

# Why Law Schools Do Not Teach Contracts and What Socioeconomics Can Do About It

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## I. NO CONTRACTS

Contracts have been a central feature of western law for at least a thousand years, and they form an extremely important part of American legal practice. However, American law schools virtually never teach the subject. As far as I am aware, there is no law school that includes a course on contracts in its first-year curriculum. A few teach contracts as an upper level elective that a small number of students take, but even this very limited exposure to the subject is probably restricted to a minority of law schools.

To be sure, there is a course called Contracts that is included in the first-year curriculum of every law school, but this is not a course in

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contracts at all. It is a course in judicial adjudication of disputes regarding contracts. In learning how courts resolve these disputes, students naturally get a glimpse of some of the underlying issues involved in contracts themselves, just as a course that explored the way courts resolve disputes about buildings would give students a glimpse of civil engineering. However, such a course would not be considered a “Civil Engineering” course, and the course taught in law schools that is labeled “Contracts” is not a contracts course. Most of the students who take this course never read even a single contract, and even fewer read a thirty- or forty-page “long form” contract of the sort that is common in transactions between firms, or a “standard form” contract that firms commonly use in consumer transactions.<sup>1</sup> Similarly, most of these students are never given any instruction about the way to negotiate a contract,<sup>2</sup> to draft a contract, or even to interpret a contract during the time when the contract is governing the relationship between the parties. Their exposure to the subject begins at the point when the contractual relationship between the parties has broken down.

This disconnect between contractual relationships and the law school “Contracts” course is illustrated by the structure of contemporary legal practice. In most large firms, the bulk of the contract work is carried out by the corporate department. It is this department that negotiates contracts, drafts contracts, and interprets contracts during the course of the contractual relationship between the parties. If the relationship breaks down, however, and one of the parties files suit against the other to enforce its rights under the contract, the corporate lawyers who have worked on the contract will typically refer the matter to the litigation department of the firm. Sometimes, this is motivated by the corporate lawyers’ desire to avoid getting involved in the inevitably unpleasant process of litigation, and thus alienating a good client, but the principal reason why corporate lawyers refer contract litigation to a separate department is that litigation is regarded as a distinctly different expertise. Law schools provide students with a good deal of training in this area of expertise. In addition to contract litigation, they teach torts litigation, property litigation, criminal law litigation, constitutional law litigation, civil procedure, criminal procedure, evidence, and a variety of other

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1. There are, of course, exceptions. *See, e.g.*, ROBERT S. SUMMERS & ROBERT A. HILLMAN, *CONTRACT AND RELATED OBLIGATION: THEORY, DOCTRINE, AND PRACTICE* 724 (3d ed. 1997) (providing the text of a contract for analysis); *see also* Robert A. Hillman, *Enriching Case Reports*, 44 ST. LOUIS U. L.J. 1197, 1203–04 (2000) (discussing how supplementing case reports with documents from practice enriches a contracts course).

2. Again, some contracts teachers use negotiation exercises. *See* Peter W. Salsich, Jr., *A Property Law Instructor Looks at the Contract Law Course*, 44 ST. LOUIS U. L.J. 1215, 1222–23 (2000).

litigation related courses. But they do not teach contracts.

Why do law schools overlook this enormously important subject? Why have they done so for over one hundred years, ever since the inception of the modern legal curriculum, without seeming to notice the omission that their students will rapidly discover upon graduation, if they have not already done so during their summer jobs at law firms? No explicit rationale for this omission can be found in the descriptive literature of any law school, nor is there any rationale that can be readily inferred from the stated mission of these institutions. Elementary schools avoid teaching particle physics because it is beyond the intellectual capacities of their students, public policy schools avoid teaching techniques for bribing public officials because they are immoral, psychology departments avoid teaching phrenology because it is invalid, and medical schools avoid teaching romantic poetry because it is outside their area of concern. Educators in these institutions could readily offer these rationales if they were asked to justify their exclusions, but none of these rationales can explain why law schools fail to teach contracts.

Rather, the explanation, as for so many of the other pedagogic lacunae in modern legal education, lies with C.C. Langdell. Like many legal scholars of his day, Langdell believed that the law, and more specifically the common law, was animated by enduring principles that inhered in Anglo-American legal culture.<sup>3</sup> These principles, profound and recondite, were not directly articulated by any government authority, but emerged in the course of judicial adjudication. Students could discern them by reading adjudicatory records, that is, appellate decisions. Langdell's spectacularly influential pedagogic method was based upon this theory. In his view, when students read appellate decisions, they were conducting primary research into the visible manifestations of the law's enduring principles, just as natural scientists researched the enduring principles of nature by observing chemical reactions in the laboratory.<sup>4</sup>

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3. See Thomas C. Grey, *Langdell's Orthodoxy*, 45 U. PITT. L. REV. 1, 2, 53 (1983) (discussing how Langdell and his colleagues promulgated a distinctive system of legal thought, called classical orthodoxy); Dennis Patterson, *Langdell's Legacy*, 90 NW. U. L. REV. 196, 203 (1995) (analyzing Langdell's legacy as an explanatory approach to the nature of law); G. Edward White, *The Impact of Legal Science on Tort Law, 1880-1910*, 78 COLUM. L. REV. 213, 220-25 (1978) (describing Langdell's conception of legal science as both a revolutionary change in methods of acquiring knowledge and a static, dogmatic orthodoxy).

4. See WILLIAM C. CHASE, *THE AMERICAN LAW SCHOOL AND THE RISE OF ADMINISTRATIVE GOVERNMENT* 23-59 (1982); ROBERT STEVENS, *LAW SCHOOL: LEGAL EDUCATION IN AMERICA FROM THE 1850S TO THE 1980S* 51-53 (1983).

When law professors interrogated the students in class about the internal logic of the decisions, they were amplifying and refining the understanding that the students derived from their research. Of course, no one believes in Langdell's theory of law anymore, so much so that it is difficult to describe it without lapsing into sarcasm, but the pedagogic method used in law schools is still based on this concept of law.

Langdell's pedagogic method focuses entirely on judicial decisions. This has the virtue of using primary source material, rather than the dull-as-dishwater treatises that still dominate legal education in Europe, but it does not provide a way of including any other primary source material. In particular, it does not include contracts. While the Langdellian method can be used to teach contract adjudication—in fact, “contracts” was Langdell's subject—it cannot be used to teach students about contracts themselves. A contract is an agreement between two private parties which each party enters into for its individual advantage. A contract is not an effort by a public official to discern the underlying principles of common law, even though it is often shaped by explicitly stated legal rules and sometimes shaped by the desire to circumvent these rules. Thus, a pedagogic methodology that treats its source material as an effort to discern enduring legal principles will regard contracts as beneath its notice, the chattering of people too self-interested and mundane to see anything but shadows on the walls of the cave.

Legal thought, to be sure, has evolved a great deal since Langdell. His approach, now disparagingly labeled formalism, was succeeded by the legal realists, the legal process school, law and economics, and critical legal studies.<sup>5</sup> Although these movements rejected virtually every element of formalism, they retained its emphasis on discovering the animating principles of law and of looking at the law from the perspective of a public official, most commonly a judge. Legal process asks public officials, such as constitution drafters and legislators, to allocate authority to the most competent official decisionmaker and then advises judges to make the proper decisions on the basis of their competence.<sup>6</sup> Law and economics in its early form asked legislators and, most often, judges to make decisions on the basis of efficiency, while critical legal studies asked them to base their decisions on a concern for social justice. All

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5. Edward L. Rubin, *The New Legal Process, the Synthesis of Discourse, and the Microanalysis of Institutions*, 109 HARV. L. REV. 1393, 1394–1402 (1996). See generally GARY MINDA, *POSTMODERN LEGAL MOVEMENTS: LAW AND JURISPRUDENCE AT CENTURY'S END* (1995) (describing the historical move from legal modernism, which was influenced by Langdell, to postmodern forms of jurisprudence such as law and economics and critical legal studies).

6. See generally William N. Eskridge, Jr. & Philip P. Frickey, *An Historical and Critical Introduction to The Legal Process*, in HENRY M. HART, JR. & ALBERT M. SACKS, *THE LEGAL PROCESS* li (William N. Eskridge, Jr. & Philip P. Frickey, eds., 1994).

these movements, therefore, regarded legal theory as a framework that public officials could utilize to reach optimal or at least desirable decisions. The legal actions of private parties, by negative implication, were regarded as beyond or beneath the realm of legal theory. These actions were merely efforts to conform or to evade the legal rules, and lacked any underlying logic that could be conveyed to law students. Teaching law students about these private legal actions—how lawyers create contracts, interpret contracts, advise clients, and negotiate with each other—could be nothing other than a “how to” course, a set of instructions about practical tasks that did not belong on the university curriculum. They were merely plumbing, entirely divorced from legal theory.

There is, to be sure, a good justification for this point of view. To teach a body of information as an academic subject, one needs a generalized methodology of some sort. This is not necessarily a theory, and certainly not a theory in the sense of a complete explanation that predicts future occurrences, like quantum electrodynamics. Rather, it is a unified approach to the subject matter that enables students to answer a set of evaluative questions. Confronted with a narrative of past occurrences, history students using the methodology they have been taught can discuss the nature and reliability of the account, the political, social, and economic causes of the event it describes, and the effects of that event on subsequent events. Confronted with a judicial decision, law students using the methodology they have been taught can identify the facts of the case, its holding and dicta, the doctrine on which the judge’s decision is based, and the extent to which the decision is consistent with other decisions based on the same doctrine. However, law students did not have any methodology that they could utilize when confronted with a contract, which is at least one reason why their teachers have protected them from this embarrassing event. The contract was regarded as a set of particularized provisions reflecting nothing more than the parties’ effort to secure their own advantages and memorialize the idiosyncratic details of their transaction. One might offer the students some techniques or stratagems for increasing their client’s advantage, but that mundane level of instruction, akin to a set of lessons on “How to Improve Your Game of Golf,” was all that could be done.

Socioeconomics provides a methodology for understanding contracts.<sup>7</sup> Jeffrey Harrison has recently provided an illuminating account of the way that socioeconomics can inform and expand existing contract courses.<sup>8</sup> In addition, socioeconomics creates the possibility that contracts, and not merely contract adjudication, can be taught in law schools as an academic subject. Its merger of economics and sociology provides a methodology for understanding both contracts negotiated between business parties and contracts negotiated between businesses and consumers. At first, one might assume that contracts between business firms would be analyzed according to the economic branch of socioeconomics because businesses are presumed to be rational actors, while contracts involving consumers would lend themselves to sociological analysis. However, socioeconomics does not merely merge these two fields, which are, after all, both forms of social science, by simply placing them side by side. Rather, it represents an interpenetration of the two, together with other branches of social science, producing a mode of understanding that simultaneously recognizes the economic and the social aspects of law and legal action.

Part II of this Article will discuss contracts between businesses, and Part III will discuss contracts between businesses and individuals. An individual is a natural person; a business is an organized group of natural persons acting collectively. It is assumed that any such organized group is a business, even if it is not designed to serve commercial purposes, such as a church or a fraternal society, and no matter how small, such as a two person partnership. An individual acting in a professional capacity, such as a solo doctor or attorney, is a consumer, not a business, and a family is a set of separate individuals. Businesses contract with each other as businesses, or organizations, and individuals contract with businesses in the role of consumer or supplier, usually of their labor but sometimes of a creative or other product. Individuals also contract with other individuals, most often in specialized markets such as real estate or used cars. For simplicity, however, labor contracts and consumer-to-consumer contracts will not be discussed.

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7. For general descriptions of socioeconomics, see Robert Ashford, *Socio-Economics: What Is Its Place in Law Practice?*, 1997 WIS. L. REV. 611; Jeffrey L. Harrison, *Law and Socioeconomics*, 49 J. LEGAL EDUC. 224 (1999).

8. Jeffrey L. Harrison, *Teaching Contracts from a Socioeconomic Perspective*, 44 ST. LOUIS U. L.J. 1233 (2000). Some of Harrison's proposals are similar to those in this Article in that Harrison's proposals would introduce transactional elements. See *id.* at 1244-46 (describing a professor's inclusion of empirical studies dealing with consumer contracts for cars and the activities of corporate counsel in the professor's classroom discussions).

## II. BUSINESS-TO-BUSINESS CONTRACTS

### A. *Transaction Cost Economics*

By and large, contracts belong to the world of commerce, and the particular social science that focuses on this realm is economics. Neoclassical economics was still the dominant approach to this subject when interdisciplinary legal scholarship began to supplant the legal process school in the 1970s. According to the neoclassic model, a contract is an exchange between a willing buyer and a willing seller. Such an exchange will occur whenever the buyer values something that the seller owns more highly than the seller does. For example, a person who has just bought a new car may place a much lower value on her old car than another person who has no car. The difference between these two values constitutes a surplus that can be realized by making the exchange, that is, by transferring the car to the person who values it more highly. This surplus, according to the neoclassic model, will be divided between the parties in accordance with their bargaining ability and a variety of other factors. From a public policy viewpoint, the division of the surplus is not important. What is important is that courts be available to enforce the contract, thereby giving the moving party the benefit of its bargain. The reason is that the bargain, being an exchange between a willing buyer and a willing seller, is efficient, which means that it increases social welfare. However, there are various circumstances under which a bargain will be inefficient, including cases in which one of the parties is not willing to make the exchange, but does so under duress or as a result of a misunderstanding, or cases in which the market for the item being transferred fails due to the presence of a monopoly, externalities, or information asymmetry.

The absorption of neoclassic economics into legal scholarship resulted in a major shift in the standards for evaluating the judicial enforcement of contracts. Instead of focusing on either the fairness or the doctrinal coherence of a court's decision, scholars began to focus on its efficiency. However, the emphasis remained on judicial enforcement. To some extent, this was the result of the tendentious quality that Richard Posner imparted to the fledgling field of law and economics through his desire to refute the tenets of liberalism,<sup>9</sup> but there were at least two more basic reasons. The first was the assumption that the overarching goal of

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9. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 4–6 (1972).

efficiency would be served as long as the parties were willing actors; the particular way in which the surplus was divided was of no concern from the efficiency or public policy perspective. Thus, the contract itself—its terms, its structure, and the negotiating strategy of the parties—remained a sort of black box, walled off from analytic consideration by its asserted efficiency. The second reason was the assumption, labeled legal centralism by Oliver Williamson, that “efficacious rules of law regarding contract disputes were in place and were applied by the courts in an informed, sophisticated, and low-cost way.”<sup>10</sup> To the extent that this was not the case, it could be corrected, in Posner’s view, by convincing courts to use economic efficiency as the basis for deciding contract cases. As a result of these assumptions, neoclassic economics provided a new methodology for analyzing the familiar subject of judicial contract adjudication, but like formalism, failed to offer a methodology for the analysis of contracts themselves.

By the early 1980s, it had become apparent to many economists and legal scholars that both these assumptions were false, even with respect to contracts between businesses. Litigation is expensive and courts lack the knowledge to interpret contracts in a reliable manner; as a result, the parties strive to avoid litigation by drafting contracts that are self-enforcing.<sup>11</sup> This means, in turn, that a business-to-business contract is not merely an effort to divide a transactional surplus and submit oneself to judicial enforcement, but rather a means of private ordering, an effort to organize a commercial relationship to achieve a complex variety of purposes. As a result of this insight, the contract itself—its creation, its terms, its role in the ongoing relationship between the parties—becomes an important subject for economic and legal analysis.

Transaction cost economics, developed by Williamson, Ronald Coase, Douglass North, Armen Alchian, Benjamin Klein, and others, is the economics of suboptimality.<sup>12</sup> Given economies of scale, as Coase

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10. OLIVER E. WILLIAMSON, *THE MECHANISMS OF GOVERNANCE* 42 (1996).

11. IAN R. MACNEIL, *THE NEW SOCIAL CONTRACT: AN INQUIRY INTO MODERN CONTRACTUAL RELATIONS* 4–5 (1980) (describing contract as exchange relations and discussing how such exchange relations do not always give rise to legal rights); Marc Galanter, *Justice in Many Rooms: Courts, Private Ordering, and Indigenous Law*, 19 J. LEGAL PLURALISM 1, 2–17 (1981) (submitting that legal centralism is deficient and arguing that the most significant legal traffic is the centrifugal flow of legal messages, rather than a centripetal flow of cases into official forums); Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 616 (1981); L.G. Telser, *A Theory of Self-Enforcing Agreements*, 53 J. BUS. 27, 27–28 (1980).

12. For representative statements, see OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 2 (1985); Armen A. Alchian, *Specificity, Specialization, and Coalitions*, 140 J. INSTITUTIONAL & THEORETICAL ECON. 34, 36, 38–39 (1984); Benjamin Klein, *Transaction Cost*

pointed out, the only reason why the entire world is not organized into a single, all-embracing firm is that organizational difficulties produce countervailing diseconomies.<sup>13</sup> In particular, the firm's hierarchical structure undermines its members' incentives to be efficient, and the opportunities within the hierarchy for excessive intervention and inappropriate resistance allow inefficient behaviors to prevail. Given the ability to transfer property by contract, as Coase also pointed out, the only reason why property arrangements make an economic difference is that transaction costs impede the contracting process.<sup>14</sup> In particular, uncertainty about future states, people's inability to process information, and people's incentives to engage in opportunistic behavior make transactions costly. Because people are only rational within certain bounds and their information processing abilities are limited, these organizational and contractual suboptimalities persist over time and are never fully "cleared" by the market. Because people are opportunistic and think they can gain an advantage from ambiguity, and because money and effort are required to achieve clarity, contracts are often incomplete, that is, they do not even take advantage of the information that is actually available to the parties.<sup>15</sup>

### *B. Analyzing Business Contracts*

Transaction cost economics, by addressing these issues, provides a methodology for analyzing contracting behavior. To begin with, it provides a framework for understanding why businesses use contracts at all. A contract is an intermediate device between no relationship, or a purely competitive relationship, and a hierarchical relationship in an integrated organization or firm.<sup>16</sup> Businesses enter into contracts because they want to bind each other to a particular relationship, either for a

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*Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. 356, 356, 361–62 (1980) (discussing the transaction costs of incomplete contracts due to uncertainty and measurement costs); Douglass C. North, *Transaction Costs, Institutions, and Economic History*, 140 J. INSTITUTIONAL & THEORETICAL ECON. 7, 7, 10 (1984).

13. R.H. Coase, *The Nature of the Firm (1937)*, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION, AND DEVELOPMENT 18, 23 (Oliver E. Williamson & Sidney G. Winter, eds., 1991).

14. *Id.* at 35, 48; R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15–19 (1960).

15. OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 9–10 (1975) [hereinafter WILLIAMSON, MARKETS]; WILLIAMSON, *supra* note 12, at 64–67.

16. See WILLIAMSON, MARKETS, *supra* note 15, at 8–10.

single transaction, a delimited series of transactions, or a long-term relationship, without joining together in a single firm. Conversely, a single firm decides whether to produce something itself or contract with a separate party—the “make-or-buy” decision—by balancing its ability to reach a satisfactory agreement with another party against the organizational complexities of internal production. Often the decision turns on the extent to which the production process in question involves advance commitments that are irreversible and unsalvageable, such as locating a facility near an existing resource, building a machine to produce a particular product, or training a group of workers to engage in a particular process.<sup>17</sup> When such asset specificity is necessary, or more precisely, when it has the potential to produce the product at a lower price than reliance on reversible and salvageable assets, there will be an incentive to engage in long-term contracting in order to obtain the commitments necessary to secure the irreversible asset’s value.

These insights, which can be explained in straightforward, nonmathematical terms (always an important goal in dealing with law students) can be used in the classroom to analyze actual contracts. Presented with a contract, the students can be asked why the firm is contracting for this particular product or service and why it is entering into the particular kind of contract that they see in front of them. For example, a contract for sale of a patent by one firm to another might contain an option clause, whereby the buyer pays a relatively small amount to control the patent for a one-year period and then has the option, upon payment of a larger amount, to buy the patent outright. Students can be asked to explain why the buyer would not want to pay the entire purchase price at once due to uncertainty, how the buyer could reduce uncertainty through initial utilization of the patent, how such utilization would involve irreversible, unsalvageable expenditures that would place the seller in a position to act opportunistically unless the buyer had an option to secure the entire patent, and why the seller could obtain a higher price by agreeing to the option than it could by selling the patent outright in the first instance. The students might also be given secondary source readings about a given industry—biotechnology, for example—that would explain how firms decide whether to purchase patents or generate their own discoveries. To take one more example, the students could be shown long-term requirements contracts, of the sort discussed by Macneil,<sup>18</sup> and asked to explain why the buyer would want to obtain a

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17. Klein & Leffler, *supra* note 11, at 618–19; Benjamin Klein et al., *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297, 308–09, 313 (1978).

18. IAN R. MACNEIL, *CONTRACTS: EXCHANGE TRANSACTIONS AND RELATIONS* 859–71 (2d ed. 1978).

commitment from the seller and why the seller would agree.

Transaction cost economics also provides a methodology for explaining the terms that appear in business-to-business contracts. Most of these contracts follow a standard pattern: (1) identify the parties, (2) describe the transaction, (3) state the price, (4) specify the means of payment, (5) list the representations and warranties made by the seller and, less frequently, the buyer, (6) list the covenants and conditions being made by the parties, and (7) state enforcement oriented terms, such as an arbitration or choice of law clause. In a pathbreaking article, Ronald Gilson explains that these contractual provisions, as drafted by attorneys, are designed to reduce transaction costs.<sup>19</sup> Gilson uses the standard form corporate acquisition contract as his example. If the parties could agree upon the value of the firm being transferred, they could simply record that value in dollar form, and the contract drafter's task would be essentially secretarial. The contract would go forward under the neoclassic model because the firm, at its agreed upon value, was worth more to the buyer than the seller, perhaps because of synergies with other parts of the buyer's firm. In many cases, however, the buyer and the seller disagree about the value of the firm, or more specifically, the earning power of the firm in the immediate future. The lawyer might then draft a contractual provision that allows the seller to remain in control of the firm for a one-year period, have the buyer pay what it thinks the firm is worth at the beginning of the year, and then require the buyer to pay some additional amount if the firm's performance reflects the seller's higher estimate of its earning power. As Gilson points out, however, this solution creates an incentive problem because the seller, anxious to demonstrate the earning power of its firm, might engage in short-term practices to enhance earnings during the one-year period, at the expense of the firm's long-term value. To guard against this possibility while preserving the advantages of the variable pricing term, the attorney would need to draft conditions and covenants governing the seller's managerial practices.<sup>20</sup>

Williamson provides another example of contractual devices to reduce transaction costs. Asset specificity allows a firm to produce a product at lower cost, as described above, but makes the firm vulnerable to the other firms that purchase the product for resale. If these firms fail to buy

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19. Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *YALE L.J.* 239, 243 (1984).

20. *Id.* at 265–67.

the product, the value of the seller's specific asset can be lost; knowing this, potential buyers are in a position to act opportunistically, to the seller's disadvantage. The seller, and its attorney, can reduce this risk by drafting a contract that requires the buyer to pay a cancellation fee, and the buyer will agree to such a term in order to obtain the lower price items generated by the specific asset. Williamson describes such mechanisms as hostage taking on the seller's part. They are a form of self-help and thus a recognition of the costs and uncertainties that legal centralism tends to ignore.<sup>21</sup> Another more comprehensive strategy to deal with the same problem of asset specificity is for the seller to contract with multiple buyers through franchise agreements, which are essentially agreements imposing a condition that each buyer invest in specific assets of its own.<sup>22</sup> Such agreements can be regarded as a mutual exchange of hostages.

The examples given thus far involve negotiated terms. Most business contracts, however, are based on forms contracts that circulate among attorneys in an industry, or that are promulgated by trade organizations such as the American Institute of Architects or the Dramatists' Guild.<sup>23</sup> The prevalence of these forms is also explained by transaction cost economics, as Michael Klausner and Marcel Kahan have shown.<sup>24</sup> First, and most obviously, drafting a contract is itself a transaction cost. This cost will be counterbalanced by transaction cost savings achieved by the negotiated terms when the relationship between the parties possesses distinctive or idiosyncratic features, but it will be minimized by using standard forms when the relationship is stereotypical. In virtually every transfer of rights from a writer to a publisher, for example, the publisher will want to secure the same set of written publication rights, and will want the same representations and warranties regarding the originality of the work. Even more important, the rejection of legal centralism recognizes that courts often misinterpret contracts in unpredictable ways. Using a standard form reduces this uncertainty because the contracts incorporating its terms have already been litigated, and the judicial response to them is

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21. Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 83 AM. ECON. REV. 519, 521–22, 524 (1983).

22. Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927, 931–32 (1990).

23. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 762 (1995); Edward L. Rubin, *The Phenomenology of Contract: Complex Contracting in the Entertainment Industry*, 152 J. INSTITUTIONAL & THEORETICAL ECON. 123, 130–31 (1996); Eric Schanze, *Legalism, Economism, and Professional Attitudes Toward Institutional Design*, 149 J. INSTITUTIONAL & THEORETICAL ECON. 122 (1993).

24. Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 361–62 (1996); Klausner, *supra* note 23, at 826–29.

known. Thus, as Klausner points out, standard contract forms, like telephones, provide a positive network externality; the item becomes more valuable to each person as more people use it.<sup>25</sup>

Here again, students can be provided with the texts of these various agreements, given guidance about how to read them—just as law school begins with guidance about how to read a case—and then asked to analyze the contract's provisions. Transaction cost economics provides a framework for this analysis. It explains that various contract terms that appear, from the neoclassic perspective, as merely profit-maximizing efforts to divide a contractual surplus, in fact respond to an underlying logic driven by uncertainty, the bounded nature of rationality and the consequent suboptimality of firms and markets. With a relatively simple set of concepts, students can understand why the parties used a standard form contract or a specially negotiated one, what the buyer and seller were trying to achieve with a particular term, why they insisted on that term, and why they were willing to accept it or modify it in particular ways. The students can read a contract as they now read a case, assessing the decisions made by the person who wrote the document according to a conceptual framework.

To be sure, the conceptual framework for analyzing business-to-business contracts is more limited. The motivations that underlie the contract drafter's efforts are generally limited to maximizing her client's wealth and do not include more wide-ranging questions about public policy and social justice that sometimes animate a judge. On the other hand, the study of contracts presents an active learning opportunity that is absent from the study of judicial decisions. Practicing lawyers do not draft judicial opinions; as a result, opinion drafting is generally not regarded as a relevant part of law school courses, which are conceptualized as an effort to teach students how to be practicing lawyers. Rather, the students are taught how to interpret contracts, a somewhat passive enterprise. But practicing lawyers draft contracts all the time, and it would be highly relevant to a contracts course—a real contracts course, that is—to include drafting exercises. These should not be regarded as mere “how-to” exercises, although that is certainly important, but as a means of teaching understanding through participation.<sup>26</sup> By drafting a

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25. Klausner, *supra* note 23, at 772.

26. For an argument that understanding requires participation, see MAX WEBER, *ECONOMY AND SOCIETY* 7–11 (Ephraim Fischhoff et al. trans., Guenther Roth & Claus Wittich eds., 1968).

contract based on a fact pattern about the relationship between the business parties, students will begin to understand how contract drafters make decisions and why they use the particular solutions that appear in actual contracts. If they are then given the future results of the fact pattern—whether prices went up or down, whether the other party performed or defaulted—and then asked to compute how their contract served their client in these circumstances, they can be given a visceral sense of the uncertainties and informational constraints that shape contractual practice.

Moreover, judicial decisions are not irrelevant to a real contracts course. While questions about how judges interpret contracts should be avoided, the theory of positive network externalities suggests that these decisions can be viewed from the perspective of the contract drafter. The question is how firms using a standard form will respond to a judicial interpretation of that form, particularly if the contract is incomplete and elicits a significant amount of judicial interpretation.<sup>27</sup> If the interpretation is unexpected and alters the form's intended purposes, regular users of the form will typically redraft the interpreted clause to restore its intended meaning. In some cases, this will not be possible, and the drafter will need to make other adjustments. Students can be given the original form contract, the judicial decision, and the revised version of the form. They can be asked to explain, according to the methodology of transaction cost economics, why the drafters responded as they did. By doing so, students will see judicial decisions from the perspective of those governed by the decision, that is, from the only perspective that the overwhelming majority of them will experience in their professional careers and that the small minority who ultimately become judges will nonetheless experience for their first twenty or thirty years.

All of this might seem like an application of pure economics to law, even if it is not neoclassical economics. However, transaction cost economics, its name notwithstanding, is not pure economics; it is socioeconomics. Its break with neoclassicism lies precisely in its recognition of sociological factors involving real human and organizational behavior. While transaction cost economists often tend to phrase these insights in economic sounding terms, their approach represents a real combination of economics, organizational theory, and individual psychology. In addition, because of the emphasis on the cost of adjudication, the alternative value of self-help, and the choice between public and private ordering, law is regarded as an essential element in transaction cost

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27. See Gillian K. Hadfield, *Judicial Competence and the Interpretation of Incomplete Contracts*, 23 J. LEGAL STUD. 159, 159–64 (1994).

economics, not merely as a field to which economic analysis can be applied. This integration of law and social science at the level of theory is another feature of the socioeconomic approach.

### III. CONSUMER CONTRACTS

Individuals contract with businesses in various ways, most commonly in their capacity as employees or consumers. As stated, only consumer contracts will be considered here; while employment contracts share many features with the other contracts that will be discussed, they are an integral part of labor law or employment law<sup>28</sup> and can be omitted from a first-year contracts course on the ground that they would be considered in upper-class courses.<sup>29</sup> Consumer contracts, however, are generally not considered elsewhere in the curriculum. They represent the overwhelming majority of contracts in the United States and raise distinct and interesting issues.

The most notable difference between consumer contracts and business-to-business contracts is that consumer contracts are virtually never negotiated. They appear on forms prepared by the business, generally in its role of seller, and are offered to the consumer on a take-it-or-leave-it basis; in other words, they are contracts of adhesion.<sup>30</sup> Of course, as discussed above, businesses frequently use form contracts as well, but use of the form generally represents a conscious decision by business parties, who often modify the form, and almost always consider modifying it. Consumers virtually never do either of these things.

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28. *But see* Susan A. Fitzgibbon, *Teaching Unconscionability Through Agreements to Arbitrate Employment Claims*, 44 ST. LOUIS U. L.J. 1401, 1401–02 (2000) (asserting that a contracts course could benefit from a discussion of employment agreements).

29. The more precise statement is that employment contracts should be considered in labor law and employment law courses. In fact, these courses, like almost all the other courses taught in law school, generally focus on judicial decisions.

30. *See generally* Melvin Aron Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211 (1995) (discussing how actors characteristically violate the standard rational-choice or expected-utility model because of the limits of cognition); Michael I. Meyerson, *The Reunification of Contract Law: The Objective Theory of Consumer Form Contracts*, 47 U. MIAMI L. REV. 1263 (1993) (describing special risks and problems of consumer form contracts); Todd D. Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1176–77 (1983) (defining contracts of adhesion and concluding that they ought to be considered presumptively unenforceable); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529 (1971) (constructing an “administrative law” of standard form contracts that is designed to restore both fairness and consent to the law of contracts).

Contracts of adhesion are not necessarily inefficient or unfair. It is true that consumers generally cannot negotiate the terms of a contract, but they cannot redesign a car or a television either. The market for product designs is generally considered efficient because consumers can shop among alternative models that are offered, and producers, motivated to maximize their profits, will carefully attend to consumer desires. There is no a priori reason to assume that consumers cannot engage in the same shopping behavior with respect to contractual terms. It is sometimes true that contract terms are harder to understand than product design, and always true that such terms are less interesting. However, it is also well accepted among economists that shopping behavior by a relatively small proportion of consumers is sufficient to create a competitive market.<sup>31</sup> The question is whether such shopping behavior occurs and whether firms respond to it.

Scholars applying the neoclassical economic model to law have often tried to answer this question by deductive reasoning.<sup>32</sup> They begin with the premise that the market must work and then argue that consumers necessarily behave in ways that will enable it to do so. When these arguments begin to seem implausible, even to true believers, they buttress them by asserting that consumers who are so irrational that they will not behave the way a neoclassical economist would predict should suffer the consequences. Such arguments, of course, reintroduce the legal moralism, the emphasis on fairness and just results, that law and economics claims to extirpate. In fact, consumer behavior regarding form contracts is an empirical question and a question that lends itself to psychological and sociological analysis.<sup>33</sup> Economic discussions of form contracts that are not informed by these other social sciences are

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31. George L. Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1347 (1981). But see R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of an Informed Minority to Correct for Imperfect Information*, 47 HASTINGS L.J. 635, 635–36 (1996); Meyerson, *supra* note 30, at 1270–71.

32. See, e.g., Priest, *supra* note 31, at 1297–99; Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1392 (1983); Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 631 (1979).

33. See William K. Brandt & George S. Day, *Information Disclosure and Consumer Behavior: An Empirical Evaluation of Truth-in-Lending*, 7 U. MICH. J.L. REFORM 297, 297–99 (1974); Eisenberg, *supra* note 30, at 212, 213 (noting that empirical evidence is needed to better understand the bargain principle); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 638–40 (1999) (utilizing behavioral research to outline a new model of the human decisionmaker); Dennis P. Stolle & Andrew J. Slain, *Standard Form Contracts and Contract Schemas: A Preliminary Investigation of the Effects of Exculpatory Clauses on Consumers' Propensity to Sue*, 15 BEHAV. SCI. & L. 83, 84 (1997).

therefore inadequate. In other words, the only approach to consumer contracts that makes sense is a socioeconomic one.

This socioeconomic approach to consumer contracts, like the transaction cost economics approach to contracts between businesses, provides a framework for teaching consumer contracts in a real contracts course. Once again, the primary source materials should be the contracts themselves. The content of these contracts can be analyzed according to the principles of transaction cost economics that were discussed in the previous section. Students can be asked why the seller chose particular terms. Very often, the explanation is that the seller wanted to reduce the uncertainty of judicial interpretation by denying liability, or to reduce the uncertainty and expense of judicial interpretation by providing self-help remedies. Conscientious sellers need to protect themselves against opportunistic behavior such as nonpayment or the return of merchandise that is not defective. In addition, they want to establish a framework for their ongoing relationship with the buyer that will secure brand loyalty and thus protect the value of specific assets. Less scrupulous sellers want to reap the maximum profit from a single transaction and are not concerned about future dealings with the buyer. In addition to this passive process of interpretation, students can be given the participatory exercise of drafting a consumer contract. They can be asked to achieve particular objectives on behalf of either conscientious or unscrupulous sellers.

With consumer contracts, however, questions arise that are generally not present in business-to-business contracts. These involve the way that the buyer perceived the seller's terms. One approach to these questions is as participatory as contract drafting; students can be asked to simply read the contract and explain their own understanding of its terms. Although they are in law school, first-year law students may be closer to ordinary consumers than to experienced contractual drafters, and their own comprehension, bewilderment, or boredom will provide some insight into the problems involved in understanding contractual terms. They can then be given a few simple articles that describe what is known about consumer behavior and asked to analyze the contract from that perspective. The fact that these articles are likely to be drawn from sociology or social psychology journals is not a sign of their irrelevance to law, but a recognition that many crucial areas of law, such as the study of contracts themselves, are best approached on the basis of socioeconomics.

Having analyzed consumer contracts from the consumer perspective,

the transaction cost and consumer sociology approaches can then be combined by asking the students whether the use of particular contracts is efficient or fair. These considerations lead to the next level of analysis, which involves consumer protection legislation. During the past several decades, a number of major federal statutes have been enacted to regulate consumer contracts, including the Truth in Lending Act<sup>34</sup> and the Magnuson-Moss Warranty Act.<sup>35</sup> State statutes often track the federal statutes, but sometimes contain novel provisions. Because first-year contracts courses are really courses in contract adjudication, and because the justification for teaching adjudication and not contract is an emanation of the formalist deification of the common law, these statutes are not taught, and frequently not mentioned, in first-year contracts courses.<sup>36</sup> Taking account of the Uniform Commercial Code, and thus acknowledging the awful truth that the common law of contracts has been largely displaced, represents the largest dose of reality that most current “Contracts” courses can tolerate.<sup>37</sup> In fact, consumer protection legislation is a major force in shaping consumer contracts. This legislation can be analyzed from the drafter’s perspective in the same way that judicial decisions regarding business contracts are analyzed. Students can be shown consumer contracts subject to a particular statute and asked how the drafter responded to its requirements, and what she did to achieve her client’s original purposes despite the existence of the statute. Moreover, a real contracts course can go beyond this perspective and ask whether the legislature should have enacted the statute on either efficiency or fairness grounds. This does not present the same dangers as asking whether the judge should have reached a particular decision, because legislation is also underemphasized in legal education, whereas the analysis of judicial decisions is its continuing, unhealthy obsession.

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34. Pub. L. No. 90-321, 82 Stat. 146 (codified as amended at 15 U.S.C. § 1601–13, 1631–41, 1671–77 (2000)).

35. Pub. L. No. 93-637, 88 Stat. 2183 (codified as amended at 15 U.S.C. §§ 2301–12 (2000)).

36. See H. Miles Foy, III, *Legislation and Pedagogy in Contracts 101*, 44 ST. LOUIS U. L.J. 1273, 1274 (2000). Foy, however, limits his discussion to the U.C.C. and the *Restatement of Contracts* and does not discuss consumer protection laws.

37. Thus, the U.C.C.’s unconscionability provision, U.C.C. § 2-302, is the only statutory provision for consumer protection that first-year law students ever see. See U.C.C. § 2-302 (2002).

## IV. CONCLUSION

There was never much excuse for legal education's failure to teach contracts. The only excuse that ever made much sense is that there was no systematic methodology for analyzing contracts, so the study of contracts seemed too mundane and anecdotal for a graduate program in a university. Socioeconomics solves this problem by providing a methodology for analyzing contracts themselves. By combining transaction cost economics, which is itself a combination of economics, organization theory, and law, with sociology and social psychology, this interdisciplinary approach opens a new world for law teachers. Contracts themselves can join judicial decisions as primary source materials for law students. Business strategy can be added to judicial decisionmaking. Consumer legislation can be acknowledged and analyzed. The entire field of transactional law, a major division of practice and a major concern of legislative activity, can be opened to the students' view.

Transforming the existing contracts course along transactional lines, or to put the matter more bluntly, replacing the existing course with an entirely new one, is admittedly a daunting proposition, but the transactional approach can be added to existing "contracts" courses gradually. Form contracts are readily available, and even negotiated contracts are generally easy to obtain. Most practicing lawyers have contracts in their files that can be provided to students with the names redacted, and contracts that are in litigation become part of the public record without redaction. Reading even a single contract or engaging in even a single drafting exercise will provide the students with some sense of what contracts really are and will make the existing courses on contract adjudication more concrete and comprehensible for students. Using socioeconomic analysis for even one such exercise will provide students with a sense of the relevance and power of this approach.

