

## *A Conversation at an Impasse: Assessing the Value of Contract Economics*

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### I INTRODUCTION

Imagine the following scenario. A legal economist has delivered a well-received seminar on the latest theories of contract economics – the economic analysis of contract law. After the seminar, the economist adjourns to the nearest pub with two old friends from law school. One is a non-economist contract scholar. The other is a judge. The conversation proceeds something like this:

*The Contract Scholar:* Great seminar. Your theories and models are incredibly sophisticated and coherent. But tell me, you can't really suggest that economics or "efficiency" can *really* explain contract law, can you?

*The Legal Economist:* I agree, but tell me whether any other theory that you've come up with can explain the idiosyncrasies of contract!

*The Contract Scholar:* I take your point, but at least I can provide a principled account of the main doctrines of contract. The predictions of your models have nothing to do with the law as it stands.

*The Legal Economist:* We stopped trying to predict contract law decades ago! What we're trying to do now is provide a basis for criticizing and reforming the law to increase efficiency, or at least identify the efficiency costs and benefits of legal rules.

*The Judge:* I must cut in here. Even if, and that's a big "if", I should decide cases to maximize efficiency, your theories never give me clear

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recommendations how to do that! What's the use of all your fancy theories if I can't use them to resolve a real-life case before me?

*The Legal Economist:* That's not entirely true. Even when we can't recommend the most efficient rule, we can at least tell you the efficiency costs and benefits of the rules you have to choose from.

*The Judge:* Yes, but how do I weigh up the efficiency costs and benefits? I can hardly be expected to conduct a detailed economic analysis in my courtroom!

The conversation reaches an impasse. One gets the feeling that the three friends are talking at cross-purposes. Each is trying to question or defend the value of contract economics as a legal theory, but each has different expectations of the theory. How do we mediate between these expectations? Which expectations are valid and which should be discounted? Which friend is correct?

The purpose of this article is to explore these questions. Part II provides some general background to contract economics. Part III describes the approach taken towards assessing the value of contract economics. In Part IV, the arguments and counter-arguments at each point of the above conversation are fully described and critically analysed. Part V summarizes the conclusions reached.

The Antipodean reader may well object that these issues are of trifling practical importance. After all, the law and economics movement has had a limited effect here. While Australian courts regularly cite economic literature in areas of law where economics has traditionally had a role (such as restrictive trade practices, tax, etc), movement into contract and torts has been limited.<sup>1</sup> While the New Zealand Court of Appeal regularly cites economic efficiency as a relevant policy consideration in the decision to impose a duty of care in novel negligence cases,<sup>2</sup> there is a dearth of authority that has applied or even referred to contract economics.

Yet the fact that contract economics has not been a significant feature in Antipodean legal thinking and practice is not a reason in itself to pay it scant attention. Recent exhortations for a greater role for law

<sup>1</sup> Smyth, "Law or Economics? An Empirical Investigation into the Influence of Economics on Australian Courts" (2000) 28(1) ABLR 5.

<sup>2</sup> See e.g. *South Pacific Manufacturing Co. Ltd v NZ Security Consultants & Investigations Ltd* [1992] 2 NZLR 282 (CA); *Invercargill City Council v Hamlin* [1994] 2 NZLR 513 (CA).

and economics by Justice Kirby<sup>3</sup> and Sir Ivor Richardson<sup>4</sup> provide, at the very least, food for thought.

## II WHAT IS CONTRACT ECONOMICS?

Contract economics is a branch of the law and economics movement. To put the former in its historical and academic context, it is useful to explore the origins of the latter.

Oliver Wendell Holmes's oft-cited exhortation in "The Path of the Law"<sup>5</sup> for legal scholars to embrace economics heralded the beginnings of what was to become the law and economics movement.<sup>6</sup> Holmes wrote: "for the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics."<sup>7</sup> While its origins can be traced to 19<sup>th</sup> century Europe, the movement has been largely driven by American scholars. Pioneering studies in the 1940s and 1950s focused on legal subjects with clear economic connotations, such as monopolies, securities regulation and tax.<sup>8</sup> In contrast, the modern movement, which began in earnest in the 1970s with the writings of Richard A Posner, had much more ambitious goals. Not only would economic analysis be applied to areas of regulation readily associated with economics, but to all areas of law, including contract, property, tort, and criminal law.<sup>9</sup> Modern law and economics is "the application of economic theory and econometric methods to examine the formation, structure, processes and impact of law and legal institutions."<sup>10</sup>

The central tenet of law and economics is efficiency, which can be measured by two alternative standards.<sup>11</sup> The first is Pareto efficiency. Under this standard, a transaction must meet the criterion that at least one

<sup>3</sup> Hon Justice Kirby, "Law and Economics – Is there Hope?" (1997). <[http://www.hcourt.gov.au/speeches/kirbyj/kirbyj\\_lawecon.htm](http://www.hcourt.gov.au/speeches/kirbyj/kirbyj_lawecon.htm)> (at 30 September 2005).

<sup>4</sup> Richardson, "Law and Economics – and Why New Zealand Needs It" May 2002 8(2) NZBLQ 151; Also "Changing Needs for Judicial Decision-making" (1991) 1 JJA 61.

<sup>5</sup> Holmes, "The Path of the Law" (1897) 10 Harv L Rev 457.

<sup>6</sup> Mackaay, "History of Law and Economics" in Boudewijn and de Geest (eds), *Encyclopaedia of Law and Economics* (2000) 66.

<sup>7</sup> Holmes, *supra* note 5, 469.

<sup>8</sup> MacKaay, *supra* note 6, 66.

<sup>9</sup> *Ibid.*

<sup>10</sup> Rowley, "Rent-Seeking versus Directly Unproductive Profit-Seeking Activities" in Rowley, Tollison and Tullock (eds), *The Political Economy of Rent-Seeking* (1988) 125.

<sup>11</sup> Posner, "The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication" (1979-1980) 8 Hofstra L Rev 487, 487-491.

person is better off under the second allocation of resources than the first, and no one is worse off. A less stringent standard, and one that is employed more often in practice, is the Kaldor-Hicks criterion. This standard requires that the increase in the value or utility enjoyed by those who benefit from a transaction is sufficiently large so that those who are worse off could be fully compensated. Given the reality of scarce resources, efficiency is the means by which the goal of wealth maximization is achieved. Sir Ivor Richardson identifies the complementarity of legal and economic concerns in promoting efficiency to conserve resources, observing that “the efficient use of scarce resources and the economic and social implications of suggested alternatives cannot, or at least should not, be ignored.”<sup>12</sup>

The economic analysis of contract law, or “contract economics” as Craswell terms it, is a natural application of law and economics. Compared to applications in criminal, family, or constitutional law, contract law is more closely associated with economic transactions and rests on general principles that may be expected to have economic consequences.<sup>13</sup> Contract economics is based on relatively simple foundations. A basic premise is that parties enter into a contract to secure efficiency gains through a jointly beneficial project.<sup>14</sup> In a world of perfect certainty and costless transactions, the parties might enter into a theoretically complete contract, that is, one that provided for all possible contingencies that might arise in the contractual relationship.<sup>15</sup> In reality, transaction costs of fully specifying all contingencies, especially for low-probability events, means that all contracts are necessarily incomplete to some extent.<sup>16</sup> As such, there is a necessity for a background legal regime to provide default and mandatory rules.<sup>17</sup> It is this regime that is the focus of contract economics. Broadly, the question the field attempts to answer is this: Which legal rules best serve the interests of the parties?<sup>18</sup> Expressed in another way, what are the most efficient rules of contract law?

This enquiry can take a descriptive or normative form.<sup>19</sup> Contract economics as a descriptive theory attempts to predict or explain

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<sup>12</sup> Richardson (2002), *supra* note 4, 151.

<sup>13</sup> Mason, “Law and Economics” (1991) 17 *Monash Uni L Rev* 167, 171.

<sup>14</sup> Posner, “Economic Analysis of Contract Law After Three Decades: Success or Failure?” (2002) 112 *Yale LJ* 829, 832. (Eric A. Posner is not to be confused with Richard A. Posner.)

<sup>15</sup> Miceli, *Economics of the Law: Torts, Contract, Property Litigation* (1997) 71.

<sup>16</sup> *Ibid.*

<sup>17</sup> Posner, *supra* note 14, 833.

<sup>18</sup> *Ibid.*

<sup>19</sup> I generally follow the taxonomy of Eric Posner, *supra* note 14, although with some modifications that are discussed below.

current legal rules; as a normative theory, it aims to recommend the most efficient rules. The distinction between the two types of theory is often not sharply delineated. For example, contract economics as a positive theory identifies the efficiency costs and benefits of legal rules. Where a rule is identified as inefficient, normative recommendations may be implied but are not purported to be made.

Contract economics is, at least arguably, the “dominant academic theoretical perspective” of modern contract scholarship.<sup>20</sup> Yet modern scholarship has not had a large impact on either judges or legislators.<sup>21</sup> Judges do not tend to cite the scholarship and, with few exceptions, are ignorant about its results.<sup>22</sup> Many, including those inside the field, appear to suffer a perpetual crisis of confidence about the value of contract economics. We need only refer to the burgeoning literature evaluating and criticizing the field. Papers by Eric Posner,<sup>23</sup> Peter Benson,<sup>24</sup> and Richard Epstein<sup>25</sup> are recent examples. In defence of the field are papers by Richard Craswell<sup>26</sup> and Ian Ayres.<sup>27</sup>

From the point of view of the non-economist legal scholar or practitioner, what has been lacking is an accessible treatment of the competing arguments, placed in the context of the different roles a legal theory may play. These roles include, for instance, generating insights or increasing understanding about the law, or practical use in the courtroom to resolve cases. This article is an attempt to fill that gap. For ease of exposition, detailed economic analysis will be kept to a minimum. A single example, the economic analysis of contractual remedies, will be used throughout to illustrate the competing arguments.

### III AN APPROACH TO ASSESSING THE VALUE OF CONTRACT ECONOMICS

We begin by justifying the approach taken in this article to assessing the value of contract economics. A useful starting point is the approach

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<sup>20</sup> Benson, “Contract” in Paterson (ed), *A Companion to Philosophy of Law and Legal Theory* (1996) 25, 48.

<sup>21</sup> Ayres, “Valuing Modern Contract Scholarship” (2002) 112 Yale LJ 881, 895.

<sup>22</sup> *Ibid.*

<sup>23</sup> Posner, *supra* note 14.

<sup>24</sup> Benson, *supra* note 20.

<sup>25</sup> Epstein, “Law and Economics: Its Glorious Past and Cloudy Future” (1997) 64 U Chi L Rev 1167.

<sup>26</sup> Craswell, “In That Case, What Is the Question? Economics and the Demands of Contract Theory” (2002) 112 Yale LJ 903.

<sup>27</sup> Ayres, *supra* note 21.

taken by Eric Posner, who evaluated the “success” of contract economics in terms of whether it had fulfilled its original aspirations as a descriptive and normative theory.<sup>28</sup> Notice Posner’s implicit assumption that a legal theory is a success if, and only if, it achieves what it set out to do. While this approach is attractive in its simplicity, it does not do justice to the width of Posner’s enquiry as to the general success of a legal theory. For instance, if a theory diverts from its original aspirations while making valuable contributions in other ways, under Posner’s approach it would nevertheless be pronounced a failure.

A better approach is to focus on *expectations* rather than aspirations. A fundamental assumption, borrowed from Craswell, is that the suitability of a theory depends on what it is that theory is expected to do.<sup>29</sup> We can ask, expected to do by *whom*? Those who are likely to form expectations about a theory can be called, for the lack of a better word, the “constituents” of the theory. The opening conversation included two constituents of contract economics, the contract scholar and the judge. Other conceivable constituents are lawyers and perhaps even contracting parties themselves. Different constituents expect different things of a theory. For example, one of the contract scholar’s expectations was for contract economics to provide a principled account of contract law. The judge’s expectations focused on the practical applications of contract economics in the courtroom.

Each class of constituents would regard contract economics as valuable if it fulfilled or exceeded their expectations, rather than its original aspirations. Expectations are a better measure of the value of a theory than original aspirations for two reasons. First, expectations can shift to reflect the changing goals of a theory. Second, aspirations represent a measure of success defined internally to the theory and by the theory; expectations allow the success of a theory to be judged from the wider legal context in which the theory applies.

The focus on expectations has its own weaknesses. First, the expectations of a certain class of constituents may not be congruent with the explicit or implicit limitations of the theory. These limitations may arise from the theory’s methodology or assumptions. This raises difficult questions of whether the expectations are nevertheless reasonable ones to make of the theory. The second weakness is that it is unclear how to mediate among expectations. What if a theory meets some expectations but not others? In spite of this, however, it is best to proceed with the

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<sup>28</sup> Posner, *supra* note 14, 831.

<sup>29</sup> Craswell, *supra* note 26, 920.

expectations approach and manage these weaknesses if and when they arise.

In summary, this article will assess the value of contract economics by assessing whether it has met the expectations of its constituents. In the next section, the competing expectations alluded to in the opening conversation will be more fully described and critically assessed.

#### IV THE COMPETING EXPECTATIONS

##### A General Theory of Contract Law

*The Contract Scholar:* Great seminar. Your theories and models are incredibly sophisticated and coherent. But tell me, you can't really suggest that economics or "efficiency" can *really* explain contract law, can you?

*The Legal Economist:* I agree, but tell me whether any other theory that you've come up with can explain the idiosyncrasies of contract!

Peter Benson argues that economic analysis has not produced a general theory of contract and seems unlikely to do so in the future.<sup>30</sup> Both claims are correct and uncontroversial. However, there are strong reasons to believe that Benson's expectation itself is not well founded. These reasons are developed below.

To Benson, a general theory would provide a fully integrated, systematic and comprehensive account of contract law.<sup>31</sup> That is, a descriptive theory that explains what contract law is. While the basic forms and concepts of contract doctrine are for the most part clearly established and accepted, there is no generally accepted framework that gives coherence to contract law in its entirety.<sup>32</sup> Instead, there is a multiplicity of competing theoretical approaches that purport to provide a comprehensive yet distinct understanding of contract law.<sup>33</sup>

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<sup>30</sup> Benson, *supra* note 20.

<sup>31</sup> Benson, *supra* note 20, 24.

<sup>32</sup> *Ibid.*

<sup>33</sup> *Ibid.*

Benson claims that before a general theory can be conceived, there must be a “public justification” of contract law.<sup>34</sup> A public justification would operate at one level of abstraction higher than the public sources of contract law. These public sources are doctrines, principles, and rules found in authoritative judicial opinions and works of scholarship.<sup>35</sup> A public justification would provide internally consistent answers to the major issues of modern contract theory. As Benson defines them, they are: the remedies awarded for breach; the centrality of the doctrine of consideration; and the relationship between contractual liberty and contractual fairness.<sup>36</sup>

Benson argues that since economic analysis fails to begin from the standpoint of a public justification, its results inevitably diverge from the actual content or underlying rationales of contract law:<sup>37</sup>

[I]f a theory were to ignore and not to take up, even provisionally, the standpoint of the law, the law would rightly dismiss it as extraneous and hence irrelevant to its own concerns and analysis – however internally coherent, sophisticated or otherwise valid that theory might be.

This is a strong claim that deserves close scrutiny. The first step is a fuller understanding of Benson’s own methodology.

In effect, Benson’s general theory is the fullest realization of an interpretive theory of law. Such theories proceed by determining the social propositions that are explicitly found in contract doctrines, or those that best justify or rationalize doctrine as a whole or significant areas of doctrine.<sup>38</sup> Social propositions are moral norms, policies or empirical propositions that are salient in the law.<sup>39</sup> Interpretive theorists seek a point of view that is *internal* to the body of law in question. They do not attempt to evaluate the law from the standpoint of an external normative premise (such as, for example, efficiency).<sup>40</sup>

However, as Melvin Eisenberg argues, interpretive theories are nevertheless implicitly reliant on external premises.<sup>41</sup> In essence, interpretive theorists must have a theory of law to fashion the legal

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<sup>34</sup> Benson, *supra* note 20, 25.

<sup>35</sup> Benson, “The Unity of Contract Law” in Benson (ed), *The Theory of Contract Law: New Essays* (2001) 124.

<sup>36</sup> *Ibid* 119.

<sup>37</sup> *Ibid* 124.

<sup>38</sup> Eisenberg, “The Theory of Contracts” in Benson (ed), *supra* note 35, 213.

<sup>39</sup> *Ibid*.

<sup>40</sup> Craswell, *supra* note 26, 918.

<sup>41</sup> Eisenberg, *supra* note 38, 213-222.

materials that they are interpreting. Eisenberg gives three reasons for that proposition. First, existing doctrine is always subject to as-yet-unarticulated exceptions that cannot be determined from doctrine itself. They can only be determined from a theory of law that allows such exceptions to be made. Second, given that precedents in a certain area will always display a degree of inconsistency, an interpretive theorist must have a theory of law to choose which precedents will count and, of these, how much each precedent will count. Doctrine itself will not guide the theorist in these choices. Third, since it is often not entirely clear what rule a precedent establishes, the data the theorist describes will inevitably be partly a product of a theory of how to describe the data. In other words, interpreting a rule cannot take place outside an implicit or explicit theoretical framework.

Eisenberg's insight is important since it undermines Benson's criticism that economic analysis must be extraneous and irrelevant to the law's concerns because it is predicated on the external premise of efficiency. Note that Benson's public justification is merely "one step removed" from the actual legal doctrines and principles on which it rests.<sup>42</sup> Once, or rather if, it is achieved, there is still much work to be done to conceive a general theory.<sup>43</sup> The force of Eisenberg's proposition is that a general theory, even if it starts from a public justification, must implicitly rely on an external premise. Yet this is exactly the reliance that Benson cites as the reason that economic analysis will fail to produce a general theory. Put simply, if Benson's criticism is correct, his approach is equally vulnerable to that criticism. This does not make economic analysis any more successful in producing a general theory. However, it at least gives us reason to doubt whether it is viable to expect a general theory developed entirely from principles found internally to the law.

More fundamentally, and by Benson's own admission, there is widespread scepticism about the very possibility of formulating a general theory of contract that commands widespread acceptance.<sup>44</sup> Dennis Patterson argues that the most that one can mean by a "correct" theory is that a theory enjoys inter-subjective assent from those who are, in the terminology of this article, the constituents of the theory.<sup>45</sup> However, as Patterson argues:<sup>46</sup>

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<sup>42</sup> Bigwood, *Exploitative Contracts* (2003) 9, n 42.

<sup>43</sup> *Ibid.*

<sup>44</sup> Benson, *supra* note 35, 118.

<sup>45</sup> Patterson, "The Philosophical Origins of Modern Contract Doctrine: An Open Letter to Professor James Gordley" (1991) *Wis L Rev* 1432, 1436.

<sup>46</sup> *Ibid.*

Two thousand years of philosophy has failed to yield anything like a plausible account of what it would mean to provide a “correct” account of the “thing” called contract. Instead of continuing to ask for such an account, we might be better off dropping the question.

We do not need to go as far as Patterson in saying that the search for a general theory is inevitably a fool’s errand. It is enough to say that the task is fraught with difficulties that no theory, economic analysis included, has been able to overcome. This is reason enough to set aside the expectation that economic analysis should produce a general theory of contract law.

### **Descriptive Theories of Individual Contract Doctrines**

*The Contract Scholar:* I take your point, but at least I can provide a principled account of the main doctrines of contract. The predictions of your models have nothing to do with the law as it stands.

*The Legal Economist:* We stopped trying to predict contract law decades ago! What we’re trying to do now is provide a basis for criticizing and reforming the law to increase efficiency, or at least identify the efficiency costs and benefits of legal rules.

Can contract economics provide descriptive theories of individual contract doctrines? These theories would provide a rationale for the internal concepts and categories present in particular doctrines, rather than trying to explain contract law as a whole through a general theory. Eric Posner uses a narrower definition of a descriptive theory by using “explain” as a synonym for “predict”.<sup>47</sup> Here, the theorist’s task is to predict the rules of a certain contract doctrine through application of the theorist’s model. However, both conceptions of a descriptive theory can be assessed simultaneously, because if a theory fails to predict the rules of a doctrine (the lower threshold), it cannot account for the conceptual rationale of the doctrine (the higher threshold).

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<sup>47</sup> As observed by Craswell, *supra* note 26, 920.

Legal economists formulating a descriptive theory of a doctrine ask what the law in that area would look like if efficiency were its sole purpose; and whether in fact the law does look like that.<sup>48</sup>

Posner, for one, argues that contract economics fails as a descriptive theory.<sup>49</sup> A good example to illustrate his point is the economic analysis of remedies for breach of contract.<sup>50</sup> It is well-established that expectation damages are the standard remedy for breach of contract. As Parke B said in *Robinson v Harman*:<sup>51</sup>

The rule of the common law is, that where a party sustains a loss by reason of a breach of contract, he is, so far as money can do it to be placed in the same situation, with regard to damages, as if the contract had been performed.

Predicting rules such as these was the task of early contract economics scholarship. The awarding of expectation damages was justified on efficiency grounds as a consequence of the theory of efficient breach. The theory posits that, in some situations, it is more efficient for a party to breach a contract than to perform as promised. Expectation damages is the only measure of damages that provides incentives for only efficient breaches. A simple example will help illustrate why.<sup>52</sup>

A buyer, B1, contracts with a seller, S, for the future delivery of a widget. The contract price of \$170 is paid by B1 in advance. B1 subjectively values the widget at \$200. B1 invests \$10 on reliance on the contract. S's production cost is \$150. Thus, on performance, S's profit is \$20,<sup>53</sup> B1's profit is \$20,<sup>54</sup> and their combined profits are \$40. However, before delivery occurs, S becomes aware of another buyer, B2, whose valuation of the widget is either \$180 or \$250. Efficiency, measured by the combined profits of S1 and B1, will rise if S sells to B2 if, and only if, B2 values the widget more than B1. That is, breach is only efficient if

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<sup>48</sup> Hanson and Hart, "Law and Economics" in Paterson (ed), *A Companion to Philosophy of Law and Legal Theory* (1996) 311.

<sup>49</sup> Posner, *supra* note 14, 832-854.

<sup>50</sup>The standard Fuller & Perdue taxonomy of damage measures is as follows. Expectation damages compensate the innocent party for the loss of the bargain, the object being to financially restore the innocent party to the position which he or she would have occupied had the contract been performed. Reliance damages compensate the innocent party for steps taken in reliance on the contract, the object being to restore the innocent party to the position he or she would have occupied had the contract not been made. Restitutionary damages restore to the innocent party a valuable benefit conferred on the breaching party, the object being to prevent unjust enrichment.

<sup>51</sup> (1848) 1 Exch 850, 855.

<sup>52</sup> The example below is adapted from Polinsky, *An Introduction to Law and Economics* (2 ed, 1989) 31-34.

<sup>53</sup> Contract price (\$170) - production cost (\$150).

<sup>54</sup> Valuation (\$200) - contract price (\$170) - reliance investment (\$10).

B's valuation is \$250. As shown below, the measure of damages awarded for breach will affect the incentives for breach.

- (a) Expectation damages (\$200)<sup>55</sup> – if B2's valuation is \$250 and S breaches, B1's profit is \$20<sup>56</sup> and S's profit is \$70<sup>57</sup> (thus S has an incentive to breach). Since the combined profit rises to \$90, the breach is efficient. If B2's valuation is \$180, S breaks even<sup>58</sup> (thus S does not have the incentive to breach). S only has the incentive to breach when B's valuation is \$250, that is, when breach is efficient.
- (b) Reliance damages (\$180)<sup>59</sup> – if B2's valuation is \$250 and S breaches, B1 breaks even<sup>60</sup> and S's profit is \$90<sup>61</sup> (thus S has an incentive to breach). Since the combined profit rises to \$80, the breach is efficient. If B2's valuation is \$180, B1 breaks even<sup>62</sup> and S's profit is \$20.<sup>63</sup> Here, S is indifferent between performance and breach, so could conceivably choose to breach when B's valuation is only \$180. Since combined profits are only \$20, the breach is inefficient.
- (c) Restitutory damages (\$170)<sup>64</sup> – if B2's valuation is \$250 and S breaches, B1 makes a loss of \$10<sup>65</sup> and S's profit is \$30 (thus S has an incentive to breach). Since the combined profit rises to \$40, the breach is efficient. If B2's valuation is \$180, B1 makes a loss of \$10<sup>66</sup> but S's profit is \$30<sup>67</sup> (thus S has the incentive to breach). Since combined profits are only \$20, the breach is inefficient.

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<sup>55</sup> Expectation damages = B1's valuation.

<sup>56</sup> Expectation damages (\$200) - contract price (\$170) - reliance investment (\$10).

<sup>57</sup> B2's contract price (\$250) + B1's contract price (\$170) - expectation damages (\$200) - production cost (\$150).

<sup>58</sup> B2's contract price (\$180) + B1's contract price (\$170) - expectation damages (\$200) - production cost (\$150).

<sup>59</sup> Reliance damages = contract price (\$170) + reliance investment (\$10).

<sup>60</sup> Reliance damages (\$180) - B1's contract price (\$170) - reliance investment (\$10).

<sup>61</sup> B2's contract price (\$250) + B1's contract price (\$170) - reliance damages (\$180) - production cost (\$150).

<sup>62</sup> Reliance damages (\$180) - contract price (\$170) - reliance investment (\$10).

<sup>63</sup> B2's contract price (\$180) + B1's contract price (\$170) - reliance damages (\$180) - production cost (\$150).

<sup>64</sup> Restitutory damages = B1's contract price.

<sup>65</sup> Restitutory damages (\$170) minus contract price (\$170) minus reliance investment (\$10).

<sup>66</sup> *Ibid.*

<sup>67</sup> B2's contract price (\$180) plus B1's contract price (\$170) minus restitutory damages (\$170) minus production cost (\$150).

Expectation damages are efficient because they provide incentives for only efficient breaches. However, this conclusion of early contract economics was premature because it overlooked the effect of the expectation measure on decisions other than breach.<sup>68</sup> Craswell identifies at least seven other decisions that are affected by the remedy awarded.<sup>69</sup> These are worth setting out in full in order to get a sense of the complexity involved. They are: 1) the level of reliance investment on the faith of the contractual promise; 2) the level of precautions taken to avoid breach; 3) which parties to contract with and at what price; 4) how much time and effort to spend searching for better contracting parties; 5) how carefully to evaluate the proposed transaction before committing oneself to a contractual promise; 6) how much to tell the other party prior to the contract; and 7) the allocation of risk between the parties.

Consider the first decision, the level of reliance investment undertaken by the promisee. The basic result is that expectation damages induce over-reliance by the promisee because the promisee does not have to take into account the possibility of breach.<sup>70</sup> An extension of the above example will illustrate the proposition.<sup>71</sup>

B1 now has the option of investing an additional \$20 on reliance investment, which will raise B1's valuation by \$30 (for example, purchasing special machinery that better exploits the widget's potential). At first sight, since the benefits of investment exceed the costs, B1 should invest. However, this does not take into account the chance that B1 will breach. Assuming that there is an equal chance that B2 will value the widget at either \$250 or \$180, there is a 50 per cent chance that B1 will breach, since B1 will breach only when B2's valuation is \$240.<sup>72</sup> Thus, since the expected benefit from reliance (\$10) is less than the cost of the investment (\$20), the investment is inefficient. As shown below, the measure of damages awarded for breach will affect the promisee's decision to invest. Note that if B1 invests and S performs, B1's profit is \$30.<sup>73</sup>

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<sup>68</sup> Posner, *supra* note 14, 835.

<sup>69</sup> Craswell, "Two Economic Theories of Enforcing Promises" in Benson (ed), *The Theory of Contract Law: New Essays* (2001) 26-32.

<sup>70</sup> The seminal article that generated this result is Shavell, "Damage Measures for Breach of Contract" (1980) *Bell Journal of Economics* 466.

<sup>71</sup> Adapted from Polinsky, *An Introduction to Law and Economics* (2 ed, 1989) 34-37.

<sup>72</sup> Assuming, for the purposes of this example, that the breach is efficient.

<sup>73</sup> Valuation with investment (\$230) – contract price (\$170) – reliance investment (\$30).

- (a) Expectation damages (\$230)<sup>74</sup> – If B1 invests and S breaches, B1's profit is \$30,<sup>75</sup> which is identical to B1's profit if S performs. Therefore, B1 will invest inefficiently because B1 receives the full benefit of the investment regardless of whether the contract is performed.
- (b) Reliance damages (\$200 if B1 invests, \$180 if B1 does not)<sup>76</sup> – If B1 invests and S breaches, B1 breaks even.<sup>77</sup> Therefore, B1 will invest inefficiently because the investment has an 'upside' (\$20)<sup>78</sup> but no 'downside'.
- (c) Restitutionary damages (\$170)<sup>79</sup> – if B1 invests and S breaches, B1 makes a loss of \$30.<sup>80</sup> Thus, B1 will not invest since B1 must take account of the probability that S will breach.

Since expectation damages encourage efficient breach but inefficient reliance, they could no longer be rationalized as the unambiguously most efficient remedy. As a result, the most efficient measure of damages cannot be settled as a principle of general application, as in legal doctrine, but only as an assessment that depends crucially on the relative quantitative importance in efficiency terms of the breach and reliance decisions in each particular case.<sup>81</sup> Further complexity is added when one considers how expectation damages affect the six other decisions that Craswell identifies above.

How can contract economics reconcile these complexities with the reality that expectation damages are the standard remedy? The most obvious approach is to conduct the empirical research necessary to properly weigh the various efficiency considerations.<sup>82</sup> Other than the prohibitive costs and complexity involved in such an approach, it is unclear whether such research could be wide-ranging and comprehensive enough to produce a plausible answer.<sup>83</sup> The standard approach has been to propose that given the "average" circumstances of the parties, expectation damages are the most efficient remedy.<sup>84</sup> For example, we

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<sup>74</sup> Expectation damages = B1's valuation.

<sup>75</sup> Expectation damages (\$230) – contract price (\$170) – reliance investment (\$30).

<sup>76</sup> If B1 invests, reliance damages = contract price (\$170) + reliance investment (\$30). If B1 does not invest, reliance damages = contract price (\$170) + reliance investment (\$10).

<sup>77</sup> Reliance damages (\$200) minus contract price (\$170) minus reliance investment (\$30).

<sup>78</sup> B1's profit with investment (\$40) minus B1's profit without investment (\$20).

<sup>79</sup> Restitutionary damages = B1's pre-paid contract price.

<sup>80</sup> Restitutionary damages (\$170) minus contract price (\$170) minus reliance investment (\$30).

<sup>81</sup> Benson, *supra* note 20, 53.

<sup>82</sup> Hanson and Hart, *supra* note 48, 328.

<sup>83</sup> *Ibid.*

<sup>84</sup> Posner, *supra* note 14, 838.

may think that on average, the “perform or breach” decision has greater efficiency implications than the reliance decision. Without empirical evidence for this claim, however, this can only be speculation at best.<sup>85</sup>

An alternative rationalization proposed by Charles Goetz and Robert Scott is that while economic analysis suggests that reliance damages are the most efficient remedy, in practice expectation damages are optimal once administrative costs are factored in.<sup>86</sup> Goetz and Scott’s rationalization succeeds in predicting that expectation damages is the standard remedy. That satisfies the lower threshold of a descriptive theory. Does it satisfy the higher threshold of providing a rationale for the internal concepts and categories of the rule? Compare Goetz and Scott’s rationalization with the standard rationale advanced for expectation damages, which is that expectation damages compensate the victim of a breach for loss of a bargain in order to protect expectations created by the contract.<sup>87</sup> That explanation can be incorporated as part of a promise-based theory of contract law:<sup>88</sup>

If I make a promise to you, I should do as I promise; and if I fail to keep my promise, it is fair that I should be made to hand over the equivalent of the promised performance.

Goetz and Scott’s rationalization for expectation damages that it is the most efficient remedy once administrative costs are taken into account does not accord with the rationale expressed in cases, or, it is submitted, with our intuitive sense of compensation for a broken promise. Their rationalization is possibly but not plausibly true. This worrying dichotomy, Benson argues, characterizes contract economics as a descriptive theory.<sup>89</sup>

More fundamentally, contract economics often fails the lower threshold of predicting legal rules. For instance, on Posner’s analysis, contract economics fails to explain why liquidated damages are not always enforced, the function of the consideration doctrine or promissory estoppel, or why the law encourages certain disclosures of information and not others.<sup>90</sup>

To summarize so far, where the predictions of economic analysis match with legal rules, the economic rationalizations advanced for these

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<sup>85</sup> *Ibid.*

<sup>86</sup> Benson evaluates this theory in Benson, *supra* note 20, 50-54.

<sup>87</sup> Trietel, *The Law of Contract* (10 ed, 1999) 873.

<sup>88</sup> Fried, *Contract as Promise: a Theory of Contractual Obligation* (1981) 17.

<sup>89</sup> Benson, *supra* note 20, 54.

<sup>90</sup> Posner, *supra* note 14, 880.

rules are often implausible. Often, economic models fail to predict legal rules in the first place. For these reasons, Posner concludes that economic analysis fails as a descriptive theory.

However, there are strong reasons for questioning whether Posner's conclusion is largely redundant. To explain why requires a brief detour into the history of contract economics scholarship. Early scholarship aimed to predict the content of contract law in order to test Richard Posner's famous (some would say infamous) hypothesis that common law rules and institutions tend to promote economic efficiency, otherwise known as the "descriptive hypothesis".<sup>91</sup> The rationale behind this hypothesis is unclear. Eric Posner labels it an "accident of intellectual history".<sup>92</sup> Frank Michelman labels the descriptive hypothesis "a striking – a remarkable – notion that the mass of judicial decisions and rules should turn out to meet the standard of wealth maximisation."<sup>93</sup> Given the lack of intellectual justification for the claim, and growing evidence that it did not have empirical support, it is unsurprising that the descriptive hypothesis has largely been abandoned by contract economics. As the legal economist says in the conversation above, contract economics has been repositioned as a normative theory (a basis for criticizing or defending current legal rules on efficiency grounds) and as a positive theory (a means to identify the efficiency costs and benefits of legal rules).

The shift away from the descriptive hypothesis also reflects methodological realities. The orthodox economic approach is partial analysis, in which the economist holds constant most relevant variables and institutions in order to focus on just one or two.<sup>94</sup> As illustrated above, the economic analysis of remedies involves considering the relationship between the remedy awarded and a certain pre-breach decision by the contracting parties (for example, the reliance decision). This requires holding constant the other pre-breach decisions that may conceivably be affected (for example, the breach decision). Such an approach is ill-suited to the development of a descriptive theory to bring broad coherence to a particular area of contract law.<sup>95</sup> That task is best achieved through interpretive theories of law.

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<sup>91</sup> Craswell, *supra* note 26, 904.

<sup>92</sup> Posner, *supra* note 14, 833 n 8.

<sup>93</sup> Michelman, "A Comment on *Some Uses and Abuses of Economics in Law*" (1978-1979) 46 U Chi L Rev 307, 311.

<sup>94</sup> Craswell, *supra* note 26, 921.

<sup>95</sup> *Ibid* 921-922.

Craswell uses the following example to illustrate the different methodologies.<sup>96</sup> In analysing the efficiency effects of substantive rules, economists tend to take the current enforcement structure (one plaintiff and one defendant) as given. Economists ask, what substantive rule would be best *given* the costs and other consequences of the current enforcement structure? However, for the interpretive theorist, the enforcement structure and substantive rules are part of the body of law that must be interpreted. Any theory that explained one but not the other would be lacking from an interpretive point of view. In other words, the aspiration towards broad coherence pushes interpretive theorists strongly towards an “all or nothing” point of view, which is foreign to economics.<sup>97</sup> The difference of methodology is between the legal and economic culture, or more broadly between the humanistic and scientific approach.<sup>98</sup> As Richard Posner observed:<sup>99</sup>

An economic approach that explained 90 percent of some set of legal rules or outcomes would be judged strikingly successful by the standards of social science, but it would have the legal practitioner with a hollow feeling if he had a case to which the unexplained 10 percent of the precedents were relevant.

Why, then, does Eric Posner evaluate contract economics according to the fulfilment of a hypothesis that has largely been abandoned? Ayres suggests that the descriptive hypothesis is used as a straw man.<sup>100</sup> That may be so, but the explanation is probably simpler. Posner is compelled to do so because he adopts an overly simple and ultimately flawed approach to evaluating the success of a legal theory solely by the fulfilment of the theory’s original aspirations (one of which was to substantiate the descriptive hypothesis). As argued, asking whether a theory has met the expectations of its constituents, which can shift when the theory repositions itself, is a better approach to assessing the value of the theory.

In summary, while Eric Posner is correct that contract economics often fails as a descriptive theory, his conclusion is largely redundant. For pragmatic and methodological reasons, contract economics has been repositioned as a normative and positive theory. The descriptive

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<sup>96</sup> Ibid 921.

<sup>97</sup> Ibid 922.

<sup>98</sup> Posner, “Uses and Abuses of Economics in Law” (1978-1979) 46 U Chi L Rev. 281, 301.

<sup>99</sup> Ibid 302.

<sup>100</sup> Ayres, *supra* note 21, 881.

accuracy of contract economics is not without its significance, though. As Posner observes, the perceived legitimacy of contract economics as a normative theory is influenced by the extent of the variance between its normative recommendations and current legal rules:<sup>101</sup>

Courts and legislatures are more likely to pay attention to scholarly recommendations that follow naturally from the logic of contract law, than those that float down from the ether... When economics was able to keep the descriptive and the normative together, when it was able to say that contract law was essentially efficient but for some tweaking here and there, it had the potential to influence decision-makers for it worked with the past, not against it...

In other words, the greater the variance, the less that normative recommendations will be seen as a legitimate guide to reform. This is one of the challenges for contract economics as a normative theory.

### **Contract Economics as a Normative Theory**

*The Judge:* I must cut in here. Even if, and that's a big "if", I should decide cases to maximize efficiency, your theories never give me clear recommendations how to do that! What's the use of all your fancy theories if I can't use them to resolve a real-life case before me?

#### *1 Efficiency as a Legal Concern*

The Judge is correct to point out the "big if", which is an inescapable caveat of any teleological theory, for we only care about the theory's recommendations if we care about the theory's stated goal. For contract economics, the goal is wealth maximization, which is pursued through increasing efficiency. Thus, a prior enquiry to assessing contract economics as a normative theory must be to ask two simple but maddeningly vexed questions: Should efficiency be a legal concern? If so, is it a decisive or simply a legitimate concern? Exploring the vast literature on these questions is well beyond the scope of this article. However, we consider one strand of the debate that illustrates some of the important arguments and results.

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<sup>101</sup> Posner, *supra* note 14, 853.

Unsurprisingly, Richard Posner adopts the most strident position in favour of efficiency as a legal concern. Posner argues that judicial consideration of factors such as distributive justice or other “justice” factors, on which a social consensus is lacking, “would introduce an unacceptable degree of subjectivity and uncertainty into the judicial process.”<sup>102</sup> On the other hand, efficiency “has always been an important social value, and it may be the *only* value that a system of common-law rulemaking can effectively promote”.<sup>103</sup> Michelman interprets Posner as “insisting on confining the politically unaccountable judiciary to furtherance of the set of *socially uncontested* values...”<sup>104</sup> In fact, Posner may be making a lesser claim, simply that judges lack the tools to further goals other than efficiency, in particular, as Posner notes, effective tools of income distribution to further distributive justice.

However, as Posner would acknowledge, while the end goal of efficiency (wealth maximization) may be largely uncontested, the process by which one reaches that goal is highly contestable. One need only contemplate the standard of Kaldor-Hicks efficiency in which efficiency is said to increase even though at least one party is the loser from the transaction. While the standard requires that the losing party could theoretically have been fully compensated by the gains of the winning party, Kaldor-Hicks efficiency does not require that the party *actually* be compensated.<sup>105</sup> Thus, it is not difficult to see that when elevated to the status of an exclusive basis for adjudication, the Kaldor-Hicks criterion is “simply unacceptable, both to judges and to society generally.... [because] [i]t reflects an unacceptably limited view of the human condition.”<sup>106</sup>

Even the more stringent standard of Pareto efficiency is by no means uncontested. Take the theory of efficiency breach, introduced above. Putting aside criticisms of whether efficient breaches are in fact efficient, the theory is routinely criticized for undermining the moral weight of promise-keeping.<sup>107</sup> To an extent, that criticism rests on value judgements that are themselves contestable. Scanlon, for one, argues that the perceived non-equivalence between fulfilment of promises and compensation for non-fulfilment is greater in personal life than in

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<sup>102</sup> Posner, *supra* note 98, 292.

<sup>103</sup> *Ibid* (original emphasis).

<sup>104</sup> Michelman, *supra* note 93, 313 (original emphasis).

<sup>105</sup> Benson, *supra* note 20, 48.

<sup>106</sup> Smilie, “Formalism, Fairness and Efficiency: Civil Adjudication in New Zealand” [1996] NZ Law Rev 254, 270.

<sup>107</sup> See e.g. Khouri, “Efficient Breach Theory in the Law of Contract: An Analysis” (2002) 9 Auckland U L Rev 739, 758-759.

commerce.<sup>108</sup> Craswell notes that no critic of efficient breach has contended that a promise read as an “intermediate obligation” to perform or pay damages would be “positively immoral.”<sup>109</sup> However, what the above discussion should highlight is that while efficiency and wealth maximization are not generally contestable concepts in themselves, their pursuit may involve trade-offs with other important values that contract law is seen to promote (for instance, keeping one’s promises).

Because of these trade-offs, even Richard Posner implicitly accepts that wealth maximization must be justified in terms of how it promotes less contestable social values. Coleman takes this as an article of faith in stating, without supporting justification, that “because wealth is not something of intrinsic value, its claim to moral worth depends on its extrinsic value, that is, on its capacity to secure other things of value.”<sup>110</sup> On this basis, Posner argues that a society that aims to maximize wealth will produce an “ethically attractive combination of happiness, of rights (to liberty and property), and of sharing with the less fortunate members of society”.<sup>111</sup> Focusing on the conferring of rights, Coleman points out the logical ambiguity in that claim.<sup>112</sup> Is Posner meaning that people acting to maximize wealth will invariably respect rights that other individuals have? If so, he would find support from Gordon Tullock, who argues on empirical grounds that “there is fortunately little clash between ethical criteria and efficiency considerations.”<sup>113</sup> However, the claim, if true, would be a remarkable extension of the Invisible Hand doctrine. At least on the level of interaction between individuals, the pursuit of wealth maximization can and often will be inconsistent with other highly valued rights, as the efficient breach example above illustrates. At a societal level, it is unclear why the assignment of rights and duties so as to achieve wealth will achieve a more attractive combination of these rights and duties than, say, pursuing them directly through a combination of social goals.<sup>114</sup> In this vein Sir Anthony Mason remarks that, “[e]conomic rationalisation is by no means synonymous with our ideas of justice.”<sup>115</sup> His Honour illustrates the conflict by noting that if efficiency or wealth maximization were to become decisive or dominant legal criteria, such bedrocks as

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<sup>108</sup> Scanlon, “Promises and Practices” (1990) *Phil & Pub Aff* 199, 205.

<sup>109</sup> Craswell, *supra* note 70, 27.

<sup>110</sup> Coleman, “Efficiency, Utility and Wealth Maximization” (1979-1980) 8 *Hofstra L Rev* 509, 528.

<sup>111</sup> Posner, *supra* note 11, 487.

<sup>112</sup> Coleman, *supra* note 110, 528-530.

<sup>113</sup> Tullock, “Two Kinds of Legal Efficiency” (1979-1980) 8 *Hofstra L Rev* 659, 662.

<sup>114</sup> Coleman, *supra* note 110, 530.

<sup>115</sup> Mason, *supra* note 13, 179.

*Donoghue v Stevenson*<sup>116</sup> and *Walton Stores (Interstate) Ltd v Maher*<sup>117</sup> might well cease to be part of the law.<sup>118</sup>

Alternatively, Posner could be taken to mean that rights are mere instruments in the pursuit of wealth. As Coleman argues, this “instrumentalist” defence of wealth maximization is problematic.<sup>119</sup> By treating all rights as instruments of wealth maximization, the defence suggests that wealth maximization is the only good in society. Yet this is inconsistent with Posner’s starting assumption that wealth is valued instrumentally as a means to less contestable social ends. More fundamentally, the claim is deeply implausible. Justice, fairness, and other socially acceptable values are regarded, in legal and non-legal contexts, as important in themselves, not merely as instruments to achieving wealth.

A more plausible view is that efficiency can be placed somewhere along a hierarchy of values relevant for legal decision-making. If no other more highly-prized values are at stake, courts will clearly prefer the more efficient outcome. Often, however, there will be a trade-off between efficiency and other social values. In these situations, normative theories such as contract economics that are based on a single value will be found lacking because they deny the complexity of life.<sup>120</sup> As Eisenberg observes:<sup>121</sup>

Part of the human moral condition is that we hold many proper values, some of which will conflict in given cases, and part of the human social condition is that many values are relevant to the creation of a good world, some of which will conflict in given cases.

In other words, any theory of contract law must account for a pluralistic society. This accords with judicial comment, even in the opinion of proponents of law and economics. For example, Sir Ivor Richardson readily acknowledges that economic analysis “is not an Aladdin’s lamp....Efficiency concerns are only one factor in an assessment of public interest.”<sup>122</sup> In resolving cases, judges must take into account a variety of factors, including precedent, history, morality, culpability,

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<sup>116</sup> [1932] AC 562 (HL).

<sup>117</sup> (1988) 164 CLR 387 (HCA).

<sup>118</sup> Mason, *supra* note 13, 179.

<sup>119</sup> Coleman, *supra* note 110, 530.

<sup>120</sup> Eisenberg, *supra* note 38, 240.

<sup>121</sup> *Ibid* 240-241.

<sup>122</sup> Richardson, “Lawyers and Economic Consequences” 1 New Zealand Law Conference Papers (1993) 358.

justice and fairness, and “do not regard themselves as being at liberty to subordinate these considerations to the dictates of economic goals.”<sup>123</sup> In other words, the limited role for efficiency as a legal concern is a necessary consequence of the constitutional role of the judiciary.

To summarize, efficiency and wealth maximization are legitimate legal concerns insofar as they do not conflict with any more highly prized social value. This conclusion is reflected in Guido Calabresi’s account of the role of efficiency in judicial decision-making. In deciding cases in which discretion exists for courts to apply policy-based reasoning, policies are based “on that mixture of efficiency and distribution that in the particular context is thought by the court to be instrumental toward justice and, in particular, does not violate any fairly precisely defined rights or veto points.”<sup>124</sup> The “veto points” are values such as fairness, which place a decisive veto-like constraint on what can be done in pursuit of efficiency.

Having addressed when efficiency is a legitimate legal concern, we can turn to the question of how well contract economics performs as a normative theory; that is, how well it recommends the most efficient legal rule or rules that are relevant to the case at hand.

## *2 Adjudicating Without the One Most Efficient Rule*

Eric Posner argues that contract economics fails as a normative theory because it does not provide a sound basis for criticizing or defending legal rules.<sup>125</sup> Take the example of the economic analysis of damages introduced above. As seen, early scholarship prematurely concluded that expectation damages was the most efficient remedy, since it induced only efficient breaches. However, later scholarship raised the spectre of numerous, and often countervailing, efficiency implications of each damages measure. The current position is that it cannot be said which damages measure is unambiguously the most efficient.

Consider the normative value of such conclusions. Early scholarship could not provide a sound basis for reform, since it did not consider the incentives that remedies create for decisions other than breach. Later scholarship cannot unambiguously identify the one most efficient rule. A catch-22 situation emerges in which there is a hard choice between simplicity and relevance. In Posner’s words, “[s]imple

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<sup>123</sup> Mason, *supra* note 13, 174.

<sup>124</sup> Calabresi, “About Law and Economics: A letter to Ronald Dworkin” (1979-1980) 8 *Hofstra L Rev* 553, 561.

<sup>125</sup> E.A Posner, *supra* note 14, 854-855.

models do not justify legal reform because these models exclude relevant variables. Complex models do not justify legal reform because the optimal rule depends on empirical conditions that cannot be observed.”<sup>126</sup>

Can courts nevertheless apply economic analysis even when such analysis cannot identify the one most efficient rule? One option is for courts to identify and apply the most efficient remedy in relation to the specific circumstances of the parties. For example, where the promisee makes significant reliance investment, courts could award restitutionary damages (instead of expectation or reliance damages) to constrain investment to efficient levels. Of course, if the innocent party could not foresee that restitutionary damages would be awarded, the party would not have an incentive to constrain investment. The measure of damages awarded post-breach cannot effect the pre-breach reliance investment where there is uncertainty as to the measure of damages that will be awarded. Courts would have to signal in advance that a certain measure of damages will be awarded for breach of contracts with certain characteristics. For example, where a particular class of contracts is associated with high levels of reliance investments, courts could consistently award restitutionary damages to provide an incentive for promisees to constrain investment to efficient levels. Efficient, in this context, means the level of investment at which the marginal gains from beneficial reliance (the returns from the promisee’s pre-breach investment) equal the marginal costs from detrimental reliance (the possible loss of the investment if the promisor breaches).<sup>127</sup>

To illustrate the difficulties in applying such an approach, consider the facts of *McRae v Commonwealth Disposals*.<sup>128</sup> The defendant invited tenders for the purchase of a shipwrecked oil tanker that was said to be located 100 miles offshore. After submitting a successful tender, the plaintiff, at considerable expense, conducted a salvage operation but found no tanker at the specified location. In fact, there was no such tanker in that locality at any material time. The High Court of Australia declined to award expectation damages on the basis that the expected profit from the salvage venture was too uncertain to be quantified. If the approach outlined above is applied, the Court should award restitutionary damages because that measure encourages efficient reliance by compelling the plaintiff to take account of the probability of breach by the defendant. If restitutionary damages are awarded (equal to the price of the salvage contract), reliance investment (the amount

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<sup>126</sup> Ibid 854.

<sup>127</sup> Benson, *supra* note 20, 51.

<sup>128</sup> [1951] 84 CLR 377 (HCA).

invested in salvage) would have a positive pay-off only if the contract is performed (that is, if the shipwreck is in the specified locality). Thus, the promisee has an incentive to constrain reliance investment to efficient levels. To illustrate, consider a simplified version of the facts. D sells salvage rights to P for \$1000. The predicted value of the shipwreck is \$5000. P estimates the probability of breach (that is, that the shipwreck will not be where D says it is) as 50 per cent. If P knows that courts will award only restitutionary damages for breach of salvage contracts, she will constrain reliance investment to \$2500 at most (equal to the expected benefit of the contract).<sup>129</sup>

However, the award of restitutionary damages to constrain reliance comes at the cost of fairness. On breach, D (the breaching party) breaks even, while P (the innocent party) makes a loss of \$1500. This unfair outcome sees it better to award reliance rather than restitutionary damages. However, economic analysis could still be applicable. Instead of awarding “reasonable” reliance as is the practice, the court could award the level of efficient reliance.<sup>130</sup> This approach has at least superficial attractiveness because it implies a more scientific approach to calculating reliance damages. In contrast, assessing what level of reliance is “reasonable” tends to be an arbitrary affair. However, the practical difficulties of applying the efficient reliance approach are formidable. For instance, what measure of the probability of breach should the court have regard to? If the court chooses a subjective measure (that is, the probability of breach that the defendant actually estimated), plaintiffs who objectively underestimate the risk of breach will be over-compensated from the efficiency standpoint, and vice versa. Calculating what a “reasonable” estimation of the risk would be in the circumstances requires an assumption as to the risk profile of the reasonable salvor. If the reasonable salvor is assumed to be risk-neutral, but the plaintiff is in fact risk-loving (and therefore may consciously over-invest in reliance in anticipation of the thrill of salvage), the law in the name of efficiency will be discouraging salvage expeditions motivated by adventure rather than economic efficiency! Facetious as the point may be, the above discussion illustrates the systematic difficulties for adjudicating without the benefit of the one most efficient rule.

While, as suggested, calculating “reasonable” reliance necessarily involves arbitrary choices, it is often the best that can be done

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<sup>129</sup> Value of shipwreck (\$5000) multiplied by probability of breach (50%).

<sup>130</sup> This suggestion was made in Goetz and Scott, “Enforcing Promises: An Examination of the Basis of Contract” (1980) 89 Yale LJ 1261, 1280 n 42. The discussion below attempts to explain what the authors could mean by ‘implementation costs’.

given the complex nature of reliance investment and the constraints of adjudication. Consider how *McRae* was actually decided. Given that expectation damages could not feasibly be awarded, the Court proceeded to calculate the quantum of reliance damages. Sensibly, in light of the discussions above, Dixon and Fullagar JJ deferred to the risk estimations of commercial parties, noting that “[the salvage] was a matter of business, of weighing one consideration with another, a matter of which business men are likely to be the best judges.”<sup>131</sup> The judges went on to assess what types of reliance investment would be compensated. The plaintiffs were allowed recovery, at variously discounted rates, for travelling expenses, ship’s stores and crew’s wages. Recovery was not allowed for equipment and reconditioning of the salvage ship, since these represented capital expenditure incurred well before the salvage contract, or for items that would have been covered by insurance, nor for insurance payments or office expenses, because these were expenses incurred in an ordinary course of business. The overall award of reliance damages came to £3000. How different would this award have been from the level of efficient reliance? It is anybody’s guess, given the challenges in calculating the latter. At the least, we can say that by adopting a pragmatic approach to calculating reliance damages, judges can arrive at a sum that is reasonable, and perhaps even broadly efficient. Other ways of ameliorating the reliance problem within contract include applying the doctrine of foreseeability.<sup>132</sup> Finally, parties themselves can constrain reliance investment by contracting in advance of breach for liquidated damages.

In summary, the fact that contract economics often fails to generate the one most efficient rule seriously limits its value as a normative theory. Adjudication without the single most efficient rule is problematic at best and impossible at worst.

### 3 Other Challenges to Using Contract Economics in the Courtroom

Conspicuously absent from the discussion thus far is a recognition of the time, resources and expertise needed for courts to undertake meaningful economic analysis. Moreover, there is doubt whether the administrative costs incurred as a result would be outweighed by any efficiency gains.

The most important challenge to using contract economics in the courtroom may be the plain fact that judges are not generally economists.

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<sup>131</sup> *McRae*, supra note 128, 413.

<sup>132</sup> *Newmans Tours Ltd v Ranier Investments Ltd* [1992] 2 NZLR 68 (HC).

Consider *DHL International (NZ) Ltd v Richmond Ltd*,<sup>133</sup> where the relevant issue was the proper construction of an exclusion clause that excluded a courier's liability for consequential damages. Richardson J, as he then was, noted that a party entering into a low-price courier contract that excludes liability on the part of the courier should be taken to have elected to bear any resulting losses. The low cost of the courier service "reflects the responsibilities and risks undertaken by each party."<sup>134</sup> Though the case was not cited by His Honour, the reasoning is similar to that advanced in *Davis v Pearce Parking Station*.<sup>135</sup> In that case, the High Court of Australia held that an exclusion clause was effective against negligence because, among other reasons, the small price paid for bailment indicated that both parties intended that the bailee would protect himself against the negligence of a servant. Writing extra-judicially, Sir Ivor Richardson explains the *DHL* decision in economic language: to read down exclusion clauses in those circumstances would be "inhibiting mutually beneficial bargains" and would prevent future parties negotiating a lower price in return for an exclusion of liability.<sup>136</sup> With respect, it is unclear how much value couching the decision in economic terminology really adds to explaining the decision. The same decision can be, and was, reached by the less convoluted, and arguably more legitimate, means of objectively construing the parties' intentions.

Deeper problems occur when judges explicitly try to apply economic analysis to decide cases. Richard Posner tells the cautionary tale of Judge Sneed's opinion in *Union Oil Co v Open*.<sup>137</sup> The case considered a lawsuit by commercial fishermen against oil companies whose joint venture had caused a serious oil spill that impaired the livelihoods of the fishermen. The issue was whether injury to a business expectancy (the fish that had not yet been caught) as opposed to a vested property right was compensable under the applicable tort law. With reference to Calebresi's book on the costs of accidents, the Judge set about applying the principles developed in that book to the case at hand. To Posner, while the Judge's conclusion (that the oil companies should be liable) was correct as a matter of economics, "[his] effort to articulate his reasoning in economic terms was disastrous".<sup>138</sup> The Judge's

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<sup>133</sup> [1993] 3 NZLR 10 (CA).

<sup>134</sup> *Ibid* 22.

<sup>135</sup> (1954) 91 CLR 642 (HCA).

<sup>136</sup> Richardson (2002), *supra* note 4, 161.

<sup>137</sup> 501 F 2d 558 (9<sup>th</sup> Cir, 1974) (CA); discussed in Posner, *supra* note 98, 297-301.

<sup>138</sup> *Ibid* 300.

application of economic analysis was “superfluous”, “confused”, and an illustration of the adage that a little knowledge is a dangerous thing.<sup>139</sup>

Yet one can hardly blame Judge Sneed for attempting to use the relevant economic literature. As Epstein has observed, “[m]odern law and economics can encourage the dangerous feeling in judges that, with the grand theoretical principles now elaborated, they can know a great deal about specific transactions.”<sup>140</sup>

The discrepancy between confidence and actual competence did not always exist. In the early days of the law and economics movement, lawyers could understand the technical economics underlying the movement’s theories, if not actually reproduce it.<sup>141</sup> However, over time the technical barriers have become almost insuperable for non-economists.<sup>142</sup>

Finally, it appears that even for luminaries in the field, the institutional and practical constraints of adjudication place natural limits on how economic analysis can be used in courts. Richard Posner, who was appointed to the bench in 1981, observes the constraints on a legal-economist turned judge.<sup>143</sup>

He will want to be thought a good judge, and he will not if he uses his position to peddle his academic ideas. He will not have the respect of his colleagues or of the bar, he will have trouble marshal[ing] his court behind his positions, he will find that a judicial opinion is an inefficient vehicle for developing complex ideas, he will find that his opinions are discounted because of the ulterior motive behind them, and he will not have the time to write articles in opinion format. The whole atmosphere will be against him.

In summary, there are serious challenges for the meaningful use of economic analysis in the courtroom. However, the discussion below suggests that similar outcomes could be achieved by a much simpler means.

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<sup>139</sup> *Ibid* 297-299.

<sup>140</sup> Epstein, “Economics and the Judges: The Case for Simple Rules and Boring Courts” (Speech delivered at invitation of New Zealand Business Roundtable, Auckland Centra Hotel, 14 December 1995) <<http://www.nzbr.org.nz/documents/publications/dba-publications/eco.pdf>> (at 30 September 2005).

<sup>141</sup> Epstein, *supra* note 25, 1173.

<sup>142</sup> *Ibid*.

<sup>143</sup> Posner, “Wealth Maximization and Judicial Decision-Making (1984) 4 *International Review of Law and Economics* 131.

#### *4 A Return to Formalism?*

Given the difficulties of applying economic analysis in the courtroom, Epstein suggests that “[t]he legal profession is better off taking economics more as a set of heuristic principles for understanding fundamental social relationships than as a set of formal equations or precise quantitative knowledge.”<sup>144</sup> In the course of a related discussion, Smillie identifies some heuristic principles that can be drawn from recent judgments that apply concepts of economic efficiency.<sup>145</sup> First, in the absence of clear evidence that harsh contractual terms are the product of the unconscionable use of bargaining power, all contracts should be enforced. Secondly, courts should not adopt a hostile approach to provisions that exclude or limit liability and should be reluctant to imply protective terms or superimpose obligations over and above those voluntarily agreed. Thirdly, where a person failed to avail himself of the opportunity to allocate a known risk by contract, a court should assume he intended to assume the risk himself. Finally, to facilitate voluntary and informed choices, the requirements for contract formation must be clear and readily understandable, and the remedies for breach must be capable of reasonably accurate prediction at the time of contracting.

The irony is that these are the very principles prescribed by the application of common law rules developed in the late 19<sup>th</sup> century. Thus, Smillie concludes that economic theory can at most “be employed as a justificatory cover for moving back towards a more formalistic approach to civil adjudication”.<sup>146</sup> It is submitted that the explanation is simpler, for the liberal conception of contract, at its peak during that time, is largely consonant with modern neoclassical economics.

The question of whether judges could reap the benefits of economic analysis through a return to a more formalistic application of common law rules is beyond the scope of this article. However, it is a fascinating future line of enquiry that perhaps signals a resurrection of the descriptive hypothesis. Judges in the 19<sup>th</sup> century could unconsciously have been applying the very principles that modern economic analysis would recommend.

Four conclusions arise from the discussions above. First, efficiency is a legitimate legal concern only within narrow parameters defined with reference to more highly prized social values. Second, where contract economics is unable to recommend the one most efficient

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<sup>144</sup> Epstein, *supra* note 140, 8.

<sup>145</sup> Smillie, *supra* note 106, 272.

<sup>146</sup> *Ibid* 273.

rule, its value as a normative theory is limited. Thirdly, because of constraints on time, resources and expertise, courts are unable to apply economic analysis in a meaningful manner. Finally, the benefits of economic analysis *may* be able to be achieved through a return to formalism.

### Contract Economics as a Positive Theory

*The Legal Economist:* That's unfair. Contract economics can identify the efficiency costs and benefits of legal rules.

*The Judge:* Yes, but how do I weigh up the efficiency costs and benefits? I can hardly be expected to conduct a detailed economic analysis in my courtroom!

As a positive theory, contract economics operates in the grey area between its descriptive and normative roles. The goal of a positive theory is to identify the efficiency costs and benefits of contract rules. This is achieved through the methodology of partial analysis introduced above. We should note that normative implications often arise where a rule is identified as having high efficiency costs. However, the key distinction between a normative and positive theory is that the latter does not purport to support legal reform and so should not be assessed on what is the task of the former.

Eric Posner does not make this distinction. For Posner, the results of partial analysis are “distressingly open-ended and unambitious”.<sup>147</sup> For an example of the open-endedness that Posner is referring to, recall the seven pre-breach decisions that are affected by the remedy that will be awarded for breach. The efficiency implications of each remedy on each of these decisions are often countervailing and uncertain in magnitude. Given this, Posner argues that “a wise judge might, in order to avoid paralysis, simply ignore them”.<sup>148</sup> Craswell disagrees, arguing that possession of knowledge of the efficiency implications of particular rules is valuable to legal decision-makers, even if decision-makers cannot be provided with a “complete algorithm” to produce the most efficient rule.<sup>149</sup> Craswell is incorrect insofar as he is referring to judges. As argued in the previous section, judges struggle to apply economic analysis where they cannot be provided with the one

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<sup>147</sup> Posner, *supra* note 14, 855.

<sup>148</sup> *Ibid.*

<sup>149</sup> Craswell, *supra* note 26, 913.

most efficient rule. The results of partial analysis are far too indeterminate for practical use in the courtroom. However, partial analysis may be useful for the other key legal decision-maker that has been ignored up to this point – the legislator. Legislators conceivably have the time and the resources that judges lack to use the results of partial analysis to generate the most efficient rule with respect to the circumstances to which the rule is likely to be relevant. As Ayres observes, “[i]n particular settings, lawmakers can reasonably conclude that one or another problem... is the most salient. Using the insights of modern scholarship, they can fashion with greater clarity laws that further their consequential objectives.”<sup>150</sup> Ayres cites the example of the exhaustive categorization of mandatory rules in the (United States) Uniform Trust Code law as a response to the economic analysis of the mandatory/default rule dichotomy.<sup>151</sup> The analysis also clarified when mandatory rules are appropriate and enhanced the level of the lawmaker’s analysis in creatively setting default rules.<sup>152</sup>

Even without normative implications, partial analysis is useful for the fundamental reason that it increases our knowledge of phenomena that are fraught with complexity. As Craswell observes, “shedding any light at all on those questions is a useful contribution, whether or not we are able to produce a definitive answer.”<sup>153</sup> In assessing whether these partial analyses can be put together to generate optimal rules, Eric Posner overlooks the value of qualified conclusions, which have made major contributions to our knowledge of the efficiency implications and properties of a vast array of legal rules and problems. These include, for example, the formation rules, the doctrine of mistake, contractual interpretation, fraud, duress, unconscionability, and, as illustrated above, the analysis of remedies. This knowledge can provide normative guidance for legislators, or at least shed light on complex phenomena. It is difficult to argue with Craswell when he says that if we are interested in the efficiency impacts of contract rules and doctrines “it behoves us to know as much as we can about those effects, rather than deliberately closing our eyes to them.”<sup>154</sup>

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<sup>150</sup> Ayres, *supra* note 21, 884.

<sup>151</sup> *Ibid* 866.

<sup>152</sup> *Ibid*.

<sup>153</sup> Craswell, *supra* note 26, 914.

<sup>154</sup> *Ibid* 915.

## V CONCLUSIONS

Can we say which friend in the opening conversation is correct? The legal economist is correct in pointing out that the failure of contract economics to produce a general theory is a correct but hollow conclusion. No other theory has come even close to fulfilling that goal. Similarly, the failure of contract economics as a descriptive theory of individual contract doctrines is a redundant conclusion. The legal economist is correct in pointing out that contract economics has long abandoned pretensions to descriptive accuracy. Instead, its positive and normative roles are dominant. However, the judge is correct in qualifying the normative value of contract economics to cases in which efficiency is a legitimate legal concern. These cases were defined as those in which efficiency does not conflict with any more highly prized social value. Further doubts can be cast on the normative use of contract economics. First, it is not feasible for courts to apply economic analysis where the analysis has not generated the one most efficient rule. Second, there are real challenges to using economic analysis in the courtroom, arising from resource, institutional and practical constraints. However, the legal economist is correct in highlighting the achievements of contract economics as a positive theory. While partial analysis is not useful for judges, it can be useful for legislators. Even without normative implications, it has made major contributions to our understanding of the efficiency implications of contract rules and doctrines.

What does this mean for the value of contract economics as a legal theory? After all, in different ways, both the sceptic and the supporter of contract economics can feel vindicated by the conclusions above. The most that can be said is that the theory produces useful results in some applications but not others. In other words, some constituents of the theory will be satisfied and some disappointed. It is submitted that little more can be said for any other theory that tackles a subject as nebulous as contract.