a meaningful justification for the “minimal evidentiary base” based on theoretical argumentation alone, rather than an argument with more empirical sensitivity. Recall that the “minimal evidentiary base” they promote and consider to be textualist is “the parties' contract, a narrative concerning whether the parties performed the obligations that the contract appears to require, a standard English language dictionary, and the interpreter's experience and understanding

---

<sup>39</sup> Id. at 577.

<sup>40</sup> Economic contract theorists refer to this case as one where information is “observable but not verifiable.” See id. at 605 (“A datum of information is ‘observable but not verifiable’ if a party can observe it, but cannot verify the information's existence to a third party such as a court at an acceptable cost.”).

of the world.”<sup>41</sup> Schwartz and Scott’s assertion of this base of evidence as the minimal necessary for courts to reach correct interpretive results on average appears to rest only on their intuitions about the costs and utility of different classes of evidence. It is hard to see how the practical question of evidentiary utility could be decided as a theoretical matter; there simply isn’t enough information in the theory to conclude that “a dictionary” is useful but that trade usage is not justified by its administrative costs.<sup>42</sup> Schwartz and Scott would presumably agree that flipping a coin—despite incurring administrative costs drastically lower than typical adjudication—is insufficient for courts to reach the right interpretive result on average,<sup>43</sup> but why is a dictionary plus a stochastic resolution sufficient? What affirmative argument is there for the minimal evidentiary base?<sup>44</sup>

There is another problem for Schwartz and Scott’s stochastic view of courts.<sup>45</sup> Simply speaking, if the parties agree on the court’s mean interpretive result and they are risk-neutral, why would they ever litigate a contract in the first place? In some respects, this is the *ex post* mirror image of the argument that language with a known mean is unambiguous. The point here is stronger, though: language with a known mean is not worth litigating. To put it differently, if Schwartz and Scott’s model actually applied to contracting parties, it is difficult to see why they would ever bring a lawsuit. If lawsuits are not brought, parties do not experience the litigation costs that Schwartz and Scott’s textualist argument aims to permit them to avoid.

Interpretation raises, of course, a significant set of questions that are hard to simplify and unlikely to succumb to broad theoretical analysis. Indeed, against the normal practice of common law, Schwartz and Scott limit their argument to particular types of business firms, an interesting limitation that I have critiqued elsewhere.<sup>46</sup> My point is not that further study, even from an economic perspective, is inappropriate; it is simply that economists have not offered a conclusive or persuasive approach to contract interpretation, even if their approaches come with technical sophistication and mathematical specificity.

---

<sup>41</sup> Id. at 572.

<sup>42</sup> I mean this information-theoretic point in a technical sense—specifically, that the information contained in an expression of the theory is insufficient to derive such complex specifics regarding textual sources. Cf. Andrei N. Kolmogorov, Logical Basis for Information Theory and Probability Theory, 14 IEEE Transactions Info. Theory 662 (1968) (relating information theory to compressibility and complexity).

<sup>43</sup> Given that plaintiffs can specify the interpretive question at issue, an interpretive regime that rests on a coin flip would encourage plaintiffs to ask implausible interpretive questions because they would have a 50% chance of being judged “correct” as to those questions.

<sup>44</sup> Cf. also Juliet P. Kostritsky, Plain Meaning vs. Broad Interpretation; How the Risk of Opportunism Defeats a Unitary Default Rule for Interpretation, 96 Ky. L.J. 43 (2007) (identifying parties’ incentives to behave opportunistically under textualist interpretive regimes).

<sup>45</sup> Bayem, *supra* note 30, at 968-71.

<sup>46</sup> See Bayem, *supra* note 23, at 1107-15.

### III. Ways Forward

What is to be done, then, for those of us who believe that instrumental concerns are not irrelevant for common-law judges but who also believe that the leading instrumentalist analyses are unpersuasive? My sense is that the best way forward is not to ignore the legal-economics movement but to try to extract useful principles from it—and, in doing so, to suggest a broader form of analysis that economically minded legal scholars might adopt.

One central problem, as Dan Farber pointed out as early as 1985,<sup>47</sup> is that pressures in academic institutions often encourage analysts to produce counterintuitive conclusions. This is particularly unfortunate in law and in economics, two fields that are, at their best, concerned with developing plausible solutions to real problems. This problem has only grown since 1985. Six years ago, a prominent American legal journal published a paper defending the efficiency of trial by battle.<sup>48</sup> Differently, legal-economics has been motivated not just by innovation but also by what seems to be an intense desire to popularize the methods of economists; a reader of Posner's early work can't escape the conclusion that Posner was engaged in an attempt to show that economic reasoning could be relevant to law and that he could reach any result or justify any legal rule by means of economic reasoning. But such an application of economics is a "just-so" story, and it cannot easily inform legal decisions.

Still, economic thinking is not and should not be irrelevant to law. Much can be learned from consensus positions that are modest in scope and tied to particular effects of rules that lawyers can evaluate in context. For example, consider the general observation (probably a rough consensus among modern American instrumentalists) that the illusory-promise rule in contract law, and indeed most applications of classical ideas of mutuality, are unproductive and antagonistic to the notion that commercial bargains should be enforced. That recognition forms the basis of a useful critique of the formalism of classical consideration doctrine. An instrumental analysis of the preexisting-duty rule in contract law, focused on the possible gains in efficiency from enforcing modifications, should at least cause a lawyer or judge to question the superficial appeal of that rule. Similarly, as a more focused example, an instrumental "economic" analysis of a particular proposed rule of contract law that shows that the rule would permit one party to speculate at the expense of the other party may highlight important weaknesses in a rule—weaknesses, it is important to say, that amplify "noneconomic" concerns like the transactional unfairness of that sort of speculation.

What differentiates this broader, more sensitive use of normative economic reasoning from the normal ways in which the current American law-and-economics

---

<sup>47</sup> Daniel A. Farber, *The Case Against Brilliance*, 70 *Minn. L. Rev.* 917 (1985).

<sup>48</sup> Peter T. Leeson, *Trial by Battle*, 3 *J. Legal Analysis* 341 (2011) ("In a feudal world where high transaction costs confounded the Coase theorem, I argue that trial by battle allocated disputed property rights efficiently.").

movement has proceeded? The differences include at least the following: (1) it is not politically motivated, or at least not consciously and cynically in the service of a particular set of ideological results; that is, it does not seek to advance a particular political policy by applying whatever economic arguments happen to be available to support that policy; (2) it is fused with legal analysis and to the context-sensitivity of the common lawyer; (3) it seeks not to dictate legal policy but to provide answers to questions raised by legal policy; and (4) it does not ignore noninstrumental considerations, such as the transactional morality associated with a contract, but instead tries to incorporate those concerns into its calculus.