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The Economics of Contract Law

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BOOK REVIEW


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In the twenty years since Ronald Coase published The Problem of Social Cost,⁴ the “‘new’ law and economics”⁵ has produced an enormous literature subjecting nearly every important legal field to economic analysis.⁶ Almost as great a body of literature has been created by writers⁷ who have attacked those who claim for the economic approach “broad explanatory and reformative power, and . . . growing empirical support.”⁸ While the pages of law journals have exploded with the debate, the appropriate role of economics in legal education remains unresolved.⁹ Traditionally, economics has appeared in the law school curriculum only in courses examining fields like antitrust where the economic impact of conduct is, to a great extent, the legal norm by which the conduct is judged.¹⁰ As the economic theory of law has expanded its jurisdiction to traditional common law fields¹¹ and even to

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⁸ R. POSNER, supra note 5, at 17.
¹⁰ See R. POSNER, supra note 5, at xxi, 15.
constitutional law,\(^\text{12}\) many educators have come to appreciate the pervasive importance of both the mode of analysis and the substantive commentary offered by the theoreticians.\(^\text{13}\)

Still, teachers will differ as to the wisdom and the means of introducing students to economic analysis early in law school. On one hand, law and economics writers offer some of the most provocative contemporary commentaries on doctrines central to the first year of law study; at the same time, economic analysis is a controversial and technical approach to legal study requiring, for proper evaluation and perspective, a background not possessed by many law students or, for that matter, professors. An instructor who concludes that first year law students should be exposed to economic analysis in a systematic way must balance the necessity of presenting the material in depth sufficient to allow the development of technical proficiency with the danger of encouraging a sense that economic analysis has an unlimited descriptive and prescriptive reach and no peers as a theory of law.

Professors Kronman and Posner suggest that the alternatives facing law teachers include "[s]pecial courses on the economics of law, co-teaching of law courses by economists, the inclusion of economic materials in casebooks, and the preparation of supplementary reading materials" (p. ix). The first approach, gaining in popularity,\(^\text{14}\) is vulnerable to the same criticism of overcomprehensiveness that some writers\(^\text{15}\) levelled at Posner's innovative *The Economic Analysis of Law*.\(^\text{16}\) Co-teaching may tax scarce university resources and may signal undue emphasis on one of several alternative theories of law. And while some contracts casebooks have recently begun to include a smattering of economic materials,\(^\text{17}\) it is still a subject generally neglected by casebook editors. *The Economics of

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\(^\text{13}\) See note 9 *supra*.


Contract Law, intended primarily for use as a supplement to the casebook in the first year contracts course (p. ix), represents the fourth alternative.

I.

The book is a compilation of essays, reprinted from a variety of journals, treating the economic implications of substantive concepts of contract law. Each section of essays is followed by a series of notes which attempt to bring focus to and question arguments made in the essays. An introductory chapter written by the editors provides an overview of the relationship of economics to contract law and the final chapter offers different views on freedom of contract and the role of economic analysis.

The readings vary substantially in age, style, and orientation. The first set of essays examines “The Economic Basis of Contracts” and includes excerpts from Hobbes’ Leviathan\(^{18}\) (pp. 10–11) and Holmes’ The Common Law\(^{19}\) (pp. 28–30) in an effort to elucidate the economic impact of state-imposed controls on private contracting. This section, like previous studies of this subject,\(^{20}\) presents contract law as a means of maximizing the value of private transactions by reducing the negotiating costs associated with nonsimultaneous performance, contingency planning, and inadequate information. Selections in this part of the book provide a generally clear, though somewhat random, introduction to notions like the price mechanism (p. 31), game theory (pp. 16–21), Pareto optimality (p. 17), risk allocation (pp. 26–28), and the nature of the firm (pp. 31–32).

The following four chapters offer a rich selection of commentary on particular doctrines in contract law. While the editors were unable to discover worthwhile material considering the economic implications of the Statute of Frauds, conditions, third-party beneficiaries, and assignments (p. 8), they have presented, in the notes and excerpts, a wide range of material on the more central doctrines of consideration and assent (pp. 40–66), duress and unconscionability (pp. 67–113), mistake and impossibility (pp. 114–53), and remedies (pp. 154–229). Among the highlights are Fuller’s\(^{21}\) explanation of (pp. 40–45) and Posner’s\(^{22}\) attack on (pp. 46–58) the paternal-

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\(^{21}\) Fuller, Consideration and Form, 41 COLUM. L. REV. 799, 814–15 (1941).

istic justification for the consideration requirement, papers examining doctrines of excuse through cases ranging from the famous *Sherwood v. Walker*23 (p. 150) to Westinghouse's recent invocation of "commercial impracticability" to avoid performing multimillion dollar uranium agreements24 (pp. 143-49), and an examination of the effect of damage awards on a communist economy25 (pp. 220-23). The chapter on duress and unconscionability may be the most valuable to students first being exposed to law and economics since it puts economic theory to the test in an area seemingly least conducive to the promotion of efficiency. Readings in this part range from Coase's26 (pp. 77-78) and Epstein's27 (pp. 93-100) attacks on broad notions of unconscionability to Kennedy's28 (pp. 100-07) and Goldberg's29 (pp. 72-77) calls for greater judicial scrutiny of standard form agreements.

The final chapter of the book "attempts to place the economic analysis of contract law in a broader, more philosophical perspective than that of the earlier chapters" (p. 9). While the body of the work suggests limits on the application of economic analysis to the study of law, it is in this final section that the editors present explicit challenges to economic theory and alternative models. The selections set out, and the notes evaluate, Weber's assault on "purposive contracts" in the market community as abhorrent to fraternal ethics30 (pp. 230-33), Marx's examination of the market in labor31 (pp. 245-50), Nozick's entitlement theory32 (pp. 240-44), Horwitz' class bias thesis of contract law history33 (pp. 250-52), and a critical

23 66 Mich. 568, 33 N.W. 919 (1887) (case involving Rose 2d of Aberlone).
24 The selection in the book is from Joskow, Commercial Impossibility, the Uranium Market and the Westinghouse Case, 6 J. LEGAL STUD. 119, 143-46, 171-74 (1976).
evaluation\textsuperscript{34} of Posner's \textit{The Economic Analysis of Law}\textsuperscript{35} (pp. 233–39). This portion, and the book itself, concludes with the editors' only extended substantive foray, a "Note on Paternalism" (pp. 253–61) in which particular legal interferences with individual autonomy — doctrines concerning capacity of minors, self-enslavement, and penal clauses — are examined and found wanting in economic justification.

II.

The editors' note, which applauds signs of "a retreat from paternalism" (p. 261) in contract literature, illustrates the dilemma which the teaching of law and economics in general, and Kronman and Posner's book in particular, poses for first year instructors: can economics and law be presented in a way which will permit students to appreciate both its value and its limits? Most teachers would agree that economic inquiry serves to broaden the horizons of both practicing\textsuperscript{36} and academic lawyers, providing them with a more complete or at least a different view of legal concepts.\textsuperscript{37} Whether one accepts the ultimate value and conclusions of the endeavor, economic analysis has become so important a part of legal thinking that it is irresponsible for law professors to ignore it. And the first year of law school, when exposition is general, introductory, and in the form of required courses, may be the best time to begin exposure to economics — as well as to other disciplines with important contributions to make to legal study. Indeed, the central postulate of economic theory — that men and women's actions can be explained by their rational self-interest\textsuperscript{38} — can provide the basis for an examination of the purposes of the legal order; in a modern analogue to Hart and Sacks' classic \textit{The Legal Process},\textsuperscript{39} economic theory provides

\textsuperscript{34} Baker, \textit{The Ideology of the Economic Analysis of Law}, 5 PHILOSOPHY \\ & PUB. AFF. 3, 32–41 (1975).

\textsuperscript{35} R. Posner, \textit{supra} note 5.

\textsuperscript{36} If a practicing lawyer knows that a particular rule of law at issue in an ongoing lawsuit was intended to maximize efficiency or necessarily has that effect, she might be advantaged if she can argue that a judgment in favor of her client will result in the most efficient resolution of the dispute.

\textsuperscript{37} See W. Hirsch, \textit{supra} note 6, at xi–xv, 1–15.


\textsuperscript{39} See H. Hart \\ & A. Sacks, \textit{The Legal Process} 8–9 (tent. ed. 1958):

\textit{[T]he mass of private decisions are the primary motive force which determines the direction of the society from day to day. It is useful to think of the working apparatus of official procedures ... as engaged in a continuous review of these private decisions, and in continuous revision of the terms and conditions under which similar decisions will be made in the future.}
a means for studying the validity and limits of a system of laws designed to promote informed individual autonomy.

At the same time, even a first year professor who agrees with Kronman and Posner that "economics has a substantial contribution to make to the study of contract law" (p. 1) may be reluctant to assign a book entirely devoted to an examination of that contribution. Law teachers making decisions about course content cannot ignore the assertions of critics who claim that, in some law and economics presentations, "ideology has been disguised as mere analysis." Teachers have been warned that "there is a danger that law students may accept the recommendatory force of the [law and economics] approach without critically examining the value judgments laden in the analysis." Furthermore, even if carefully delineated, the descriptive function of the economic analysis of law is still highly controversial.

Teachers might well be wary of the seductive power of a theory which seems to offer a comprehensive, logical, "right and wrong" explanation of a discipline otherwise frustratingly inconsistent, chaotic, and indefinite. Beginning law students, whose consumption of commercial outlines suggests a certain desperation for unequivocal answers and whose familiarity with doctrine and theory is preliminary, would seem especially vulnerable to the attractions of an exclusively economic description of the law. Moreover, even if the use of economics as an analytical tool can be kept in perspective, the appeal and the methodology of the approach may too easily lead the untrained to a much more controversial normative use of the theory. Professors may reasonably fear that first year law students will be unable to discern and discount what many consider the excesses of economics.

The expansion of economic legal scholarship has created a good deal of debate concerning the positive-normative dichotomy. Criticism has been partially engendered by what some would characterize as the delusions of grandeur of those positive theorists who claim that wealth maximization is the

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40 Minda, supra note 7, at 473.
41 Id. at 474.
43 See id. at 1027-28, 1030, 1038-40.
44 Positive analysis attempts to understand, explain, and make predictions about our legal system while normative theory offers prescriptions designed to improve the system.
central guiding principle in the development of the common law. In addition, those asserting that the common law has traditionally been an instrument for promoting economic efficiency often appear to believe that an efficient legal system is best.\(^4\)\(^6\) One strenuously setting forth a controversial postulate to explain behavior can easily be read as arguing that the law should be that way. And the fact that some of the most important positivist writers do often make normative arguments about the value of an efficient legal system\(^4\)\(^7\) further clouds the controversy. A critic of positive analysis can easily believe, often correctly, that positive statements by economic theorists are intended to support questionable normative arguments.

Generally, The Economics of Contract Law remains true to a clearly positive, that is explanatory, orientation and successfully guards against the positive-normative “blur.” At the outset, the editors acknowledge that “the maximization of value cannot be regarded as an uncontroversially proper goal for society to pursue” (p. 2). They recognize, for example, that since willingness to pay, the measure of value in economic terms, is a function of the existing distribution of wealth, it may reasonably be maintained that the economic approach implicitly accepts the existing arrangement of income (id.). There are several readings throughout the book, notably Duncan Kennedy’s in the unconscionability section,\(^4\)\(^8\) which suggest alternative purposes for contract law. A thoroughgoing airing of the normative complaint does not appear, however, until the final chapter. There, the note on paternalism makes clear that certain types of judicial protection of private parties can be justified, if at all, by recourse to social goals other than efficiency; the articles and questions evaluate a variety of alternative views of freedom of contract.\(^4\)\(^9\) While this chapter does much to minimize the risk that students will slip too easily from “is” to “ought,” its placement at the end of the book, after extensive economic analysis of the substantive doctrines, may be too little, too late. The editors would have shown more sensitivity to the problem if, in what may be the only law and economics text read by some first year students,

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\(^{46}\) See Michelman, supra note 42, at 1031, 1038-40. See also R. Posner, supra note 5, at xvii, 17-19.


\(^{48}\) See p. 1042 & note 28 supra.

\(^{49}\) See pp. 1042-43 & notes 30-34 supra.
they had set forth early in the book the objections and con-
ceded limits to economic reasoning.

III.

Assuming the book's safeguards and the diligence of the
teacher can mitigate the dangers of student confusion over
description and prescription, the value of *The Economics of
Contract Law* must still be considered in the light of challenges
to the use of economics even as a purely positivist tool. The
book stands or falls here, for it has no place in the curriculum
unless one accepts as at least colorable the editors' initial
contentions:

Since buying and selling — and related transactions, such as
leasing and borrowing, which are also governed by contract
law — are quintessentially economic activities, it would seem
that economics should have something useful to say to stu-
dents of contract law. For example, economics may be able
to tell us why people make contracts and how contract law
can facilitate the operation of markets. And to the extent that
contract doctrines reflect judicial efforts, whether deliberate
or unconscious, to achieve efficiency, economics may help
toward an understanding of the meaning of the doctrines and
their appropriate limits. (P. i).

This sort of statement will be far more controversial with
some professors than its moderate tone may suggest to stu-
dents. Most lawyers, being of generalist temperament and
training, react strongly to what they consider reductionism.50
Whether they possess any economic knowledge or not, lawyers,
academic and otherwise, view our legal system as an exceed-
ingly complex order of rules, obligations, procedures, and lim-
itations derived from an adversary system seeking to assure,
or at least promote, justice. Such "noncognivists" may find it
hard to believe that our complicated common law heritage is
susceptible to explanation by any single theory.

Since positive economists argue that wealth maximization
generally explains and describes the common law system, their
theory is understood to reject, at least as primary to the com-
mon law, fundamental assumptions and values almost univer-
sally held about our legal system. Thus, critics have expended
much effort to show that concepts of justice, fairness, and
morality are important facets of judicial decisionmaking that
cannot be explained by resort to economic theory.51 Similarly

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50 See Leff, Law and, 87 *Yale* L.J. 989, 1010–11 (1978); Michelman, supra note
42, at 1044–47.

51 See, e.g., Baker, supra note 34; Michelman, *A Comment on Some Uses and
contentious has been the economic positivist’s rejection, both implicit and explicit, of other “competing” theories of the common law.\textsuperscript{52}

Additional skepticism about the value of the economic approach stems from the fact that the main thrust of positive economic theory thus far has been to establish \textit{how} the law is, not \textit{why} it is that way.\textsuperscript{53} Because of the current lack of sufficient empirical evidence showing that the law is efficient, however, an answer to the “why” question has become increasingly important to those critics who are taking the positive economic theory seriously.\textsuperscript{54} In other words, a demonstrable causal explanation is thought necessary to verify the theory. This formidable burden of proof may result in part from the fact that wealth maximization is, for some, intuitively unappealing as a standard for decisionmaking,\textsuperscript{55} particularly when contrasted with noneconomic human intangibles such as justice, fairness, morality, compassion, and impartiality — notions thought to be engrained in the judicial mentality. It is difficult for many to understand how the primary purpose of the common law can be to achieve economic efficiency when historically judges, like lawyers, have had no economic training and judicial decisions traditionally are devoid of explicit economic reasoning or terminology.\textsuperscript{56} Thus, the assumption is strong that even if the law is efficient it must have gotten that way inadvertently.

Kronman and Posner address this question in four paragraphs of the introduction (pp. 5–7). While they contend that the likely desire of contracting parties for efficient terms and the courts’ general deference to party intent makes the notion of an efficiency goal in contract law quite credible,\textsuperscript{57} they


\textsuperscript{53} \textit{But see} R. Posner, \textit{supra} note 5, at 180–81; Priest, \textit{supra} note 45; Rubin, \textit{supra} note 45.

\textsuperscript{54} See Michelman, \textit{supra} note 51, at 311–12; Michelman, \textit{supra} note 42, at 1041.

\textsuperscript{55} See Michelman, \textit{supra} note 51, at 311.

\textsuperscript{56} See Michelman, \textit{supra} note 42, at 1039–40, 1041–42. \textit{But see} Posner, \textit{supra} note 52, at 292.

\textsuperscript{57} The editors plausibly argue that since contract law traditionally entered private negotiation to supply missing or implicit terms for the agreement and since the parties will generally prefer cost-efficient terms, inefficient legal rules would have disappeared as the parties bargained around them. What may be called the editors’ notion of
ultimately justify their enterprise on an uncharacteristically explicit normative idea: “[T]he relevance of economics to contract law does not depend on proving that the logic of that law is economics. Since efficiency is an important value in our society (we need not decide here how important), a critique of contract law based on efficiency is a potentially powerful tool of legal reform” (p. 7). As indicated earlier, such reform-mongering is generally kept in check throughout the book. Similarly, the descriptive analysis is usually modest and self-aware and thus partly responsive to antireductionist criticism. Enthusiastically economic, the book successfully suggests the range of perspectives available within the economic framework. The editors seek to illustrate the economic significance of legal rules, rather than to establish a causal connection between economics and the law or to advance a specific economic perspective.58

Furthermore, the editors often question the economic assertions made in some of the essays or add alternative economic views of the issues raised by others (pp. 108–11). The reader is left to draw her own conclusions: economics appears to explain and justify a variety of results and does not offer a single answer to every legal question. A thoughtful student, guided by a careful teacher, should understand that economics provides only one possible explanation for the evolution of legal doctrine.

That it in fact is a reasonable explanation is the one undorned hypothesis of The Economics of Contract Law with which a teacher considering its use must contend. For me, the case for a positive — and indeed perhaps a normative — economic analysis of law seems especially strong in contracts. Few can doubt that a body of rules whose explicit historical purpose has been to permit the free exchange of wealth should be at least partially comprehensible by resort to economic analysis; as the editors assert, transactions governed by contract law are “quintessentially economic” (p. 1). If contract law provides the rules for bargained for exchanges of value, economic considerations may have been important in the formulation of existing rules and may be important in changing those rules. Whatever the merits of determining future rules by reference to distributive or associational goals, it is easy to contract "Darwinism" is supported, they argue, by courts' deference to party choice of law and the development of private arbitration; rational contractors would avoid the less efficient of available forums (p. 6).

58 Several writers, for example, employ economic analysis to arrive at opposite conclusions on the doctrine of unconscionability. Compare Epstein, supra note 27, with Goldberg, supra note 29.
imagine that the judicial creators of traditional contract law were concerned, albeit inarticulately, with social cost and individual autonomy. It is worthwhile, if that is true, to attempt to identify the impact economic considerations may have had in formulating the rules as well as the economic effect of the rules that were in fact adopted.

For these reasons, law schools interested in exposing their students to economic analysis at an early stage of their education might find contracts to be the least controversial part of the curriculum in which to do it. Furthermore, contract law, which lies at the very root of the common law system and whose principles permeate almost all sectors of the law, may be an excellent vehicle for a comprehensive examination of the role of the legal order as it can be illuminated by economics.59

At bottom, however, contracts teachers, especially those with little economic background themselves, must be convinced of the worth of including economic readings in a course already loaded with substantive material before they will assign *The Economics of Contract Law*. Skepticism of the value of the economic approach and of the necessity for a supplemental focus on economics rather than a broader spectrum of writings will prove a major obstacle to the use of this book. Some may feel the approach of Professor Rabin, in his *Perspectives on Tort Law*,60 a predecessor volume to the Kronman and Posner book, offers a “safer” method. There, economics is treated as one “Comprehensive Theory of Tort Liability” in apparent competition with “Concepts of Morality.”61 If one resists the claim of economic theorists that theirs “appears to be the most promising positive theory of the law extant,”62 one may conclude that Kronman and Posner’s book is better suited for use in an upper level seminar attended by students who, having been already exposed to the basic substantive concepts of contracts, can focus their attention solely on the merits of economic legal reasoning.

Many legal educators now realize that the economic approach to the law has made and promises to continue to make valuable contributions to our understanding of the formulation of doctrine and that, properly presented, economics can provide beginning law students with a useful tool of analysis as well as an early familiarity with an important body of literature. But works that present an exclusively economic per-

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59 See p. 1042 supra.
60 *Perspectives on Tort Law* (R. Rabin ed. 1976).
61 *Id.* at 139-210, 211-57.
spective, such as *The Economics of Contract Law*, must overcome doubt generated by the excesses of the perspective. Pragmatically, a teacher must believe that economic insights into contracts are more valuable than other positive explanations of the law. The difficulty, which Kronman and Posner do not purport to resolve, is that competing theories rarely meet head on; rather, each seeks supporting evidence which may exist independently or which may ignore empirical data relevant in another context. Comparative judgments are difficult to make intelligently.

But the merits of *The Economics of Contract Law* must be judged within the confines of its pretentions. The book does not mean to defeat other theories. The collection is nothing more than an attempt to provide, in concentrated and accessible form, economic insight into one traditional area of the law; along the way, it introduces students to the basic concepts and language of economic thought. The book serves both of these limited functions well. But whether this achievement should be forced on students in the first year of law school — when they may be unprepared to evaluate the soundness of the economic approach — presents a dilemma which the instructor alone must resolve once the nature of the choice is understood.