CHAPTER 1

INTRODUCTION

When noneconomists want to make fun of economists (or when economists want to make fun of each other), they often tell the following story:

A shipwreck has left a physicist, a chemist, and an economist without food on a deserted island. A few days later a can of beans washes up on the shore. The physicist proposes the following method of opening the can:

I've calculated that the terminal velocity of a one-pound object — the weight of the can — thrown to a height of twenty feet is 183 feet per second. If we place a rock under the can the impact should just burst the seams without spilling the beans.

The chemist's response is:

That's risky since we can't be sure we will throw it to the correct height. I've got a better idea. Let's start a fire and heat the can on the coals for one minute, thirty-seven seconds. I've calculated that this should just burst the seams. This method is less risky since we can always push the can off the fire if it starts to burst sooner.

The economist's reaction is:

Both of your methods may work, but they are too complicated. My approach is much simpler: Assume a can opener.

If you have studied economics before, you will appreciate the significance of this joke (and probably already have heard
it more than once). If you have not studied economics, you will soon learn why you should have laughed harder than you did. The can opener story illustrates one important truth and one important lie about economists. The truth is that they approach problems by making assumptions. The lie is that they make ridiculous assumptions (though, unfortunately, this is not always a lie).

The Role of Assumptions

Economists make assumptions for the obvious reason that the world, viewed economically, is too complicated to understand without some abstraction. To see this point in a legal context, consider for example the well-known products liability case of Escola v. Coca Cola Bottling Co., in which the plaintiff was injured by an exploding bottle of soda. In a concurring opinion, Justice Traynor of the California Supreme Court made the following remarks:

I concur in the judgment [for the plaintiff], but I believe the manufacturer’s negligence should no longer be singled out as the basis of a plaintiff’s right to recover in cases like the present one. In my opinion it should now be recognized that a manufacturer incurs an absolute liability when an article that he has placed on the market, knowing that it is to be used without inspection, proves to have a defect that causes injury to human beings. . . . Even if there is no negligence, . . . public policy demands that responsibility be fixed wherever it will most effectively reduce the hazards to life and health inherent in defective products that reach the market. It is evident that the manufacturer can anticipate some hazards and guard against the recurrence of others, as the public cannot. Those who suffer injury from defective products are unprepared to meet its consequences. The cost of an injury and the loss of time or health may be an overwhelming misfortune to the person injured, and a needless one, for the risk of injury can be insured by the

manufacturer and distributed among the public as a cost of
doing business. It is to the public interest to discourage the
marketing of products having defects that are a menace to
the public. If such products nevertheless find their way into the
market it is to the public interest to place the responsibility for
whatever injury they may cause upon the manufacturer, who,
even if he is not negligent in the manufacture of the product, is
responsible for its reaching the market. However intermittently
such injuries may occur and however haphazardly they may
strike, the risk of their occurrence is a constant risk and a
general one. Against such a risk there should be general and
constant protection and the manufacturer is best situated to
afford such protection.

This excerpt from Justice Traynor’s opinion implicitly
raises several complicated questions but does not go very far
in answering them. How is the criterion of “public policy” or
“the public interest” to be defined? Should it take into account
considerations of both efficiency and equity? What are the
effects of the rules of negligence and absolute (or strict) liability
on the care exercised by manufacturers in designing and pro-
ducing products? On the care exercised by consumers in using
products? On the price and output of the industry? Do the
answers to these questions depend on whether the consumer
misperceives the product risks? On whether the victim is a
third party rather than a consumer of the product? Should the
manufacturer be allowed to raise as a defense that the victim
was contributarily negligent in the use of the product? Who
is the better bearer of the product risks that are not elimi-
nated — the manufacturer or the consumer? How does the
answer to this question depend on whether the manufacturer
can self-insure or purchase liability insurance? On whether
the consumer can purchase first-party accident insurance or
is covered by general social insurance programs?

Unless you are already familiar with the economics litera-
ture on products liability, you probably cannot answer many
of these questions in a systematic way. By the end of this
book, however, you should be able to answer all of them by
thinking about them like an economist.

The way an economist would go about answering these
questions would be to isolate one or two of them at a time by making simplifying assumptions that eliminate the others. For example, one might start with the case in which the victim is a consumer of the product and assume that he has perfect information about the product risks, that he does not affect the probability or magnitude of the harm by his own actions, and that he is “risk neutral.” It is relatively straightforward in this framework to determine what effects the rules of negligence and strict liability will have on the care exercised by manufacturers and on the price and output of the industry. One then could investigate the consequences of adding the following complications to this framework: consumer misperceptions, joint determination by the manufacturer and the consumer of the probability and magnitude of harm, and “risk aversion” of the consumer (and possibly of the manufacturer). The last complication, risk aversion, would have to be considered both when insurance was and was not assumed to be available.

Each of the special cases just described—corresponding to a particular set of assumptions—can be analyzed relatively easily because only a few issues are considered at a time. Even though each special case is admittedly unrealistic by itself, it will generate some insights that are relevant to real product liability problems. And by examining all of the cases, one can obtain a comprehensive—and, more importantly, comprehensible—perspective on the economics of product liability rules.

This discussion of the role of simplifying assumptions in the economic analysis of product liability rules applies to every problem addressed by economists—including every topic considered in this book. The art of economics is picking assumptions that simplify a problem enough to better understand certain features of it, without causing those features to be unimportant ones. That economists are sometimes (often?) thought to eliminate what is interesting about a problem

2. The term “risk neutral” is defined at pp. 30-31 below.
3. The concept of risk aversion is explained at p. 57 below.
through their assumptions is what gives the can opener story its bite.

What has been said thus far is meant to be a warning, not an apology. Be prepared to accept (at least for a while) some obviously unrealistic assumptions. By the end of this book, I hope to convince you that there are many insights to be gained from the economic analysis of law and that these insights are the result of the artful choice of simplifying assumptions.

The plan of the book is somewhat unconventional. Chapters introducing basic economic concepts are interwoven with chapters applying those concepts to legal problems. In this manner, the relevant economic ideas are developed systematically for readers not trained in economics, and readers with some training in economics easily can identify and skip the material with which they are familiar. The economic concepts that are discussed include efficiency and equity, risk bearing and insurance, and competitive markets. These concepts are applied to nuisance law, breach of contract, automobile accidents, law enforcement, pollution control, products liability, principal-agent liability, and litigation. Also, in the concluding chapter, some problems with the practical implementation of the economic approach to law are considered.

The subject matter is introduced in stages of increasing complexity, both to simplify the exposition and to better convey the style of economic analysis. For example, breach of contract remedies are first examined in Chapter 5 in a contractual relationship in which the parties are assumed to be risk neutral. This chapter analyzes the effects of the remedies on the parties' breach decisions and on their "reliance" expenditures. Then, in Chapter 7, the concept of risk aversion is introduced (and the function of insurance is discussed). In Chapter 8, breach of contract remedies are reexamined under the more realistic assumption that the parties may be risk averse. That chapter focuses on the effects of the remedies on the allocation of risk from breaches that do occur. By developing the analysis in these stages, it is easier to see the separate economic functions of breach of contract remedies — to control the behavior of contracting parties with respect to breach and reliance decisions, and to allocate the risks of breaches that do occur. The
same pattern is repeated for the discussion of automobile accidents, while the development of each of the other topics—nuisance law, pollution control, law enforcement, products liability, principal-agent liability, and litigation—is contained within a single chapter.
CHAPTER 2

EFFICIENCY AND EQUITY

For purposes of this book, the term efficiency will refer to the relationship between the aggregate benefits of a situation and the aggregate costs of the situation; the term equity will refer to the distribution of income among individuals. In other words, efficiency corresponds to "the size of the pie," while equity has to do with how it is sliced. Economists traditionally concentrate on how to maximize the size of the pie, leaving to others — such as legislators — the decision how to divide it. The attractiveness of efficiency as a goal is that, under some circumstances described below, everyone can be made better off if society is organized in an efficient manner.

Is There a Conflict?

An important question is whether there is a conflict between the pursuit of efficiency and the pursuit of equity. If

4. This popular concept of efficiency is more intuitive than the technical concept of efficiency known as Pareto efficiency or Pareto optimality [after the Italian economist Vilfredo Pareto]. A situation is said to be Pareto efficient or Pareto optimal if there is no change from that situation that can make someone better off without making someone else worse off. Equivalently, if a situation is not efficient in this sense, then, by definition, someone can be made better off without making anyone else worse off. Every conclusion in this book regarding the efficiency of a legal rule or policy can be derived in terms of Pareto efficiency or Pareto optimality. I have opted for the more intuitive concept of efficiency used in the text for expository simplicity.

5. This is the standard sense in which economists use the term equity. However, lawyers and philosophers often use this term differently. For example, equity might refer to the process by which income or wealth is acquired [as opposed to its final distribution], or to the degree to which exogenously determined rights are protected.
the pie can be sliced in any way desired, then clearly there is no conflict — with a bigger pie, everyone can get a bigger piece. If, however, in order to create a bigger pie, its division must be quite unequal, then, depending on what constitutes an equitable division of the pie, there may well be a conflict between efficiency and equity. It may be preferable to accept a smaller pie [less efficiency] in return for a fairer division [more equity].

The potential conflict between efficiency and equity can be illustrated by a fanciful example. Suppose that the government must decide whether to build a dam and that the Dean of Stanford Law School and I are the only two individuals affected by it. Currently, without the dam, the Dean has $65 and I have $35, so total income is $100. The dam would cost $30 to build, consisting of $30 worth of my labor but none of the Dean’s. The dam would create benefits worth $40, all of which would go to the Dean because the only feasible location for building the dam happens to be on her property. Should the dam be built?

On efficiency grounds, the dam clearly should be built because it creates benefits of $40 and costs only $30, thereby creating net benefits of $10. But the equity effects need to be considered as well. Before the dam is built, the Dean has $65 and I have $35. After the dam is built, the Dean will have $105 (including the $40 benefit) and I will have $5 (after subtracting my $30 cost). Whether these distributional consequences are desirable depends on what constitutes a fair distribution of income. Suppose that the most equitable distribution of income involves the Dean receiving 60 percent of total income and me receiving 40 percent. If the dam is not built, then the Dean should have $60 and I should have $40. If the dam is built and total income rises by $10, the Dean should have $66 and I should have $44.

But suppose, regardless of whether the dam is built, it is impossible to redistribute income between the two of us. Therefore, the choice is between the Dean’s having $65 and my having $35 if the dam is not built, and the Dean’s having $105 and my having $5 if the dam is built. Building the dam is more efficient but less equitable. How this conflict between
efficiency and equity should be resolved depends on how important efficiency is relative to equity. If promoting equity is very important, it might be desirable to sacrifice some efficiency for more equity by not building the dam (in other words, "damn" the Dean).

Alternatively, suppose it is possible to costlessly redistribute income between the Dean and me. Then, given the preferred distribution of income, if the dam is not built, $5 would be transferred from the Dean to me, so that she would end up with $60 and I would have $40. If the dam is built, $39 would be transferred to me, so that she would have $66 and I would have $44. Clearly, since total income is distributed according to the percentages desired and we both are better off with the dam, the dam should be built. There is no conflict between efficiency and equity.

Note that, if it is possible to redistribute income at no cost, the dam should be built regardless of what constitutes an equitable distribution of income. If, for example, an egalitarian income distribution is desired, then without the dam the Dean and I each could have $50 and with the dam we each could have $55. If, alternatively, equity required that everything should go to the Dean, the dam should be built because she then could have $110 rather than $100.

The dam example illustrates two important general observations. If income cannot be costlessly redistributed, there may be a conflict between efficiency and equity. Whether there is in fact a conflict depends on the specific distributional consequences of pursuing efficiency and on what constitutes an equitable distribution of income. However, if income can be costlessly redistributed, there is no conflict between efficiency and equity. This is true regardless of the specific distributional consequences of pursuing efficiency and regardless of what constitutes an equitable distribution of income. In other words, if income can be costlessly redistributed, it is always preferable to maximize the size of the pie because the pie can be sliced in any way desired.

Whether income can be costlessly redistributed is discussed in Chapter 17. Although the conclusion there is that
income redistribution generally is costly, it is argued nonetheless that efficiency should be the principal criterion for evaluating the legal system. This argument rests on the observations, explained at length in Chapter 17, that it is often impossible to redistribute income through the choice of legal rules and that, even when it is possible, redistribution through the government's tax and transfer system may be cheaper and is likely to be more precise. In other words, the potential conflict between efficiency and equity when income redistribution is costly should be considered in the design of the government's tax and transfer system, but not generally in the choice of legal rules. Thus, for purposes of discussing the legal system, a reasonable simplifying assumption is that income can be costlessly redistributed. This assumption will be maintained until Chapter 17 (although the distributional consequences of legal rules occasionally will be noted).

Before proceeding, it is worth mentioning several other standard assumptions of economic analysis that will be made in analyzing the efficiency of legal rules. First, all benefits and costs can be measured in terms of a common denominator—dollars. It is important to emphasize that this assumption is made for expositional simplicity. It is not essential to economic analysis and does not exclude considerations that might be thought of as noneconomic—such as the protection of life and limb. Second, individuals themselves determine the dollar values to place on their benefits and costs. This is known as the assumption of consumer sovereignty. It is an acceptable assumption if one believes that individuals generally know what is best for themselves. Third, the values that individuals place on their benefits and costs are "stable" in the sense that these values are not affected by changes in public policy. For example, an individual’s evaluation of the desirability of cleaner air is assumed not to depend on whether the legal

6. However, to incorporate benefits and costs that are not equivalent to a gain or loss of money would require the introduction of economic concepts that are beyond the scope of this book.
system establishes a right to clean air. This is known as the assumption of \textit{exogenous preferences}. Finally, individuals (and, when relevant, firms) maximize their benefits less their costs. This is known as the assumption of \textit{utility maximization} (or, when firms are involved, profit maximization).
CHAPTER 3
THE COASE THEOREM

One of the central ideas in the economic analysis of law was developed in an article by Ronald H. Coase in 1960. This idea, which has since been named the Coase Theorem, is most easily described by an example. Consider a factory whose smoke causes damage to the laundry hung outdoors by five nearby residents. In the absence of any corrective action each resident would suffer $75 in damages, a total of $375. The smoke damage can be eliminated in either of two ways: A smokescreen can be installed on the factory's chimney, at a cost of $150, or each resident can be provided an electric dryer, at a cost of $50 per resident. The efficient solution is clearly to install the smokescreen because it eliminates total damages of $375 for an outlay of only $150, and it is cheaper than purchasing five dryers for $250.

Zero Transaction Costs

The question asked by Coase was whether the efficient outcome would result if the right to clean air is assigned to the residents or if the right to pollute is given to the factory. If there is a right to clean air, then the factory has three choices: pollute and pay $375 in damages, install a smokescreen for $150, or purchase five dryers for the residents at a total cost of $250. Clearly, the factory would install the smokescreen, the efficient solution. If there is a right to pollute, then the

CHAPTER 4

CONTRACT RIGHTS AND REMEDIES

§4.1 The Process of Exchange and the Economic Roles of Contract Law

The last chapter emphasized the importance of voluntary exchanges in moving resources from less to more valuable uses, and it noted various obstacles to value-maximizing exchanges; but the process of exchange, once terms are agreed on, was assumed to operate reliably without legal intervention. This is strictly true, however, only where both parties perform their obligations under the contract simultaneously; and that is rare. Where the simultaneity condition does not hold, two dangers to the process of exchange arise—opportunism and unforeseen contingencies—for which the law offers remedies.

A hires B to build a house, payment due on completion. While the house is being built and before any payment has been made, B is at A’s mercy, for he would find it difficult (especially if A owns the land that the house is being built on!) to sell the house to anyone else if A decided not to pay for it. So in the absence of a legally enforceable contract A could force B to reduce his price after construction was under way. (Since contract law, like every other social institution, does not work perfectly, one is not surprised to find that builders insist on progress payments—and not because their customers are their lowest-cost lenders.) After the house is constructed and A pays B, their roles are reversed. A is now at B’s mercy. For the construction of the house is not really the end of B’s performance but the beginning. A is counting on receiving a stream of services from the house for many years. If B has built the house shoddily, and it disintegrates after a few months of use, A’s expectations will be bitterly disappointed.

Notice the parallel to the discussion in the last chapter of the disincentive to cultivate land in a world without property rights. Both that problem and the problem of contract opportunism arise from the sequential character of economic activity. If sowing and reaping were simultaneous, the need for recognition of property rights in land (as distinct from harvested crops) would be less urgent. If contractual exchanges were simultaneous, the need for legal protection of contract rights would be less urgent. Since they are not, the absence of legally enforceable rights would

1 On the law of contracts, see E. Allan Farnsworth, Farnsworth on Contracts (2d ed. 1998) (3 vols.), and Alan Schwartz & Robert E. Scott, Commercial Transactions: Principles and Policies (2d ed. 1991); the latter is a casebook with many economic notes.

§4.1 1. This implies, and we find, that in primitive societies, where contractual exchanges tend to be simultaneous, the law of contracts, in contrast to many other areas of primitive law, is rudimentary;
bias investment toward economic activities that could be completed in a short time; and this would reduce efficiency. A wants to sell his cow. There are two bidders, B and C. The cow is worth $50 to B and $100 to C (and only $30 to A), so efficiency requires that the cow be sold to C rather than B. But B has $50 cash in hand while C cannot obtain any cash for a week. C promises to pay $75 to A in a week, and let us assume that this $75 premium would fully compensate A for the costs, in the event of default, of bringing a suit for damages or for return of the cow, discounted by the risk of default—if the law made C’s promise to A enforceable. But if the law does not enforce such promises, A may decide that, since C may fail to raise the money and B in the interim lose interest in the transaction, he is better off selling the cow to B now. If he does, the law’s failure to provide a remedy if C breaks his promise will have induced a misallocation of resources, by discouraging an exchange in which the performance of one party is deferred. (B might resell the cow to C later, but this would involve an additional transaction cost.)

Now suppose that D offers to sell a shirt for $5 and his competitor, E, offers one for $6 which he claims (truthfully) will last three times as long as D’s shirt and is therefore a better value. The difference is not apparent on casual inspection or handling. E may be willing to guarantee the superior durability of his shirt, but, if his promise is not legally enforceable, consumers may doubt the honesty of his claim and buy D’s shirt instead, again a suboptimum result.

Granted, the system of voluntary exchange would not break down completely without a law of contracts. There are contracts in societies that have no formal law-enforcement machinery and, as we’ll see later in this chapter, contracts between nations that recognize no legal constraints on their sovereignty. Someone known not to perform his side of bargains will find it difficult to find anyone willing to make exchanges with him in the future—a costly penalty for taking advantage of the vulnerability of the other party to a contract, the vulnerability that is due to the sequential character of performance. There might even be more explicit definition, either in writing or by reference to custom, of the undertakings of the parties to an exchange than there would be under a regime of enforceable contracts. Transacting parties would be particularly eager to minimize misunderstandings that might give rise to charges of bad faith, since someone against whom such charges were lodged would find it more difficult to get people to make exchanges with him in the future than would be true if contract rights were legally enforceable.

A purely voluntary system would not be efficient, though. Apart from the costs involved in maintaining credit bureaus and administering security deposits (especially in a world where the return of the deposit could not be legally compelled), self-protection would not always work. Although someone contemplating breaking his contract would consider the costs to him of thereby reducing the willingness of other people to make contracts with him in the future, the benefits from breach might exceed those costs. He might be very old; or (a related point) the particular contract might dwarf all future contracts that he expected to make; or he might not be dependent on contracts but be able to function quite nicely in the future on a cash-and-carry basis.

Thus the fundamental function of contract law (and recognized as such at least since Hobbes’s day) is to deter people from behaving opportunistically toward their contracting parties, in order to encourage the optimal timing of economic

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In particular, executory contracts—contracts where neither party has yet begun to perform his contractual undertaking—are not enforced. Richard A. Posner, The Economics of Justice 182-184 (1981).
2. Thomas Hobbes, Leviathan 70-71 (1914 [1651]).
activity and (the same point) obviate costly self-protective measures. But it is not always obvious when a party is behaving opportunistically. Suppose A hires B to paint his portrait “to A’s satisfaction.” B paints a portrait that connoisseurs of portraiture admire, although not enough to buy it themselves at the contract price. A rejects the portrait and refuses to give any reason for the rejection. If the rejection is not made in good faith, A will be held to have broken the contract. Good-faith performance—which means in this context not trying to take advantage of the vulnerabilities created by the sequential character of contractual performance—is an implied term of every contract. No one would voluntarily place himself at the mercy of the other party, so it is reasonable to assume that if the parties had thought about the possibility of bad faith they would have forbidden it expressly.

Should the law go further, and read into the contract an implied duty of reasonableness on A’s part? It should not (and does not). The parties probably meant A to be the sole judge of the adequacy of B’s performance. The language of the contract so suggests, though not conclusively; and the suggestion is reinforced by reflecting on the incompetence of a judge or jury to determine whether A, though in fact (by assumption that he is acting in good faith) dissatisfied with the portrait, ought to have liked it. But if the contract, although containing the same language, were for the painting of the outside walls of a factory, the court might decide that the parties had not intended to make the buyer’s whimsy the measure of the seller’s compliance, as judge or jury could determine without great difficulty whether the paint job was adequate to its workaday purpose.\(^3\)

Let us change the example. A, a manufacturer, gives B, a dealer, an exclusive dealership for some area. That is, A agrees not to sell his product to anyone else in that area for the period of the contract. In a famous opinion by Judge Benjamin Cardozo, the court held that a contract for an exclusive dealership contains an implied condition that the dealer shall use his best efforts to sell the supplier’s product.\(^4\) Without such a condition, B could make the contract worthless to A simply by not selling A’s product, substituting the products of other manufacturers instead. The contract would be wholly one-sided; this presumably was not intended.

This example shows that another name for opportunism is—monopoly. The contract between the manufacturer and the dealer gave the latter a monopoly because it deprived the manufacturer of the right to sell to competing dealers within the area specified in the contract. The law assumes that the parties did not contemplate that the dealer would be free to take advantage of the monopoly, so it interpolates a best-efforts condition.

This approach can be questioned. It can be argued that if the manufacturer had wanted such protection he would have negotiated for it and that if he did not it may be because the parties preferred to avoid the possibility of litigation over the meaning of “best efforts,” instead relying on the dealer’s interest in future contracts, or the shortness of the contract term, or the inclusion of a clause permitting either party to terminate the contract on short notice, to protect the manufacturer against the dealer’s exploiting the monopoly conferred by the contract. In other words, some gaps in contractual protection may be deliberate—the product of a tradeoff between the danger of opportunism on the one hand and the direct and indirect costs (including risk of error) of litigation, on the other.\(^5\)

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Subject to this caveat, it should be apparent that contract law has another function but one intimately related to that of preventing opportunistic behavior: filling out the parties' agreement by interpolating missing clauses. This function too is related to the sequential character of contractual performance. The longer the performance will take—and remember that "performance" includes the entire stream of future services that the exchange contemplates—the harder it will be for the parties to foresee the various contingencies that might affect performance. Moreover, some contingencies, even though foreseeable in the strong sense that both parties are fully aware that they may occur, are so unlikely to occur that the costs of careful drafting to deal with them might exceed the benefits, when those benefits are discounted by the (low) probability that the contingency will actually occur. It may be cheaper for the court to "draft" the contractual term necessary to deal with the contingency if and when it occurs. The two types of contingency (unforeseen and unprovided for) are closely related. The less frequent an event is, the less likely it is that the parties thought about it, their neglect being a rational response to the costs of information relative to the benefits.

The task for a court asked to interpret a contract to cover a contingency that the parties did not provide for is to imagine how the parties would have provided for it had they thought to do so. Often there will be clues in the language of the contract. But often there will not be, and then the court may have to engage in economic thinking—may have to decide what the most efficient way of dealing with the contingency is. For this is the best way of deciding how the parties would have provided for it. Each party, it is true, is interested just in his own profit, and not in the joint profit; but the larger the joint profit is, the bigger the "take" of each party is likely to be. So they have a mutual interest in minimizing the cost of performance. The court can make use of this interest to fill out a contract along lines that the parties would have approved at the time of making the contract. Do you see an analogy here to the Coase Theorem and to the merger solution to the problem of airplane noise (both discussed in the preceding chapter)?

Consider again the best-efforts case. Judge Cardozo's decision can be redescribed as determining that probably the parties wanted the supplier to have a legal remedy against the dealer's opportunism. The decision merely establishes a default rule that the parties can change by explicit provision in their contract. What would be the efficient default rule if the parties did not want the supplier to have a legal remedy against the supplier's opportunism?

Does this analysis allow us to answer the question whether contracting parties would prefer to do without a legally enforceable best-efforts clause in order to reduce the risk of litigation? It does. If that is their preference, contracts will contain provisions disclaiming any duty to use best efforts; best-efforts litigation will dry up; and eventually (one hopes) the default rule will be changed.

Now consider what to do about cases in which the parties' intentions, as gleaned from the language of the contract or perhaps even from testimony, are at variance with the court's notion of what would be the efficient term to interpolate into the contract. If the law is to take its cue from economics, should efficiency or intentions govern? Oddly, the latter. The people who make a transaction—thus putting their money where their mouths are—ordinarily are more trustworthy judges of their self-interest than a judge (or jury), who has neither a personal stake in nor firsthand acquaintance with the venture on which the parties embarked when they signed the contract. So even if the goal of contract law is to promote efficiency rather than to enforce promises as such (the latter an improbable goal, since most promises are not legally enforceable), enforcing the parties' agreement is often a rational response to the costs of information relative to the benefits.
it can be ascertained may be a more efficient method of attaining this goal than rejecting the agreement when it appears to be inefficient. Yet discrepancies between (apparent) agreement and efficiency can be important clues to the existence of mistake, incapacity, or other grounds for believing that the apparent agreement doesn't really promote the parties' joint ends.

Here is an example of how economic analysis can be used to fill in missing terms in a contract. A buys goods from B, with delivery to take place in a month, and during the month B's warehouse burns down and the goods are destroyed. The contract is silent on the allocation of the risk of loss before delivery. But since B can prevent (or insure against) a fire in his own warehouse at lower cost than A can, the parties, if they had thought about the matter, would probably have assigned the risk to B, even though he no longer "owns" the goods; and that is the assignment the court should make in the absence of contrary evidence of the parties' intentions.

Generalizing from this example, we can derive the following rule for deciding what warranties (legally enforceable promises) should be held to be implied in a sale of goods: The manufacturer warrants those and only those dimensions of performance that are primarily within his control rather than the buyer's. Thus he is held to warrant that the goods are fit for their intended use—but not that they will last indefinitely; their durability may depend to a significant degree on how the buyer uses them, a matter within the latter's control.

The State of Wisconsin once hired a man named Bentley to build wings on the state capitol under the direction of the state's architect. Bentley followed the architect's plans faithfully, but they were no good, and the wings collapsed shortly after being completed. The state sued Bentley, alleging that he had guaranteed his work against such a calamity. The contract said nothing germane to the subject; obviously neither party had thought it likely that the wings would collapse because the architect's plans were bad. The state lost its suit. This is the right economic result. The state could have prevented the calamity at lower cost than Bentley, by more careful selection or supervision of the architect. Even so, might not one purpose of the contract have been to insure the state against the collapse of the wings from any cause? Insurance is one way of dealing with unforeseen contingencies, and contracts are often a method of insurance (see §4.5 infra). But it is unlikely that Bentley was a better insurer than the state. Bentley would have had to go out and buy an insurance policy; the state could self-insure against the particular risk.

We have thus far hewn to the notion of contract law as a handmaiden of exchange, but this takes too narrow a view of the subject, as some examples will illustrate:

(1) A wealthy man in an expansive moment promises to pay my way through college. I give up my part-time job, but he then breaks his promise, and I am unable to get a new job.

(2) A promises to deliver goods to B "on the twelfth." B thinks he means the twelfth of this month, but in fact A means the twelfth of next month—he could not possibly deliver as soon as B (unknowing to him) expects.

(3) A steel company agrees to deliver steel to a bridge-building company within 60 days, but the steel company is shut down by a wildcat strike and cannot make delivery within that time.

In none of these cases is the issue whether a party to an exchange has refused to carry out his end of the bargain. There is no exchange in the first case; giving up my part-time job confers no advantage on the wealthy promisor. He may not even have known that I gave it up. In the second case there is no exchange, in fact or in intent; the parties intended different transactions. In the third case performance was prevented by circumstances beyond the promisor’s control. Yet in all three cases there is an economic argument for imposing sanctions on the party who failed to perform.

The wealthy man’s idle promise induced reliance that cost the promisee heavily when it was broken. Such a cost can be avoided for the future by holding such a promisor liable for the promisee’s cost of reliance. We must distinguish, however, between the sort of donative promise that is likely to induce reliance and the sort that is not. I promise you a trivial gift and the next day withdraw my promise. I had no reason to expect you to rely—your reliance was precipitate, imprudent—so whether or not you do rely the law will not hold me to my promise.

Suppose, in the case in which the buyer and seller confuse the date, that the custom in the industry is that a delivery date without specification of the month refers to the current month. A is new to the industry and ignorant of the custom. Nevertheless, to hold him to the promise understood by B will have the salutary effect of inducing newcomers to master the language of the trade promptly—although to be confident that this would be the optimal result we would have to consider (1) whether existing firms might not be the cheapest source of newcomers’ information about the custom and (2) the possible anticompetitive effects of placing the burden of acquiring this information on new entrants.7

As for the third case, the steel company is probably in a better position than the buyer to anticipate and take appropriate safeguards against an interruption of production due to a wildcat strike. If so, placing the risk of such an interruption on the steel company, by making it liable for damages to the purchaser from delay, may be the cheapest way of minimizing the costs of such delays in the future.

The question whether to treat a failure to carry through an undertaking as a breach of contract is similar to the question whether to treat an interference with a neighbor’s land use as an invasion of the neighbor’s property rights. We ask: Will imposing liability create incentives for value-maximizing conduct in the future? The difference is that less is at stake in a contract case. It is a setting of low transaction costs, and therefore a judicial failure to discover the efficient solution can be rectified for the future by a drafting change. This point suggests that contract law cannot readily be used to achieve goals other than efficiency. A ruling that fails to interpolate the efficient term will not affect future conduct; it will be reversed by the parties in their subsequent dealings. It will only impose additional—and avoidable—transaction costs.

To summarize (and anticipate), contract law has five distinct economic functions: (1) to prevent opportunism, (2) to interpolate efficient terms, (3) to prevent avoidable mistakes in the contracting process, (4) to allocate risk to the superior risk bearer, and (5) to reduce the costs of resolving contract disputes.