What Can Contract Lawyers Learn from Law and Economics?

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I INTRODUCTION

This article aims to offer some general observations on what insights law and economics, which is also known as the economic analysis of law, can offer us into contract law. It is argued that despite some serious limitations of this approach, contract lawyers can benefit from the economic analysis of contract law in at least three ways.[1] First, economic analysis can be a method to evaluate the effectiveness of law. Secondly, it can be used to identify the winners and losers created by the law. Thirdly, it can broaden the understanding of business behaviour to make contract law meet legitimate commercial expectations.

The article will proceed as follows. After a brief review of the history of the law and economics movement in Part II, three examples in contract law — namely misrepresentation, the exclusion clause in consumer contracts, and the unfair contract term — will be used to illustrate the values of law and economics in Part III. And then in Part IV the limitations of economic analysis are discussed. Finally, Part V concludes the article.

II WHAT IS THE ECONOMIC ANALYSIS OF LAW?

The modern law and economics movement started from the University of Chicago in the early 1960s.[2] A small number of economists[3] and lawyers[4]

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[1] For a critical evaluation of the economic analysis of contract law, see E Posner, 'Economic Analysis of Contract Law After Three Decades: Success or Failure?' (2003) 112 *Yale Law Journal* 829; R Craswell, 'In That Case, What is the Question? Economics and the Demands of Contract Theory' (2003) 112 *Yale Law Journal* 903; I Ayres, 'Valuing Modern Contractual Scholarship' (2003) 112 *Yale Law Journal* 881.

[2] F Parasi and C Rowley (eds), *The Origins of Law and Economics: Essays by the Founding Fathers* (Edward Elgar, 2005); A Ogus, 'Law–and–Economics from the Perspective of Law' in Peter Newman (ed), *The New Palgrave Dictionary of Economics and the Law* (Palgrave MacMillan, 1998) vol 2, 486; N Duxbury, *Pattern of American Jurisprudence* (Oxford University Press, 1997) ch 5.

[3] See, eg, Ronald Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 1; G Becker, 'Crime and Punishment: An Economic Approach' (1968) 76

applied economic methodologies to the study of law, and then this approach was rapidly adopted by academics in the United States in a wide range of legal subjects. Later, it gradually spread to Europe and the rest of the world.

There are different types of economic analysis of law, ranging from neoclassical economic analysis to behavioural law and economics.[5] It is impossible to cover all of them in this short article, so the focus of this discussion is on one of the most popular and conventional economic approaches, the positive economic analysis of law. This approach uses microeconomic theories, mainly the price theory, to predict how the law can modify people's behaviour by changing their incentives.[6]

The price theory in microeconomics examines how changes in the market price affect the supply and demand of the goods.[7] It is based on a number of assumptions, the most important one being a belief in the rationality of human nature, which assumes that every person is rational. When facing different behavioural options, the rational person will always choose the one which maximises his or her self-interest.[8] For example, when two sellers charge different prices for an identical product, the rational buyer will purchase from the seller who charges the lower price. Therefore, a general proposition made by the price theory is that an increase in the price for a given product will lead to a reduction in the demand, but a rise in the supply. This is because the product becomes more expensive for the buyer but also more profitable for the seller. So there will be fewer buyers and more sellers. For the same reason, a decrease in the price will lead to an increase in the demand, but a fall in the supply.[9]

Conventionally, economists apply the price theory only to the study of the market behaviour of consumers and firms, rarely considering its implications for non-market behaviour and law. Gary Becker, one of the founding fathers of law and economics, is regarded arguably as the first economist who applied the price theory to the study of non-market

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Journal of Political Economy 169; G Stigler, 'The Economic Theory of Regulation' (1971) 2 *Bell Journal of Economics and Management Science* 3.

[4] R Posner, *Economic Analysis of Law* (Little Brown, 1972); G Calabresi, *The Cost of Accident: A Legal and Economic Analysis* (Yale University Press, 1970).

[5] For general discussions of different types of economic analysis of law, see A Katz, *Foundations of the Economic Approach to Law* (Oxford University Press, 1998) ch1; N Mercuro and S Medema, *Economics and the Law: From Posner to Post-Modernism and Beyond* (Princeton University Press, 2nd ed, 2006).

[6] M Friedman, 'The Methodology of Positive Economics' in M Friedman, *Essays in Positive Economics* (University of Chicago Press, 1953) 3.

[7] M Friedman, *Price Theory* (Adline Transaction, 1976).

[8] R Cooter and T Ulen, *Law and Economics* (Pearson Addison Wesley, 5th ed, 2007) 368–72.

[9] R Cooter and T Ulen, *Law and Economics* (Pearson Addison Wesley, 5th ed, 2007) chapters IV and V.

behaviour. In his seminal paper, 'Crime and Punishment: An Economic Approach',[10] he shows how the price theory can broaden our understanding of criminal behaviour and legal deterrence. He perceives crime as a commercial product and the offender as a rational buyer. If the offender wants to buy this 'product', that offender must pay the price which is the legal penalty. So he or she will commit a crime if, and only if, the benefit from that crime to him or her exceeds the price. Legal sanctions can be seen as a device to increase the price for the crime. The law can deter crime by lifting the price higher than the benefit. Based on this theory, Becker further develops an economic model of the optimal legal deterrence of crime. Although his theory focuses mainly on crime and criminal law deterrence, some implications can be drawn from it to understand contractual behaviour and contract law remedies. In particular, Becker's theory can assist in understanding the effectiveness of contract law remedies as deterrents of contractual wrongdoing. This can be seen through the first illustration: fraudulent misrepresentation.[11]

III ILLUSTRATIONS

A *Evaluating the Effectiveness of Law*

Fraudulent misrepresentation is a false statement made by one party (the representor), for the purpose of inducing the other party (the representee) to make the contract with him.[12] The law of contract in most jurisdictions allows the representee to rescind the contract on the basis of fraudulent misrepresentation.[13] The justification for the remedy of rescission in conventional legal wisdom is corrective justice, whereby the purpose of the private law remedy is to correct the wrong or harm made by the representor.[14] According to this theory, if the representee is misled by the representor's false statement to make an unwanted contract, the wrong is

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[10] G Becker, 'Crime and Punishment: An Economic Approach' (1968) 76 *Journal of Politic Economy* 169.

[11] For a comprehensive analysis, see Q Zhou, *Economic Analysis of Misrepresentation in English Contract Law* (VDM Publishing, 2009); Q Zhou, 'A Deterrence Perspective on Damages for Fraudulent Misrepresentation' (2007) 19(1) *Journal of Interdisciplinary Economics* 83.

[12] *Derry v Peek* (1889) 14 AC 337; *John McGrath Motors (Canberra) Pty Ltd v Applebee* (1964) 110 CLR 656; *Sargent v Campbell* [1972-73] ALR 708.

[13] *Alati v Kruger* (1955) 94 CLR 216; *Islington London Borough Council v UCKAC* [2006] EWCA Civ 340; *Snyder Enterprises v Ward*, 872 F Supp 8 (EDNY, 1995); for academic discussions, see J Carter, E Peden and G Tolhurst, *Contract Law in Australia* (LexisNexis, 5th ed, 2007) 389–404; J O'Sullivan, 'Rescission as a Self-help Remedy: A Critical Analysis' (2000) 59(2) *Cambridge Law Journal* 509; J Cartwright, *Unequal Bargaining: A Study of Vitiating Factors in the Formation of Contracts* (Clarendon Press, 1991) 68.

[14] J Gordley, *Foundations of Private Law Property, Tort, Contract, Unjust Enrichment* (Oxford University Press, 2006) ch 1.

the fraud and its consequence is the contract. So, if the contract is rescinded, the wrong is corrected and justice is restored.

This view sees the remedy of rescission from an *ex post* perspective. In other words, it considers what the law should do once the representee has been misled. Rarely does it consider *ex ante* questions, such as how the legal remedy can be used to deter fraudulent misrepresentations and whether it can achieve effective deterrence. These are certainly important questions. If the law should be designed to prevent fraudulent misrepresentations, it is crucial for us to know whether a particular legal remedy, such as rescission, can achieve this goal on its own. If it can, there is no need for the use of other legal instruments. If it cannot, the reason why should be assessed, in order to choose a proper legal sanction. It is these *ex ante* questions to which the economic analysis can offer the answers.

If fraudulent misrepresentation is seen from Becker's perspective, every contractor is rational and will deceive if, and only if, the gain from the fraud exceeds the cost. If the law can increase the cost for his fraud to a level equal to, or higher than, the profit, the fraudulent misrepresentation can be deterred.[15] Assume for example that the seller can generate a net gain of $100 from deceiving the buyer. If the law can impose a liability cost of $100, he will not benefit from the fraud, and will then have no incentive to deceive the buyer. In other words, effective legal deterrence will be achieved if the legal sanction can impose on the representor a liability cost equal to, or higher than, the gain generated from the fraud.

Can the remedy of rescission achieve this? Answering this question requires a calculation of the seller's payoff from the fraud. Although there is often a lack of accurate information for such a calculation, a reasonable analysis of the deterrence of rescission is still possible. Clearly, the representor can benefit from the fraudulent misrepresentation only if he can keep all of the profit from the fraud. However, this is impossible when the contract is rescinded. The general legal principle in both English and Australian contract law is that if the contract is rescinded for a fraudulent misrepresentation, the parties to the contract must return the value they received from each other.[16] Take a sale of goods contract as an example. Where the contract is rescinded, the seller must return the price to the buyer, and the buyer must return the goods to the seller. Therefore, neither the seller nor the buyer can realise their expected profit from the contract. Although an accurate figure of the fraudulent seller's profit from the misrepresentation is not known, it is reasonable to say that the remedy

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[15] Q Zhou, *Economic Analysis of Misrepresentation in English Contract Law* (VDM Publishing, 2009) 71–3.

[16] E Peel, *Treitel on the Law of Contract* (Sweet and Maxwell, 12th ed, 2007) 401–23; Carter, Peden and Tolhurst, above n 13, 389–90.

of rescission can eliminate all of the seller's expected profit from the fraud. In other words, it can be assumed that the liability cost of rescission is at least equal to the representor's gain from the fraud.

Nonetheless, great care should be taken in coming to a conclusion that, simply because the liability cost imposed by the rescission is equal to the seller's gain from the fraud, the remedy of rescission can effectively deter the seller's fraud. The analysis is incomplete. A crucial variable is missing: the rate of legal enforcement. Rescission is an *ex post* legal sanction.[17] It creates a threat to the representor that nobody can make a profit from fraud. The threat is only credible, if the representor believes that once he or she deceives, the representee will rescind the contract. He or she cannot keep the gain from the fraud, and will then have no incentive to deceive.

In reality, the representee does not always rescind the contract. There are many reasons for this. For example, the representee, may not know that he or she was misled by the representor's misrepresentation; or he or she may be aware of the misrepresentation, but the litigation costs are too high to justify the rescission of the contract. More importantly, in common law jurisdictions, rescission is an equitable remedy which is subject to judicial discretion. It is possible that a judge may refuse to grant the remedy of rescission simply because the consequence of such a grant, in his or her opinion, would be inequitable. The fact that rescission is by nature an equitable remedy further undermines the party's incentive to rescind the contract.[18] Thus, the enforcement of rescission is imperfect. Accordingly, the deterrence of rescission is undermined. For instance, if the fraudulent seller can make a profit of $100 from the fraud, and the enforcement of rescission is perfect, he or she will have no incentive to deceive. This is because, once he or she deceives, the contract will be rescinded and he or she must return the gain from the fraud back to the buyer. Now assume that the enforcement is imperfect. There is a 50 per cent chance that the buyer will rescind the contract. Then, the seller may assume that the expected liability cost imposed by the rescission becomes $50 ($100 x 50% = $50), which is less than the expected profit ($100) from the fraud. So, he or she still has the incentive to deceive the buyer. The availability of rescission cannot deter the fraudulent misrepresentation.

In addition, the remedy of rescission increases social costs. Once the contract is rescinded, all of the resources used in making the contract, namely the transaction costs of both parties, are wasted. Although the innocent party can be compensated for his transaction costs by claiming

[17] Q Zhou, *Economic Analysis of Misrepresentation in English Contract Law* (VDM Publishing, 2009) 91–8.
[18] Carter, Peden and Tolhurst, above n 13, 391–4.

them back from the other party, this is just a redistribution of wealth from one party to the other. From a societal standpoint, the resources invested in the voided contract were wasted because they could certainly be put into a better use. So the social costs of the rescission are assessed on the basis of opportunity cost, which is completely different from the calculation of the innocent party's private transaction cost. From an economic perspective, the social cost of using the remedy of rescission for deterrent purposes is high.

Three important conclusions can be drawn from the above analysis. First, in theory the remedy of rescission can be an effective deterrence of fraudulent misrepresentation, if and only if the legal enforcement is perfect. Secondly, in reality, rescission cannot deter fraudulent misrepresentations, because there are many reasons for the representee not to rescind the contract. Thus, the legal enforcement is imperfect. Thirdly, rescission generates high social costs and is not a proper sanction to deter fraudulent misrepresentation. If we want to use rescission for the purpose of deterrence, it must be used in combination with other legal sanctions.[19] For example, in the United Kingdom, the *Misrepresentation Act 1967* allows a contracting party to claim simultaneously both the rescission of the contract and damages for losses resulting from relying on the misrepresentation. Furthermore, proper regulatory laws[20] are put into place to enhance legal deterrence. A special regulatory agency, the Office of Fair Trading, is entrusted with the enforcement of consumer protection laws. The rationale behind this regulatory design is that private legal enforcement is too weak to provide effective legal protection for consumers, so public law should intervene.

However, this UK regulatory system has two limitations. First, public legal enforcement is often more costly than private legal enforcement. If both could achieve the same level of deterrence, it would be more efficient to use the latter. Secondly, the regulatory agency is vulnerable to the well-known problem of 'regulatory capture'.[21] Regulatory laws may be manipulated by certain influential groups to pursue their private interests such as attacking their competitors in the market. Therefore, some legal mechanisms must be designed to tackle this problem.

Compared with the UK regulatory design, the Australian approach to the regulation of fraudulent misrepresentation deserves special praise. Both the above mentioned problems are of less concern in Australia. Unlike UK law, *Australian Consumer Law* focuses more on private legal

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[19] For comprehensive discussions of the deterrence of rescission, see Q Zhou, 'Contractual Mistake and Misrepresentation' in G DE Geest (ed), *Contract Law and Economics Encyclopaedia of Law and Economics* (Edward Elgar, 2nd ed, 2011) vol 6, 31–56.

[20] *Consumer Protection from Unfair Trading 2008* (UK) SI 2008/1277.

[21] A Ogus, *Regulation*: *Legal Form and Economic Theory* (Hart Publishing, 2004) ch 4.

enforcement, offering a wide of ranges of legal remedies for victims of misrepresentation. Along with traditional rules at common law, misrepresentations were largely regulated by s 52 of the *Trade Practice Act 1974* (Cth), which is now replaced by s 18 of the newly enacted *Australian Consumer Law*. It provides that a person must not, in trade or commerce, engage in conduct that is misleading or deceptive, or is likely to mislead or to deceive. Contravention of s 18 is subject to the remedies of injunction, damages and compensatory orders, as set out in ch 5 of the *Australian Consumer Law*. Under the *Australian Consumer Law*, both the regulator and the affected persons can seek the remedy of an injunction to stop a business from engaging in conduct in breach of s 18.[22] Furthermore, the affected persons may apply to a court for damages to compensate actual losses[23] or apply for compensatory orders to compensate potential losses which they are likely to suffer as a result of the contravention of s 18.[24]

This is a smart strategy. The conventional view is that the imperfect legal enforcement of private law sanctions should be addressed by public law mechanisms. Rather than relying entirely on public enforcement agencies, the *Australian Consumer Law* is largely enforced by private parties. This regulatory design significantly enhances legal deterrence. Unlike the remedy of rescission which can only be exercised by the contracting party, the *Australian Consumer Law* allows both regulators and affected persons to seek injunctions and claim damages. The affected persons include the contracting party and other persons adversely affected by the misleading or deceptive behaviour of a business. This rule indeed encourages more private parties to enforce the law. In particular, it creates a strong incentive for competitors of the fraudulent firm to bring the action by alleging that the firm uses misleading or deceptive practices. In addition, as it is private law litigation which is brought by individuals or firms, the claimants partly bear the cost of legal enforcement. Compared with the situation where the law is entirely enforced by a regulatory body, the Australian regulatory design is less costly to the government.

Moreover, it is easier for the claimant to sue in the action of damages for contravention of s 18, rather than in the action of fraudulent misrepresentation at common law. To establish a claim for damages under s 18, the claimant does not need to prove the representor's fraudulent intention as required at common law. This also makes it easier

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[22] *Competition and Consumer Protection Act 2010* (Cth) sch 2 *Australian Consumer Law* pt 5.2 div 2.
[23] *Competition and Consumer Protection Act 2010* (Cth) sch 2 *Australian Consumer Law* s 236.
[24] *Competition and Consumer Protection Act 2010* (Cth) sch 2 *Australian Consumer Law* pt 5.2 div 4 sub-div A.

for the claimant to establish the claim, and accordingly enhance the legal deterrence.[25]

Nonetheless, it should also be noted that contract law, from a conventional perspective, is not designed to pursue legal deterrence. This is reflected in many rules and doctrines in contract law, such as that both punitive damages and penalty clauses are strictly prohibited. The default remedy for breach of contract is expectation damages, which is aimed at putting the parties back to the position where they would have been, had the contract been perfectly performed. The purpose of contract law remedy is compensation, not deterrence. But even though contract law is not aimed at pursuing legal deterrence, it is by no means correct to say that contract law remedies have no deterrence effect in reality. As discussed above, a rational contracting party sees legal remedies as a cost for his breach of the contract and will take it into account when assessing the payoff derived from his breach. Inevitably, the remedies will affect his decision to breach the contract. This consequential effect must be considered in any serious legal analysis. The impact of the law on people's behaviour should not be ignored, just because the law may not be designed to have such impact.

Although the above analysis is very simplistic, it is surely a useful exercise. One of the main differences between the economic analysis and the conventional legal study is that the former focuses on *ex ante* questions and the latter on *ex post* ones. Undoubtedly, both analyses are important for contract lawyers. Insufficient consideration of *ex ante* questions will hamper the understanding of contract law. As a consequence, there is a tendency to see contract law more as a remedy to solve disputes, but rarely consider it as a mechanism to avoid problems beforehand. Obviously, the economic analysis can help us achieve a more balanced view.[26]

B *Identifying Winners and Losers*

Besides enabling a more balanced view, an economic analysis of law can also help in identifying the winners and losers created by the law. A new law can hardly make everybody better off. Often, it makes some people better off and others worse off.[27] Therefore, it is vital to know who are the

[25] Carter, Peden and Tolhurst, above n 13, 414–26.

[26] For discussion of *ex ante* and *ex post* legal reasoning, see R Craswell, 'Two Economic Theory of Enforcing Promises', in P Benson (ed), *Readings in the Theory of Contract Law* (Cambridge University Press, 2001) 19; Q Zhou, 'Damages for Repudiation: An *Ex Ante* Perspective on the Golden Victory' (2010) 32 *Sydney Law Review* 579.

[27] In the economic analysis of law, a legal rule is called as a Pareto improvement if it makes at least one person better off and nobody worse off. However, rarely can a legal rule do so. More often a legal rule makes some persons better off and others worse off. When the benefits to the winners exceed the costs to the losers, the legal rule is called Kaldor-

winners and losers. Sometimes, because of insufficient analysis of this issue, the new law may not only fail to serve the aim proposed by the lawmaker, but it may also deliver the opposite outcome. The economic analysis of law can lower this risk, as seen in the second illustration which examines the law in relation to the exclusion clause in consumer contracts.

With the progress of industrialisation in the late nineteenth century, the freedom of contract gradually became more of a fallacy than a reality.[28] Often, the parties have significantly imbalanced bargaining power. When making the contract, the weaker party normally only has two options: either to accept the standard form contract written by the strong party, or not to make the contract. Rarely can the former negotiate with the latter.[29] A typical example is the consumer contract. Nowadays, almost every consumer transaction is a standard form contract. There is no chance for consumers to negotiate. In most jurisdictions, a large number of regulations are enacted to protect consumers against exploitation. One of these regulations in English consumer law is the rule which prohibits contracting parties from using contract clauses to exclude their tort law liability for personal injury and death. Section 2(1) of *Unfair Contract Terms Act 1977* (United Kingdom) provides:

> A person cannot by reference to any contract term or to a notice given to persons generally or to particular persons exclude or restrict his liability for death or personal injury resulting from negligence.

The purpose of this rule is obvious — to prevent a strong party taking advantage of a weak party. Although the wide use of standard form contract in consumer transactions can save transaction costs and improve economic efficiency, it also creates a chance for suppliers to exploit consumers.[30] If a court enforced the contract term which excludes the supplier's liability for personal injury and death, not only would the consumer be left uncompensated, but also the supplier would be encouraged to exploit more consumers in the future. The prohibition on

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Hicks Efficient. For more discussion, see Q Zhou, 'The Evolution of Efficiency Principle: From Utilitarianism to Wealth Maximisation' (SSRN Working Paper, 2005) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=870748>; J Coleman, *Markets, Morals and The Law* (Cambridge University Press, 1988) chapters 3 and 4; R Craswell, 'Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships' (1991) 43 *Stanford Law Review* 361–98.

[28] M Horwitz, The Transformation of American Law 1870–1960: The Crisis of Legal Orthodoxy (Harvard University Press, 1977) ch 2; P Atiyah, The Rise and Fall of Freedom of Contract (Clarendon Press, 1979) 572–81.

[29] See O Ben-Shahar (ed), *Boilerplate: The Foundation of Market Contract* (Cambridge University Press, 2007); K Llewellyn, 'What Price Contract?' (1931) 40 *Yale Law Journal* 704; A Leff, 'Contract as Thing' (1970) 19 *American University Law Review* 131.

[30] L Bebchuk and R Posner, 'One-sided Contracts in Competitive Consumer Markets' in O Ben-Shahar (ed), *Boilerplate: The Foundation of Market Contract* (Cambridge University Press, 2007) 3.

the use of the exclusion clause is one of the regulatory solutions to this problem.

However, there are several interesting questions which can be asked. Will the law benefit all consumers or only some? If only some consumers will be better off, who are they? And more importantly, will the law make any consumer worse off? An economic analysis can offer the answers. Take a contract for the sale of a car between a manufacturer and a consumer as an example. First, how will the manufacturer act, if the law permits it to exclude its liability for personal injury or death caused by its defective car?

Normally, no manufacturer intends to cause personal injury and death by producing defective cars, even though the manufacturer may not invest sufficiently in the safety of the car in order to reduce production costs. It is reasonable to assume that there is a negative correlation between the manufacturer's precaution and the risk of personal injury and death resulting from a defective car. The higher the level of precaution, the lower the risk is. The law and economics literature has shown how the law can be designed to induce the manufacturer to take the optimal precautions. It is not the intention of this article to explore this question.[31]

In this discussion, the key issue is the notion of inherent risk, which is the risk that cannot be prevented. In the example used here, once the precaution taken by the manufacturer reaches a certain level, any incremental precaution will not lower the risk any further. This is the risk inherent in the process of car production. As long as the manufacturer produces cars, this risk exists. Another example of an inherent risk is that no matter how careful a driver is, as long as he or she drives, he or she may hit a pedestrian.

If the law allowed the use of an exclusion clause, the manufacturer could transfer the inherent risk to the consumer, by writing a contract term to exclude its liability for personal injury and death resulting from the defective car. Once the risk materialised, the manufacturer would not be held liable and the consumer would bear the consequences.

But, if the law prohibits the use of an exclusion clause, the manufacturer cannot transfer the inherent risk to the consumer via a contract term. In other words, the prohibition forces the manufacturer to bear the inherent risk. This rule will change the manufacturer's business strategy in dealing with the inherent risk. The manufacturer may buy liability insurance from an insurance company, and then increase the price of the car to recover its insurance cost from the consumer. In fact, the law cannot stop the

[31] See generally see S Shavell, *Economic Analysis of Accident Law* (Harvard University Press, 1987); M Geistfeld, 'Products Liability' in M Faure (ed), *Tort Law and Economics, Encyclopaedia of Law and Economics* (Edward Elgar, 2nd ed, 2009) ch 11.

manufacturer transferring the risk to the consumer. Where the use of an exclusion clause is permissible, the manufacturer directly transfers the risk to the consumer via the exclusion clause; and where the use of the exclusion clause is prohibited, the manufacturer transfers the risk to the consumer via the price. In the latter case, the incremental price is like an insurance premium which the consumer pays to the manufacturer to insure the inherent risk. Thus the law obliges consumers to purchase a 'compulsory insurance' from the manufacturer.

This theoretical proposition has been confirmed by some empirical studies. For example, a piece of research in the United States shows that increased tort liability for consumer personal injury and death in the 1980s tripled the premium for liability insurance and led to a profit decline in related industries.[32] The law aimed to improve consumer protection, but the cost of doing so was eventually passed on to consumers by manufacturers. To stabilize the insurance market, most states in the US reformed tort law to limit the liability for personal injury and death.[33]

Does this 'compulsory insurance' benefit all consumers? The answer is *no*. Consumers' risk attitude varies. Some may be more risk averse whilst others may be risk neutral. The risk averse consumer may prefer the law as it reduces the risk of personal injury and death. But the risk neutral consumer may not prefer the law, as he may believe that it is not worth paying the extra money to insure for such a risk. He prefers to bear that risk himself. So the law makes the risk averse consumer better off and the risk neutral consumer worse off.

Though English law is used in the above illustration, the implications can be equally applied to Australian law. Two issues in relation to the newly enacted *Australian Consumer Law* merit a further analysis. First, the legal rules in relation to an exclusion clause of legal liability for personal injury and death in the *Australian Consumer Law* are more flexible. Suppliers of 'recreational services' may exclude or limit their liability with respect to personal injury and death. The term 'recreational services' is defined as services that consist of participation in a sporting activity or similar leisure-time pursuit, or any other activity that involves a significant degree of physical exertion or physical risk undertaken for purposes of recreation, enjoyment or leisure. This definition is intended to encompass activities that involve significant risk or exertion by the participant, such

[32] G Priest, 'The Current Insurance Crisis and Modern Tort Law' (1987) 96 *Yale Law Journal* 1521; W Viscusi, 'The Dimensions of the Product Liability Crisis' (1991) 20 *Journal of Legal Studies* 147.

[33] M Geistfeld, 'Products Liability' in M Faure (ed), *Tort Law and Economics, Encyclopaedia of Law and Economics* (Edward Elgar, 2nd ed, 2009) ch11, 307.

as hiking, bungee jumping and paintball.[34] There are no similar specific legal rules in English consumer law.

The Australian law makes economic sense. It is reasonable to assume that the participants in these recreational activities are aware of the risks associated with such activities. Allowing the suppliers to use exclusion clauses implicitly shifts the risk to the participants themselves. This creates two desirable incentives for them. They will be more cautious when deciding to participate in these activities, and they will take more precautions against the associated risks. Consequently their decisions will be more rational, and potential accidents may be reduced because fewer persons would choose to take the risk.

Secondly, under ss 51 to 64, a number of compulsory guarantees are provided. For example, consumers have a guarantee that the goods must be of acceptable quality. The goods must be reasonably fit for the purpose which the consumer expressly or implicitly makes known to the supplier. These rules are mandatory, and any contract term or clause which is intended to exclude or limit these guarantees, is void. The law offers consumers a number of legal remedies for the breach of any of these guarantees by the supplier or the manufacturer. Along with the traditional private law remedies such as damages or termination of contract, the consumer can ask the supplier for repair, replacement and refund. These are more effective and flexible legal remedies for consumer transactions. It is not the purpose of this article to examine these remedies in detail.

The current focus is on the mandatory nature of these guarantees. The implications drawn from the illustration of the car manufacturer can be equally applied to these mandatory guarantees in *Australian Consumer Law*. Three remarks can be made. First, all things being equal, it is expected that suppliers have strong incentives to shift the costs of these mandatory guarantees on to consumers by charging a higher price. Secondly, because of this not all of the consumers benefit from these mandatory rules, as some of them may not want these guarantees, but they have to pay the higher price. And finally, there is certainly a subsidiary effect, namely that those consumers who do not want these mandatory rules partly bear the cost of these guarantees for the consumers who do want them. More serious analysis of this subsidiary effect is needed in the future, particularly on the question of what is its justification.

The second illustration, the car manufacturer and car purchaser, shows that restrictions on exclusion clauses for personal injury and death, do not benefit all consumers. Like most mandatory rules, it makes some people

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[34] Explanatory Memorandum, Trade Practices Amendment (Australian Consumer Law) Bill (No.2) 2010 (Cth) [7.136–7.139].

better off and others worse off. It is not the intention of this article to argue that the restrictions on exclusion clauses are undesirable. Rather the opposite — that proper legal restrictions on parties' freedom of contract are necessary. Nonetheless, when a new legal rule is proposed its impact on the relevant persons must be analysed to identify the winners and losers created by the new rule. An economic analysis is certainly one of the methods to serve this aim.

C *Understanding Commercial Behaviour*

One of the fundamental functions of contract law is to facilitate commercial transactions. The law of contract, at the core of commercial law, should be consistent with commercial customs. If contract law contradicts commercial norms and customs, it will hinder commercial activities, thereby undermining economic growth.[35] Therefore, it is important to understand commercial behaviour. Sometimes, those outside the commercial world may not fully understand commercial decisions. If scholars have an incomplete understanding of commercial behaviour, their criticisms of commercial decisions may be harsh. But if judges and lawmakers make similar mistakes, the judgments or the laws made by them can create a barrier to commercial activities. An economic analysis can broaden understanding of commercial behaviour, thereby reducing this risk. This can be seen in the final illustration, *A Schroeder Music Publishing Co v Macaulay*,[36] an English contract law case on the unfair contract term.[37]

In this case, a young pop musician made a standard form contract with a publishing house. The contract was disproportionately favourable to the publishing house. In particular, there was a term which tied the musician to the publishing house for a long period if any of the musician's songs were successful. The House of Lords held that this clause was invalid on the ground of unreasonable restraint of trade. For the House of Lords, this case was a classical example of the abuse of superior bargaining power. The musician was in a weak bargaining position. He had no chance to negotiate with the publishing house on the contractual term. His right to freedom of contract was infringed. As such, it was held that the contract was unfair and should not be enforced.[38]

However, the reasoning of the House of Lords in this case is unconvincing. An economic analysis can easily identify its weaknesses. It

[35] R Goode, *The Hamlyn Lectures: Commercial Law in the Next Millennium* (Sweet and Maxwell, 1998) 31–42.
[36] [1974] 3 All ER 616.
[37] This section is based on M Trebilcock, 'The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords' (1976) 26 *University of Toronto Law Journal* 359.
[38] *A Schroeder Music Publishing Co v Macaulay* [1974] 3 All ER 616, 624 (Lord Diplock).

seems that the Court did not sufficiently appreciate commercial behaviour in the music industry. It was wrong to see the use of standard form the contract as evidence of abuse of bargaining power. In fact, the key question should have been whether the musician had alternatives if he refused to make the contract with this publishing house. The music and entertainment industry is always highly competitive.[39] At that time, if the musician was not happy with this publishing house, he could easily have found another publishing house.[40] The abuse of the bargaining power by the publishing house was not a convincing explanation for the nature of the term. The term was more likely a reflection on the market condition of the music industry. The rate of success of unknown pop musicians is normally very low. Publishing houses have to use the profit from successful musicians to compensate for the costs spent on those unsuccessful ones. From the standpoint of insiders within the music industry, the contract tying the successful unknown musician to his publishing house does not seem to be unfair, but a widely accepted commercial practice. This 'unfair contract term' is attributable to the nature of the music industry rather than resulting from the abuse of bargaining power by the publishing house. More importantly, the House of Lords' decision has serious repercussions. If the court does not allow publishing houses to use this type of contract term, it will discourage publishing houses from investing in unknown musicians in the future. As a consequence, not only does the decision harm unknown musicians' interests, but also hampers creativity in the whole music industry. Certainly, this outcome was not intended by the House of Lords.

This final illustration shows that understanding commercial behaviour is essential for contract lawyers. An economic analysis can direct attention to those economic factors in relation to the contract, which assists in understanding the extent to which commercial behaviour is affected by economic factors and market conditions in the industry. It can also highlight the differences in norms and customs between the outsider and insider, improving evaluations of the law as a result.

IV LIMITATIONS OF LAW AND ECONOMICS

It would be dishonest to conclude that an economic analysis of law is a perfect approach, or a superior approach, to the study of law on its own. Economic analysis does have some serious limitations. Because of these

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[39] V Goldberg, *Framing Contract Law An Economic Perspective* (Harvard University Press, 2006) 13–43.

[40] M Trebilcock and D Dewees, 'Judicial Control of Standard Form Contracts' in P Burrows and C Veljanovski (eds), *Introduction: The Economic Approach to Law* (1981) 93, 101–2.

limitations, the validity of this approach is often strongly challenged by many legal scholars, as the following examples illustrate.[41]

First, economic analysis is based on a crucial assumption — the perfect rationality of human nature. It assumes that the individual is the best person to decide what is best for his or her self-interest, and will not make mistakes in assessing the consequence of his or her behaviour. It is clearly not true in reality. As early as 1955, Herbert Simon convincingly pointed out the imperfect rationality of human nature.[42] We have limited computational skills and flawed memories. We are more likely to be influenced by our past experience. We tend to underestimate the possibilities of negative events, and to overestimate the possibilities of positive events.[43] Therefore, we are rationally limited rather than perfectly rational, as assumed by most economic analyses.

The major limitation of Becker's deterrence model, outlined above, is its assumption that every individual is perfectly rational, and that he or she is capable of accurately assessing of the payoff from his or her behaviour. This assumption is certainly not always correct, and as such the outcome predicted by Becker's model should be treated with caution. If this assumption is wrong, the result of economic analysis is indeed unreliable. In the case of the first illustration, it is assumed that contracting parties are able to make an accurate cost-benefit analysis of their contractual conduct. If this assumption does not hold, the analysis of the deterrence of a legal sanction is more likely to be wrong. If the fraudulent party's calculation of legal sanction cost is lower than the actual legal sanction cost which will be imposed on him or her, he or she will mistakenly believe that his or her private gain from the fraud is still positive after deducting the legal sanction cost. Clearly, his or her misjudgement undermines legal deterrence. To achieve effective legal deterrence, the size of the legal sanction should not be decided on the basis of the correct calculation of the fraudulent party's payoff, but on the basis of the party's subjective, but incorrect, evaluation. However, it is very hard in practice to gain such information, which leads on to the second major limitation of an economic analysis: the assumption of perfect information.

The analysis of aspects of contract law in all three illustrations is based on the assumption of perfect information. It assumes that the contract party

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[41] For criticism of law and economics, see R Dworkin, 'Is Wealth a Value' (1980) 9 *Journal of Legal Studies* 191; M Trebilcock, *The Limits of Freedom of Contract* (Harvard University Press, 1997); F Parisi, 'Methodological Debates in Law and Economics: The Changing Contours of Discipline' in F Parisi and C Rowley (eds), *The Origins of Law and Economics Essays by the Founding Fathers* (Edward Elgar, 2005) 33–53.

[42] H Simon, 'A Behavioural Model of Rational Choice' (1955) 69 *Quarterly Journal of Economics* 99.

[43] A Tversky and D Kahneman, 'Judgement Under Certainty: Heuristics and Biases' in D Kahneman, P Slovic and A Tversky (eds), *Judgement Under Uncertainty* (1982) 3.

always has sufficient information when making decisions. For example, it is assumed in the second illustration that consumers have sufficient information to evaluate the risk associated with the goods which they purchase, and so they can decide whether they would like to take the risk by purchasing a lower quality product. Obviously, this is an unrealistic assumption. The information available to consumers at the time of the decision is frequently very limited. This is a problem particularly associated with the purchase of 'experience goods', the quality and characteristics of which cannot be observed in advance.[44] For example, holidays are a kind of experience goods; consumers do not know the quality until they have experienced it. Another example is education. A student certainly cannot tell the quality of the education which he or she receives from the university until he or she graduates. In brief, information in reality is often imperfect. The party has to make decisions in a state of uncertainty. If the assumption of perfect information cannot be held, an economic analysis based on such an assumption is by and large unreliable.

Thus, economic analyses have serious limitations. The most valuable merit of an economic analysis of law is its predictive power. Because it uses economic assumptions and reasoning to predict people's behaviour, it can then predict how the law can modify their behaviour. If one of the assumptions on which the analysis is based is untrue, the prediction may be incorrect and the conclusion drawn from the analysis will be unreliable.

Nonetheless, despite its limitations, the insights offered by an economic analysis should not be rejected. Economic analyses of law are indeed a valuable tool for legal research. In fact no analytical method is perfect and every approach has its own limitations. Law and economics scholars have always been aware of the limitations of this approach and have been trying to improve their methods. One of the relatively new forms of economic analyses of law — behavioural law and economics — has become more popular among scholars.[45] These scholars intend to identify flaws in the traditional economic analyses and are trying to modify the long accepted assumptions, such as the perfect rationality of human nature. With the developments in this field, economic analyses of law will certainly be improved in the future.

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[44] P Nelson, 'Information and Consumer Behaviour' (1970) 78(2) *Journal of Political Economy* 311.

[45] C Jolls, C Sunstein, R Thaler, 'A Behavioural Approach to Law and Economics' (1998) 50(2) *Stanford Law Review* 1471; F Parisi and V Smith (eds), *The Law and Economics of Irrational Behaviour* (Stanford University Press, 2005).

V Conclusion

Economic analyses of law do offer valuable insights into contract law. First, they can be a tool for evaluating the effectiveness of law. Secondly, they can assist in assessing the impact of law, and identifying the winners and losers created by laws. Thirdly, they can broaden understandings of commercial behaviour, thereby improving the way in which law is evaluated.

Sometimes insights generated from economic analyses are inconsistent with lawyers' intuitions. Perhaps they may be incorrect and unreliable. But such analyses, at least, offer a different, or perhaps 'new', perspective on the law. It is the quest of law and economics scholars for innovation in legal research, which is the most valuable lesson that can be learned from studying law and economics.

> Brilliant scholarship, even if dead wrong, may have an important stimulating effect in that it induces others to do superb work that refutes the inaccurate brilliance.[46]

[46] Daniel Farber, 'The Case Against Brilliance' (1986) 70 *Minnesota Law Review* 917, 918–23.