Introduction

Efficiency is the dominant theoretical paradigm in contemporary corporate and commercial law scholarship. The jurisprudential foundations of corporate and commercial law, then, are the foundations of efficiency analysis. They present a mix of historical, moral, and methodological questions, as well as issues of institutional design. What are the historical roots of efficiency analysis in contract, sales, and corporate law? Is moral theory irrelevant to efficiency analysis in these areas? If moral theory is relevant, are morality and efficiency compatible? Even if efficiency is otherwise reasonable as a normative goal in corporate and commercial law, does the complexity of efficiency make it practical to administer in adjudication? What is the best way of pursuing efficiency in corporate and commercial law? The essays in this volume address one or more of these jurisprudential questions.

The historical roots of efficiency analysis. In Chapter 1, "Karl Llewellyn and the Origins of Contract Theory," Alan Schwartz argues that Llewellyn was an important proponent of the modern law and economics approach to regulating contracts. The received view of Llewellyn depicts him as a rule-sceptic who sometimes advocated the regulation of sales contracts by standards other than economic efficiency. Schwartz rejects the received view, based on a critical evaluation of Llewellyn's writings on sales law between 1925 and 1940. Llewellyn's proposals, as efforts at law reform, assumed the existence and efficacy of legal rules regulating sales contracts, and only sought to replace bad rules with better ones. According to Schwartz, Llewellyn argued that the state should reduce contracting costs and create default rules, and used economic considerations to understand parties' contracting behavior. Llewellyn simply made mistakes in the efficiency analyses upon which he based his recommended rules. These mistakes, Schwartz suggests, were due to the immature state of the economics of Llewellyn's day, not to a concern to promote values other than efficiency. Some of Llewellyn's recommended rules are outdated because the economic theory of his time was too primitive to offer policy analysts much help. When devising rules to regulate contracts, analysts

today can draw on advances in the economics of information, finance theory, and transaction cost economics. These results were unavailable to efficiency-minded contract theorists in the first half of the century.

Schwartz's rejection of the received view is novel and promising. It allows a range of reassessments of Llewellyn that fall between rule-scepticism and a hostility to law reform proposals based on efficiency. Schwartz's depiction of Llewellyn's position, for instance, describes one of a number of possibilities. Another position would diagnose Llewellyn's shortcomings as simple failures to use then-current research techniques and results. This is because some of Llewellyn's proposed rules are inadequate even by the standards and knowledge available to Llewellyn. Llewellyn's defense of both the mailbox rule for when acceptance becomes effective as well as his notion of substantive unconscionability rely on the reasonable expectations of a party. The defense rests on a circularity in reasoning, as Schwartz notes. The current state of law partly grounds expectations it is reasonable to have. Thus, to justify the law by those expectations presupposes the law which they are to justify. This is a straightforward failure in analysis, which was apparent to David Hume in the somewhat similar context of promise-keeping and should have been familar to Llewellyn. Theoretical considerations were not needed to show him the circularity. There is also the failure to abide by research and sampling techniques known to Llewellyn's contemporaries. Llewellyn, and some other legal realists, generated proposed rules on the basis of unsystematic samplings of appellate caselaw. Restricting a survey to caselaw exposes one to selection effects exhibited by litigated cases, and the further restriction to appellate cases can exacerbate them. Llewellyn's methodological mistake was avoidable even by the analytic standards or sampling techniques of his day. Of course, it is possible that some of Llewellyn's proposals were marred by a failure to take into account then-contemporary learning, while other proposals were marred by the then-primitive state of economic theory.

Efficiency and morality. Daniel Farber assumes that commercial transactions implicate morality and argues that morality underwrites the use of efficiency principles in commercial law. In Chapter 2, "Economic Efficiency and the Ex Ante Perspective," he finds that the application of the efficiency principle to commercial law can derive from a moral theory. Farber uses Rawlsian hypothetical consent to justify a suitably constrained principle of Pareto efficiency as a principle of adjudication. His analysis relies on conclusions of the classic debate over the normative foundations of the economic analysis of law. According to Farber, the debate justifies four propositions: (1) Economic efficiency cannot be the sole principle of justice, (2) the ex ante perspective produces an economic efficiency rule only in the absence of risk aversion, (3) prospective legislation can properly use an ex ante perspective in selecting rules, and (4) economic efficiency requires a prior decision about the initial allocation of resources. Farber follows Rawls in assuming that Rawls' princi-

ples of justice apply to the basic structure of society, not to detailed questions of institutional design. He acknowledges that principles of adjudication, like all principles of nonbasic institutional design, are subordinate to the principles of justice. Subject to this constraint, Farber maintains that the original position can be used as a device for selecting an impartial principle of adjudication.

Farber adopts Rawls' suggestion that ideally just legislation is the legislation ideal legislators would agree to behind a thin veil of ignorance that allows them to know the general facts about their particular society. He argues that this "second stage" Rawlsian inquiry can be modified to justify a principle of adjudication. Ideal legislators, according to Farber, would agree to a limited principle of efficiency for adjudication if they were not risk-averse or did not have to undergo shifts in preferences dramatic enough to constitute a change in personal identity. Farber concludes that such a principle is both fair to litigants and, at least in a limited domain, reasonably administrable by judges. It is fair because the common law process embeds the practice of finding new principles, such as the efficiency principle, in past cases. An efficiency principle is administrable by judges because they will sometimes be able to rely on established economic theory to decide cases and mitigate the effects of error by limiting the principle's application to default rules.

Farber's argument raises a large question about the applicability of morality to commercial transactions. Simply put, does morality apply to commercial contexts to restrict the principles that properly regulate private ordering in commercial transactions? Three positions can be taken on the relation between morality and commercial contexts: (1) Some aspects of morality such as distributive justice are inapplicable to commercial transactions and the rules governing them[1]; (2) distributive justice is applicable to such transactions and rules but wrong as a substantive moral matter to use to evaluate them; and (3) distributive justice is applicable to commercial transactions and rules but itself allows other principles to be used to evaluate them. Position (1) is implausible. Distributive justice seems to apply in commercial settings. After all, whatever elses it involves, distributive justice involves the distribution of benefits and burdens to individuals.[2] What it requires, of course, is another matter. Whether morality requires that commercial transactions be tested by principles of distributive justice is a question of substantive moral truth. That distributive justice applies in commercial contexts does not guarantee that morality gives priority to distributive justice over all other moral values. Thus, the implausibility of position (1), the "inapplicability" position, still leaves both positions (2) and (3) possible. Although a discussion of the details of the positions is beyond this introduction's scope, Farber's argument for the moral permissibility of efficiency principles illustrates the difficulty of offering a compelling argument for either position.

Farber follows Rawls in assuming that distributive justice applies only to what Rawls describes as the basic structure, not to commercial transactions

occurring within it. The assumption is a version of position (1). In fact, however, Farber's argument for the use of an efficiency principle in adjudication can be understood as based on either position (1) or (3). According to Farber, parties in a variant of the original position would prefer courts to select legal rules to govern routine contractual transactions that maximize joint satisfaction of contracting parties. They would do so because basic institutions are assumed to satisfy Rawls' principles, and routine transactions do not affect individual rights or mandated wealth distributions. Farber therefore proposes that distributive justice would not condemn the use of efficiency principles to evaluate commercial transactions. The proposal does not evaluate routine transactions by principles of distributive justice.

Now the proposal faces the following dilemma: It either restricts distributive justice to basic institutions or it does not guarantee the parties' selection of satisfaction-maximizing rules. For the order in which the parties select principles is crucial to the argument and needs to be justified. Farber supposes that parties first select principles of justice to govern the basic institutions and then select principles to govern routine contractual transactions. This order of approach is justified if distributive justice is restricted to the basic institutions. In that case, distributive justice has nothing to say about routine transactions because it is inapplicable to them. Given this justification, Farber's argument therefore supports position (1), not position (3). But the prima facie applicability of distributive justice to commercial settings again makes position (1), "inapplicability," independently implausible.

Alternatively, distributive justice applies to both basic institutions and routine transactions. The exercise is to select principles to govern both environments. In that case, there is nothing inevitable about Farber's preferred order of selection – first select principles of justice to govern the basic structure and then select principles that govern routine transactions within it. Another order for choosing principles could result in different principles selected. For instance, under a "basic structure first" approach, principles P could be selected for the basic structure and principles P' for routine transactions. But under a simultaneous selection of principles, principles R might be selected, where R applies to both sorts of items. Or different principles, R and R', might be selected for application to different items. And R (and R') might be cast in terms of distributive justice, not preference satisfaction. Neither Rawls nor Farber provides a reason to prefer one approach over the other. Thus, parties might choose rules that evaluate routine transactions from a distributive perspective.[3]

An illustration of the importance of order in rule selection is helpful. Bankruptcy law largely consists of rules allocating the cost of the debtor's financial distress. Assuming that the choice of rule is partly a matter of justice, and that justice turns on the hypothetical choices of affected parties under suitably specified conditions, the rule chosen will depend on other rules in

effect. If other rules already in effect guarantee debtors, creditors, or third parties a level of welfare, for instance, they might select bankruptcy rules that maximize their expected utility. Without that guarantee, they might be risk-averse and select a rule that assures them a minimum level of welfare.[4] Parties, for instance, in the circumstances might prefer a bankruptcy discharge because it assures them of control over the postpetition returns on their human capital. Given the discharge, affected parties might be risk-neutral and select corporate bankruptcy rules that maximize expected wealth. Crucial to the choice of a bankruptcy rule is the attitude toward risk associated with each rule, and the attitude therefore can vary depending on other rules in effect. The order in which rules are selected is not inevitable. To impose a particular order on the selection of rules – for example, by assuming that the basic structure satisfies certain principles and then asking about the choice of a bankruptcy rule – requires defense.

The complexity of efficiency-based adjudication. Lewis Kornhauser is less optimistic than Farber about the use of efficiency principles in adjudication. Complexity in the notion of efficiency is a barrier to its application. Kornhauser assumes that efficiency concerns predominate in corporate and commercial law, where well-informed, profit-maximizing parties typically engage in arm's-length transactions. But the pursuit of efficiency, according to Kornhauser in Chapter 3, "Constrained Optimization: Corporate Law and the Maximization of Social Welfare," is far more complex than is typically recognized in the law and economics literature. Kornhauser first demonstrates how legal rules influence a large number decisions made by corporate and commercial actors, even though the rule that is best with respect to one decision need not be best with respect to another decision. Developing and segregating rules that are efficient for each decision is difficult. Because the information possessed by courts and commercial actors is likely to be both imperfect and distributed asymmetrically, only second- and third-best legal rules may be available. Kornhauser further argues that it may be impossible to specify an appropriate maximand under uncertainty. If actors must act without knowledge of the satisfaction of all decision-relevant factors, the evaluation of a legal rule will depend on an appropriate probabilistic weighting of potential outcomes. Probabilistic assessments based on both actors' and policymakers' beliefs create either problems of consistency or objectionable policy prescriptions. Kornhauser concludes that both actor- and policymaker-assessed conceptions of social welfare are not completely satisfactory.

Kornhauser argues for a more modest role for efficiency in commercial and corporate law. In a complex commercial world, judges cannot plausibly achieve efficiency or wealth maximization by consciously aiming to do so. Kornhauser therefore questions the wisdom of courts directly pursuing efficiency or wealth maximization. Judges, he speculates, nonetheless might indirectly pursue efficiency by pursuing it only within a particular doctrinal domain.

Whether Kornhauser's doubts about the use of efficiency criteria are justified obviously depends on the purpose for which such criteria are being used. Are they used to measure social welfare or are they used only as rough but reliable enough proxies for social welfare? Objections to the former sort of use need not be telling against the latter sort of use. Both uses raise questions of morality, but they are different questions. This point is illustrated by Kornhauser's criticism of cost/benefit analysis (CBA). One of Kornhauser's concerns is that CBA appears to require that different affected parties' beliefs about social states be aggregated by summation. His objection is that the summation of individual valuations of social states involves the summation of beliefs about the likelihood of their realization. Roughly, CBA assesses a social state by the maximum amount of money parties will pay, or the minimum amount they will demand, to have that state realized. These amounts depend on parties' beliefs about likelihoods, and with incomplete information, parties (and policymakers) can have different beliefs. Thus, in evaluating social states by summing amounts affected parties will pay or demand, CBA seems to be summing beliefs across individuals. This is at least conceptually odd and, even if possible, almost certainly very often morally undesirable.

Whether Kornhauser's argument marks a failing in CBA depends on how CBA itself is understood. CBA could be taken as either as a *direct test* of aggregate well-being or as a *justified decision procedure* in which there is potential conflict.[5] As a direct test, CBA measures well-being by the amount of money a person is willing to pay or accept, and the amount depends on his or her beliefs about the likelihood of an eventuality occurring. Summing monetary amounts to test aggregate well-being therefore arguably requires the summation of beliefs. This demand is conceptually questionable. If Peter believes that *x* and Paul believes that *not-x,* summing their conflicting beliefs is incoherent. Even if the summation were coherent, if welfare is being measured directly, and welfare depends on beliefs about the likelihood of social states, then some way is needed to select among beliefs to resolve the conflict. Kornhauser is right that summation of conflicting beliefs is not the most attractive way to proceed. Summation is too unreliable as part of a test of well-being in a social state.

Summation of belief, however, is unnecessary if CBA is understood only as a justifiable decision procedure. Here there is no assumption that beliefs must be aggregated in any way. Monetary amounts associated with each social state are offered or demanded by affected parties, and these amounts are summed. (CBA presumably is committed to holding that the amounts indirectly test individual, subjective welfare.) How individual parties arrive at these amounts is irrelevant for CBA because CBA is not directly testing well-being. The analysis is only being offered as a justified way of making social decisions, including decisions where parties have conflicting beliefs about the likelihood of social states. Thus, CBA can proceed by taking conflicting beliefs as given

and assessing social states only by a willingness to pay or be compensated. After all, CBA is a way of implementing a criterion of social choice based on potential Pareto improvements, and potential Pareto improvements do not require that all affected parties' well-being in fact is left unchanged or improved. CBA need not therefore directly test well-being, including the resolution of conflicting beliefs via any sort of aggregation.

Understood as a justified decision procedure, CBA avoids other difficulties. Kornhauser correctly observes that if policymakers want to maximize social welfare, based in part on the beliefs of affected parties, they can do so by altering those beliefs. This seems undesirable if one's concern is for well-being, not a party's expectations about well-being. As a decision procedure, however, CBA need not endorse the engineering of belief as a policy prescription. In general, a justified decision procedure is one thing; when and how it is properly used are other matters. Although each turns on moral concerns, the relevant moral concerns can be different. Even if CBA is a justified procedure, this does not mean that policymakers properly can arrange things to influence the result of the procedure's application by engineering beliefs, for instance. Doing so raises moral concerns other than the justification of CBA as a decision procedure, and CBA's decision procedure says nothing about these matters. Of course, for all of this, CBA still might be a bad decision procedure to use.

Implementing efficiency through the incorporation strategy. The complexity of implementing an efficiency-based adjudication principle suggests that judges might be ill-suited to create efficient rules, even in corporate and commercial law contexts. But it may be possible to determine a relatively efficient legal solution to corporate and commercial law problems without attempting to design such solutions. If commercial actors follow commercial norms, and these norms themselves are likely to be efficient, judges might create efficient legal rules simply by incorporating the norms into substantive legal rules. A growing literature asks whether commercial norms are likely to provide a suitable source for efficient commercial default rules.[6] There is also a separate question whether they are likely to provide an appropriate basis for interpreting the express and implied terms in commercial contracts. The remaining contributions to the volume consider the case for and against incorporating commercial practice through the judicial interpretative process.

In Chapter 4, "Do Trade Customs Exist?," Richard Craswell considers Karl Llewellyn's incorporation strategy for default rules and judicial interpretation. Craswell rejects the view that trade customs can be identified independently of the goals and beliefs of the person who attempts to identify such customs. Thus, trade custom cannot plausibly be viewed as merely a pattern or regularity in merchants' behavior or beliefs held subjectively by industry members in the form of bright-line rules. Because a pattern of behavior is subject to many different interpretations, it does not alone determine a unique custom. Sim-

ilarly, because subjective beliefs by industry members are case-specific, many different interpretations of a trade custom might account for them. Craswell makes the point by relying on the philosophy of language. Custom, like linguistic meaning, cannot plausibly be viewed as taking the form of bright-line rules. Just as meaning is determined by contextual cues, through what philosophers call "pragmatic implication," custom has a context-specific character rather than a clear semantic meaning. Thus, Craswell maintains that custom consists in industry members' own case-by-case judgments about proper behavior, the judgments taking a form that often cannot be reduced to bright-line rules. Because custom turns on judgment rather than simple empirical fact, Craswell argues that the judgment of courts, expert economists, and philosophers might be equally reliable bases for determining custom as the judgment of merchants. After examining a range of appellate decisions, Craswell concludes that courts often exercise their own judgments in determining the content of commercial custom.

It is fair to ask about the implications of Craswell's characterization of custom for the incorporation strategy. Craswell acknowledges that standards of behavior in an industry often exist, even though they might be difficult to identify and frequently are not statable as bright-line rules. Contrary to the title of his chapter (and as he acknowledges), Craswell does not deny that trade usage exists. The question therefore is how, and whether, contract terms should be interpreted by custom. There is an infinite number of true descriptions of any pattern of behavior, and selecting among them to identify custom can be difficult. The selection of a description also can involve normative evaluation of the behavior, here as with any piece of behavior. This does not by itself impugn the use of custom to interpret contract terms. Certainly there are ways of implementing the incorporation strategy that are inconsistent with the judgment-based notion of custom described by Craswell. For instance, simple frequency requirements for behavioral regularities fail to distinguish mere regularities from the prescriptive standards of custom. The judgment-based nature of custom also makes some allocations of fact finding between judge and jury more defensible than others. For instance, given the vagueness of much custom, allocating the finding of custom to a lay jury risks a higher rate of interpretive error than allocating it to a judge. Both examples show that there are better and worse ways of incorporating custom into contracts, not that incorporation is not a good idea. The incorporation strategy is unjustified only if it either produces inefficient equilibria or cannot be feasibly implemented.

In Chapter 5, "Rethinking the Uniformity Norm in Commercial Law," Robert Scott focuses on the incorporation strategy in Article 2 of the Uniform Commercial Code. Scott views the principal task of sales law to be the efficient regulation of incomplete contracts. Courts must both accurately interpret parties' contracts and provide both standardized, "predefined" meanings for contract terms as well as default terms to fill in gaps in incomplete contracts. Scott

argues that accurate interpretation and efficient standardization are inconsistent goals. No single interpretive regime can pursue both without constraint. Scott suggests that the common law, which largely prohibits the use of commercial custom to interpret the meaning of express terms, provides a far superior compromise to Article 2's incorporation strategy, which requires express terms to be interpreted in light of commercial custom. He concludes that Article 2 combines the worst of both worlds: uncertainty and thus unpredictability of contractual interpretation, few predefined express terms, and inefficient default rules. According to Scott, Article 2's failure is that it is too much of a "true" code. Because Article 2 encourages courts to ignore precedent and look to the code itself for the interpretation of express terms and for gap-filling, it undermines its own objective of incorporating commercial practice effectively. In contrast, the common law "plain-meaning" regime, Scott argues, has generated clear and predictable meaning while facilitating the development of predefined terms and relatively efficient default terms.

Central to Scott's argument is a speculation about the source of Article 2's failure to defensibly incorporate commercial practice. Since accurate interpretation and supplying standardized meanings are inconsistent goals, neither common law or statutory schemes can pursue both without constraint. The question therefore is whether common law interpretive schemes produce more accurate and efficient standardized meanings than are produced by Article 2. This is an empirical question, and Scott's speculation has testable implications. The trouble is, however, that the implications are difficult to specify with any precision. If Scott is right that Article 2's nature of a "true" code inhibits the updating of commercial practice, changes in industry practice are less likely to induce judicial reexamination of the meaning of trade terms. Thus, other things being equal, less judicial reinterpretation of trade terms would be expected under Article 2 than at common law. For the same reason, less reinterpretation would be expected under Article 2 than under codes that are not "true" codes, or less so. Scott's speculation predicts that there is less reinterpretation of custom under Article 2 than under the Uniform Sales Act. However, other things might not be equal. Common law doctrines about trade usage and its admissibility could operate to inhibit the rate at which custom is judicially updated.[7] In general, doctrinal and evidentiary matters can produce the same treatment of custom as is produced by a relatively self-contained statute such as Article 2. The potential equivalence in result makes Scott's hypothesis hard to evaluate.

In Chapter 6, "In Defense of the Incorporation Strategy," Jody Kraus and Steven Walt agree with Scott's central observation: All interpretive regimes face a trade-off between minimizing the costs parties incur to specify their most desired terms and minimizing the probability of judicial error in interpreting the express and implied terms of their contracts. Thus, in their view, any optimizing solution requires the minimization of the sum of specification and

interpretive error costs. Speculation of the size of these costs must be made at the margin. This does not condemn the incorporation strategy. Acknowledging the complexity of interpreting custom and the inherent difficulties in creating a code that effectively incorporates commercial practice, Kraus and Walt suggest that the incorporation strategy nonetheless is likely to create lower aggregate specification and error costs than alternative regimes for interpreting contracts among heterogenous contracting parties. Kraus and Walt offer a two-stage argument in support. First, anti-incorporationists overlook or underestimate the magnitude of the specification cost savings that can be achieved under an effective incorporation regime. Second, they presume that the defects of Article 2's implementation of the incorporation strategy provide strong evidence of the failure of the incorporation strategy generally. But because the incorporation strategy can be implemented in many ways, criticism of Article 2 only serves to suggest revisions that would reduce or eliminate defects; it does not undermine the incorporation strategy. Kraus and Walt consider three different critiques of Article 2's incorporation strategy and argue that each overestimates the magnitude of interpretive error costs and underestimates the magnitude of specification costs compared to "plain-meaning" interpretive regimes. They also suggest possible amendments or alternatives to Article 2 that could reduce its relative interpretive error rates and lower specification costs even further.

As Kraus and Walt acknowledge, their analysis is incomplete. Specification costs and interpretive error costs are only two of a number of variables relevant to the efficiency of an interpretive regime. Intrepretive regimes also affect the frequency and sort of contracts entered into, as well as their performance. Contract formation and performance therefore are endogenous variables that require estimation. For example, if parties' performance over the course of the contract is deemed relevant to the contract's terms, the cost of deviating from express terms is increased. The expected stream of benefits from entering into a contract with that possibility might be low enough to dissuade parties from contracting in the first place. A full assessment of efficiency of an interpretive regime must estimate its effect on contracting and performance, not just on the ex ante costs of formulating contract terms and ex post enforcement costs. Such an assessment is difficult to make, not only because reliable information about the values of all of the variables is hard to come by and intuitions must suffice. More serious is the problem flagged by Kornhauser, that a complete efficiency analysis requires comparing costs associated with competing legal rules across all variables. This requires gauging all of the potential contracting parties affected by a legal rule, identifying affected decisions, and estimating the impact of the rule on the different decisions of potential contracting parties. Kraus and Walt's analysis, as well as the analysis of antiincorporationists, must be modest because it considers only a small subset of variables relevant to the efficiency of an interpretive regime.