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Against the Reductionism of an Economic Analysis of Contract Law

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Introduction

Economic analysis of law is arguably the most influential instrumentalist perspective in the legal literature. An instrumentalist theory of law requires both a theory explaining how law guides the behaviour of legal subjects to achieve particular ends and a normative theory of what those ends ought to be. This paper reveals a problem with the way economists have argued for normative theories of law in the recent literature.

Historically, economic analysts of law held that law ought to seek efficient means. In general, the end goal was taken to be maximizing welfare, narrowly understood as wealth.[1] This normative claim has generated significant academic debate and provoked much criticism. One line questioned whether the economist's normative claim was a morally correct one, arguing that wealth maximization is in itself not a moral value or, if it is, that it is not a value that the law ought to promote, or if it is a value that the law ought to promote, that it is not the sole value that the law ought to promote.[2]

Contemporary formulations of normative theories of law employed by economic analysts have attempted to respond to this line of criticism. One strategy, responsive to the third criticism above, is to argue that certain legal institutions ought to be designed to promote wealth maximization while different legal institutions ought to seek to achieve non-wealth maximizing aims, such as distributive justice.[3] Implicit in this contemporary view is a distinction drawn between

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1. For a general overview of the evaluative project in economic analysis of the law, see Lewis Kornhauser, "The Economic Analysis of Law" in *The Stanford Encyclopedia of Philosophy (Spring 2014 Edition)*, online: http://plato.stanford.edu/archives/spr2014/entries/legal-econanalysis/.
2. See Lewis Kornhauser, "Economic Rationality in the Analysis of Legal Rules and Institutions" in Martin P Golding & William A Edmundson, eds, *The Blackwell Guide to the Philosophy of Law and Legal Theory* (Oxford: Blackwell, 2005) 67.
3. The chief proponents of the contemporary view are Kaplow and Shavell. See Louis Kaplow & Steven Shavell, *Fairness Versus Welfare* (Cambridge: Harvard University Press, 2002) [Kaplow & Shavell, *Fairness*]. The central thesis in *Fairness Versus Welfare* is that the law should be evaluated exclusively by its effects on the well-being of individuals (i.e. welfare) and never by principles that give weight to factors that are independent of individuals' well-being (such as corrective or retributive justice, to which Kaplow and Shavell assign the broad label of "fairness"). This claim provoked substantial academic commentary. See, e.g., Jules L Coleman, "The Grounds of Welfare" (2003) 112:6 Yale LJ 1511; Arthur Ripstein, "Critical Notice: Too Much Invested to Quit" (2004) 20:1 Economics & Philosophy 185; Lewis A Kornhauser, "Preferences, Well-Being, and Morality in Social Decisions"(2003) 32:1 J Leg Stud 303; Jeremy Waldron, "Locating Distribution" (2003) 32:1 J Legal Stud 277. This essay does not engage in the debate at the level of substantive moral theory; it assumes, with Kaplow and Shavell, that the sole normative criterion for evaluating law should be welfare.

legal institutions and legal systems: a legal system can achieve a broad range of values through different legal institutions. However, in order to preserve the normative claim that the *sole* aim of any single legal institution should be the promotion of wealth maximization, economists are pressed to make a further assumption: each legal institution must be organized around a single normative criterion, partitioned from and without regard to the normative aims of other legal institutions.[4] The question is whether wealth maximization can ever be the sole aim of any single legal institution, much less every institution within the same legal system. In this paper, I show why the assumption that this partitioning is possible is problematic and must be defended instead of simply assumed, as it has been by the authors I will consider.

I argue that, on the instrumentalist view, the normative justification of the ends of a particular legal institution cannot ignore the normative aims of the legal system of which it is a part. Within a single legal system, this idea of a strict normative division of labour between institutions is problematic. In developing this argument I focus on one of the more recent and clearest articulations of the contemporary economist's perspective: Schwartz and Scott's normative theory of contract law.[5] Though my focus is on a claim made by economic analysts of law, my argument has broader implications for instrumentalist theories of law more generally.

Schwartz and Scott's article "Contract Theory and the Limits of Contract Law" begins with the proposition that there can be no comprehensive normative theory of contract.[6] They argue that single value theories are unsuccessful in dealing with diverse contractual contexts while pluralistic theories lack a "meta-principle" to weigh and resolve competing values.[7] Instead, Schwartz and Scott claim that the values which legal institutions should be designed to promote are context-dependent. Efficiency, fairness, and the protection of individual autonomy may all be legitimate aims depending on the social context and should be pursued through institutions that most effectively realize those aims. Accordingly, they undertake the more modest project of developing a normative theory for a limited universe of social relations: the subcategory of contracts between sophisticated commercial firms, what they call "Category 1" contracts.[8]

The focus of this essay is on a further claim that Kaplow and Shavell make in defense of their broader thesis. Kaplow and Shavell argue that, while concerns about the overall distribution of income are encompassed by the welfare economics approach, legal rules should be evaluated according to the goal of wealth maximization, and distributive aims can be ignored because distribution should be addressed more directly using income tax and transfer programs. Part II of this essay provides a more detailed discussion about distributive objections to normative economic analysis of law.

4. Kaplow states the principle in general terms: "It is generally best to use a separate instrument to address each distinct problem; moreover for each problem it tends to be desirable to employ the instrument that addresses it most directly." Louis Kaplow, "Taxes, Permits, and Climate Change" in Gilbert E Metcalf, ed, *U.S. Energy Tax Policy* (New York: Cambridge University Press, 2011) 168 at 186.

5. Alan Schwartz & Robert E Scott, "Contract Theory and the Limits of Contract Law" (2003) 113:3 Yale LJ 541 [Schwartz & Scott, "Limits of Contract Law"].

6. *Ibid* at 543.

7. *Ibid*.

8. *Ibid* at 544.

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Schwartz and Scott's theory of commercial contracts is based on the evaluative criterion of profit maximization.[9] Their position is that aggregate wealth is maximized by the satisfaction of parties' preferences through market exchange; profit-seeking firms increase wealth by freely entering into efficient transactions. Their empirical claim is that contractual exchange is the most effective means to maximize wealth. Their normative claim is that contract law should do nothing more than facilitate firms' efforts to make efficient trade and investment decisions that maximize the contractual surplus.[10]

The efficiency theory of commercial contracts leads Schwartz and Scott to draw several conclusions about the efficacy of the "legal default project" and mandatory contract rules such as those found in the Uniform Commercial Code (the "UCC").[11] They argue that most, if not all, state-created default rules and standards are useless and inefficient; such rules result in increased transaction costs associated with parties negotiating and drafting around them.[12] Default rules that apply to a limited set of possible outcomes, are simple in form and benefit a wide range of parties, are inefficient because it is too costly for legislators to create them.[13] Default standards are undesirable because they provide parties with little or no ex ante guidance and create the risk of moral hazard.[14] Further, an efficiency-based theory of contract would require that most, if not all, contract rules should be optional. Mandatory rules reflect a paternalism that is inconsistent with a "commitment to party sovereignty" and should be considered only in the limited circumstances of preventing externalities and ameliorating a market failure that disclosure cannot cure.[15] Default and mandatory rules regulating contracts fail to meet the efficiency criterion and should be curtailed.

The key insight of Schwartz and Scott's efficiency theory is that contract law has an extremely limited role to play; the state's involvement should be restricted to the enforcement of efficient agreements and the narrow interpretation of contractual terms.[16] They observe that agreements are largely self-enforcing[17] but that legal enforcement is necessary in limited cases to prevent fraud and ex-ante duress;[18] to ensure performance when non-performance coupled with volatile markets could threaten a counterparty's survival;[19] and to encourage and facilitate

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9. *Ibid.* Schwartz and Scott, at various times, use the terms "welfare" (*ibid*), "wealth" (*ibid* at 550) and "profit" (*ibid* at 545) when making their argument. I understand them to be making a normative claim defending welfare maximization narrowly understood as wealth or profit maximization. The general structure of their argument is that commercial "firms rationally pursue the objective of maximizing profit" (*ibid* at 551) and, therefore, commercial contract law should facilitate firms in doing so. Accordingly, the right way to understand Schwartz and Scott's claim is as an argument for commercial contract law to be designed according to the evaluative criterion of profit maximization.

10. *Ibid*.

11. *Ibid* at 594-609.

12. *Ibid* at 594.

13. *Ibid* at 608.

14. *Ibid* at 601-08.

15. *Ibid* at 608-09.

16. *Ibid* at 546-47.

17. *Ibid* at 557-59.

18. *Ibid* at 565-68.

19. *Ibid* at 562-65.

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relationship-specific investments.[20] In interpreting contracts, courts should adopt a strict textualist approach that adheres to the ordinary or "majority" meaning of the words used, honor merger clauses and apply a hard parol evidence rule.[21] However, the interpretive theory that should be employed is ultimately for the parties to choose; courts should comply with requests made by firms to broaden the evidentiary bases applicable when interpreting their agreements.[22]

Since its publication in 2003, "Contract Theory and the Limits of Contract Law" has provoked considerable commentary. Much of the criticism has been directed at Schwartz and Scott's prescriptive claim that contracts ought to be interpreted using a strict formalist approach; critiques to which they responded in a subsequent article.[23] In this paper I focus on the general structure of their argument. Specifically, I argue that their "larger project arguing that the law should pursue the first order goal of maximizing contractual surplus when it chooses rules to regulate merchant-to-merchant contracts"[24] rests on problematic assumptions—a critique that goes beyond the debate that has circulated since the article was published.

The claim that contract law should be restricted solely to facilitating efficient market transactions is vulnerable to several objections, which Schwartz and Scott anticipate and attempt to address.[25] In this paper I focus on two objections. First, the negative externalities objection: that promoting the self-interested profit motives of firms would result in harmful effects which the law should deter. Second, the value objection: that the state should pursue fairness and distributional goals in addition to efficiency.[26] Schwartz and Scott employ the same general strategy in answering both the value and externalities objections. They argue that negative externalities that result from transactions of profit-motivated firms are more effectively mitigated through legal and regulatory institutions other than contract law. Further, they do not deny the legitimacy of values such as fairness and distribution, which may conflict with efficiency; they acknowledge that the market functions to "maximize welfare, subject to distributional and fairness constraints".[27] But they argue that such values are better promoted through separate legal institutions that overlay the free market (e.g., a market economy based on private property and contract coupled with a redistributive system of tax and transfer). Consequently, Schwartz and Scott's general efficiency theory of contract relies heavily on the "specialization principle": contract law should be solely focused on promoting efficiency because we can assume that other specialized legal institutions will ameliorate market failures and promote other values.[28]

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20. *Ibid* at 559-62.
21. *Ibid* at 547-50, 584-91.
22. *Ibid* at 547.
23. Alan Schwartz & Robert E Scott, "Contract Interpretation Redux" (2010) 119:5 Yale LJ 926.
24. *Ibid* at 928.
25. Schwartz & Scott, "Limits of Contract Law", *supra* note 5 at 545.
26. *Ibid* at 545-46.
27. *Ibid* at 549.
28. *Ibid* at 555.

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In this paper I argue that Schwartz and Scott's conception of institutional specialization is inadequate and, as a result, they are too quick in making the critical assumption that other institutions can or will adequately address the problems that inevitably arise from solely promoting narrowly self-interested behaviour. In Part I, I will show that Schwartz and Scott take negative externalities arising from firm-to-firm transactions as *known* and ignore the fact that such transactions may create new social harms requiring new institutional solutions. That is, they fail to acknowledge that institutional specialization, on their approach, takes a *reactive* rather than *proactive* posture in addressing negative externalities. Their theory fails to recognize that the choice between reactive versus proactive institutions is itself a question of political value; as a result, they simply assume rather than argue for the former. This reflects a more general methodological criticism of the economic analysts' approach to contract theory: by focusing on how rules affect the efficiency of individual transactions, the impact of such transactions on institutional structures as a whole is ignored. In Part II, I argue that the *strong form* of institutional specialization espoused by Schwartz and Scott, in which different policy aims are strictly compartmentalized, is untenable; it calls for the promotion and cultivation of purely self-interested motivations in one sphere of activity (i.e. efficient market transactions) while expecting legal subjects to support and comply with institutions designed to realize redistributive aims (e.g. taxation). I suggest that a *weak form* of institutional specialization may allow for the promotion of particular ends by specific institutions, subject to the condition that they not be designed in a way which compromises the integrity of the legal system of which they are a part.

Part I

Many would argue that the single-minded pursuit of profit-maximization leads firms to "do bad things" such as pollute the environment, exploit workers, and create barriers to market entry.[29] Further, most would agree that the law should deter or, at the very least, not promote such behaviour. Despite accepting both these propositions, Schwartz and Scott maintain that commercial contract law should be designed with the *sole* aim of promoting self-interested and profit-motivated trade and investment by firms. They acknowledge that the activities of firms may cause social harms, but a key premise of their theory is that an "analysis of contract law as such… can assume the absence of externalities."[30] In making this assumption, they rely on the "specialization principle" to argue that negative externalities should be regulated by dedicated institutions such as environmental, employment and antitrust laws and not by contract law.[31] However, Schwartz and Scott's discussion of the externalities objection and their general claim that all externalities can be ignored when constructing a normative theory of contract conflates three distinct lines of argument, which track three different

29. *Ibid* at 545-46, 555.
30. *Ibid* at 546.
31. *Ibid* at 555.

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types of externalities. When we separate them and examine each independently, we can see more clearly that, while Schwartz and Scott may be correct in a limited sense with respect to certain externalities, their broader claim fails.

First, we might think that externalities that bear little or no direct relationship to contract can be ignored when constructing a normative theory of contract law. An example of this kind is pollution.[32] Harms such as the over-consumption of non-renewable resources, water pollution, and excess carbon emissions are more effectively addressed through targeted environmental laws and regulations, and further, such regulations relate to the use and ownership of *property*, not contract. As an economist would put it, "the main allocative function of property rights is the internalization of beneficial and harmful effects";[33] the problem of environmental pollution is an example of such harmful effects and as such the solution lies in modifying property rights. Environmental externalities are addressed by asking when we should prefer private ownership, common ownership or state regulation of property. So, for example, the social costs of carbon emissions associated with private industrial activity may be addressed by creating a tax or placing restrictions on such activities; the risk of over-fishing may be managed through market-based quota systems; and the overuse and pollution of public parks and beaches may be addressed through regulated use of common property or by modifying incentives through privatization. In each case the institutional response is to modify property rights. What does not make sense is to ask how contract law doctrine could be designed to remedy concerns regarding environmental pollution; such externalities emanate from the use and ownership of property, not contractual exchange. That is not to say that such policies won't have an impact on the negotiation of contracts; once environmental law policies define property rights and restrictions they may influence the terms of an agreement, but they will not shape contract doctrine. I agree with Schwartz and Scott on this line of argument: analysis of contract law can ignore externalities that are not causally attributable to contract law. However, this does little to support Schwartz and Scott's general claim that contract theory may ignore *all* externalities. The salient types of social harms are those that arise from contracts, which is where the analysis should be focused.

A second type of externality does relate directly to contractual relationships but is caused by structural asymmetries between the parties. An example of this is contracts for employment. Workers are vulnerable because there is an imbalance of bargaining power inherent in the employee/employer relationship. Schwartz and Scott acknowledge that profit-maximizing firms may engage in practices that negatively impact workers, but argue that externalities that reflect asymmetries intrinsic to the relationship between the parties are more effectively addressed through targeted legal institutions.[34] Employment and labour law

32. Schwartz and Scott use the example of pollution and environmental law several times in making their argument. See *ibid* at 545-46, 555.

33. Harold Demsetz, "Toward a Theory of Property Rights" (1967) 57:2 American Economic Rev Papers & Proceedings 347 at 350.

34. Schwartz and Scott point to employment law both as grounds for restricting the scope of their theory to commercial contracts (i.e., employment law regulates firm-to-individual contracts)

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policies such as minimum wage requirements, maximum standard workweeks, and collective bargaining rights are designed to improve the bargaining position of workers. Another example, which reflects a different kind of asymmetry between contracting parties, is consumer protection law.[35] Consumer protection laws are, in part, aimed at assisting consumers in making better-informed choices in the market by requiring detailed disclosure of information about products. They are designed to ameliorate the information asymmetries inherent in the manufacturer/customer relationship. Schwartz and Scott provide a short answer to why contract law can ignore this second category of externalities: their theory addresses only commercial contracts between firms.[36] That is, they assume that contracting parties possess a level of commercial sophistication that does not make them vulnerable to harm which is a function of the parties' relationship.[37] I agree that it is sensible to establish a specific regime of regulation to address issues that are symptomatic of a particular kind of relationship; it is more effective to have a specialized body of law to address harms that repeatedly arise because of who the parties are. However, even if we accept this argument, the question remains: how do we identify such special relationships? This paper aims to address Schwartz and Scott's argument on its own terms, so I will not critique their decision to limit their inquiry to sophisticated parties, but it is worth noting that they do not provide an account of *when* a particular type of contractual relationship becomes important enough to warrant a targeted regime of its own. There is no discussion of the factors that motivate relational asymmetries; they simply ascribe such differences to a matrix of contractual relationships based on the broad categories of "firm" and "individual".

This leaves the third and final type of externality: those that arise directly from firm-to-firm contracts. Schwartz and Scott appear to provide two arguments to support their assertion that contract theory can also assume that externalities of this type are absent. First, they claim that, "as a descriptive matter, most commercial contracts affect only the parties to them", whereas externalities are caused by "a firm's *systematic* decisions that may affect third parties in material ways."[38] Their theory assumes that there is no causal relationship between the regulation of a "single contract" and "systematic" behaviour; thus, they conclude that "transactions regulated by contract law do not create externalities, unless there is a particular reason to believe that they do."[39] The implication is that normative contract theory should evaluate the impact of legal rules on a transaction-by-transaction basis. Schwartz and Scott's analysis of contract doctrine throughout reflects this methodology; they employ economic modeling to demonstrate how

and in making their assumption regarding externalities. See Schwartz & Scott, "Limits of Contract Law", *supra* note 5 at 544, 555.

35. Schwartz and Scott point to consumer protection law as an example of Category 3 contracts, i.e., consumer protection law regulates contracts which firms enter into with individuals, in their capacity as consumer. See *ibid* at 544.

36. *Ibid.*

37. Schwartz and Scott further refine the general "firm-to-firm" subcategory by restricting their discussion to only those firms that are "sophisticated economic actors". See *ibid* at 545.

38. *Ibid* at 555, emphasis in original.

39. *Ibid*.

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a particular rule (e.g., the prohibition of bans on modification) impacts on the profit maximizing behaviour of parties in a *particular transaction*.

Second, Schwartz and Scott argue that, to the extent that a firm engages in "[s]ystematically inefficient or unfair behavior" it will be "subject to legal regulation" through other institutions.[40] They cite the examples of environmental, employment and antitrust laws in support of this specialization principle. But, as I have shown in the foregoing discussion, environmental and employment law are of no help in supporting the argument that we can ignore this third type of externality. The former deals with costs associated with property law, not contract law, and the latter remedies structural asymmetries inherent in the contractual relationship; neither is an institutional response to a harm arising solely from *firm-to-firm contracts*. However, antitrust law is an example of an institutional response to negative externalities that arise from commercial contracts. For example, exclusivity agreements may have deleterious effects on the market by erecting barriers to entry and competition.[41] Schwartz and Scott argue that contract law doctrine need not address such anti-competitive behaviour; antitrust laws operate to restrict such harmful behaviour. Accordingly, they conclude that externalities of this type can also be disregarded in constructing a normative theory of contract.

Both of Schwartz and Scott's arguments suffer from serious flaws. First, their claim that commercial contracts do not create externalities is unsupported and descriptively false. Schwartz and Scott's article was published before the financial crisis of 2008 (the "Global Financial Crisis"), which resulted in the most serious global economic recession since the Great Depression.[42] The Global Financial Crisis was a complex event resulting from multiple interconnected factors. While the U.S. mortgage and housing collapse instigated the Global Financial Crisis, it is generally accepted that over-the-counter ("OTC") derivatives contracts played an important role in exacerbating the negative consequences. Very generally, an OTC derivative is a financial contract between two parties in which the parties specify conditions under which payments are to be made between them based on an underlying reference asset (e.g., interest rates, the price of oil, etc.). The U.S. Senate Subcommittee on Investigations, which issued a report analyzing the causes of the Global Financial Crisis, identified "a variety of troubling and sometimes abusive practices involving the origination" of OTC derivatives by investment dealers as a key factor in precipitating the Global Financial Crisis.[43] Investment dealers such as Goldman Sachs and

40. *Ibid*.
41. *Ibid* at 546.
42. See, e.g., the speech given by Ben Bernanke, Chairman of the Federal Reserve, discussing the causes and effects of the Global Financial Crisis: Ben S Bernanke, "Four Questions About the Financial Crisis" (Speech delivered at the Morehouse College, Atlanta, Georgia, 14 April 2009), online: The Board of Governors of the Federal Reserve System (US) www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm.
43. US, Permanent Senate Subcommittee on Investigations, Committee on Homeland Security and Government Affairs, *Wall Street and the Financial Crisis: Anatomy of a Collapse*, (S Hrg 112-675) at 319, online: www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf.

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Deutsche Bank "set up structured finance transactions which enabled them to profit at the expense of their clients"; created and marketed OTC derivatives contracts using underlying reference assets "that senior employees within the investment banks knew were of poor quality"; sold OTC derivatives contracts "without full disclosure of the investment bank's own adverse interests"; and "exploit[ed] conflicts of interest with the firm's clients".[44] As a result, leaders of the G20 nations have made commitments to implement a comprehensive legal framework for the regulation of OTC derivatives contracts.[45] The role of OTC derivatives contracts in causing the negative externalities associated with the Global Financial Crisis directly contradicts Schwartz and Scott's claim that "transactions regulated by contract law do not create externalities." OTC derivatives fall directly within the sphere of "Category 1" contracts between commercial firms that is the subject of Schwartz and Scott's normative theory. It was the profit-motivated behaviour of sophisticated firms entering into derivatives contracts that contributed to the social harms realized during the Global Financial Crisis.

To this objection Schwartz and Scott might respond that commercial contracts *generally* do not create negative externalities "unless there is a particular reason to believe they do" and, in the event that they do, institutional responses such as proposed OTC derivatives regulation are better suited to handle them than contract law.[46] But this reveals the flaw in the second part of their argument: Schwartz and Scott fail to tell us *when* there is a "particular reason" to believe that contracts between firms will give rise to externalities. That is, they do not provide an account of when or how single commercial contracts between sophisticated parties may rise to the level of "systematic" behaviour that we should be worried about. Instead, they simply make the assumption and then focus on analyzing the impact of contract doctrine at the level of a single transaction. The overemphasis on individual transactions has been leveled as a critique of economic analysis of contract law; contract scholars have noted that economic analysts often neglect the impact of doctrinal rules at the institutional or systemic level.[47] Schwartz and Scott's argument here is a perfect example of just such blind spots in economic analysis of contract law.

To the extent that Schwartz and Scott's analysis does recognize the presence of externalities, it takes them to be a *known quantity*; they assume that we already know the social harms that profit-maximizing firms create and that we have institutional protections in place to mitigate such harms. But, as the Global

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44. *Ibid*.

45. See G20, *Leaders' Statement: The Pittsburgh Summit*, 24-25 September 2009, online: https://g20.org/wp-content/uploads/2014/12/Pittsburgh_Declaration_0.pdf.

46. Schwartz & Scott, "Limits of Contract Law", *supra* note 5 at 555.

47. See, e.g., Eisenberg's discussion of the theory of efficient breach wherein he criticizes economic analysis for taking "a static and short-run approach to the issue of breach, because it addresses only the efficiency of performing or breaching an individual contract" rather than a "dynamic, long-run approach to the issue of breach [which] addresses the efficiency of the contracting system as a whole." Melvin A Eisenberg, "Actual and Virtual Specific Performance, the Theory of Efficient Breach, and the Indifference Principle in Contract Law" (2005) 93:4 Cal L Rev 975 at 1012.

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Financial Crisis demonstrates, such institutions are created *after* the harm has already been suffered; OTC derivatives regulation is an institutional *reaction* to the harm caused by investment dealers and the use of complex financial contracts. Other examples relied upon by Schwartz and Scott to support their argument for institutional specialization, such as securities law and antitrust law, also reflect the same dynamic. The *Securities Act of 1933* was introduced in response to the Wall Street Crash of 1929; it introduced the regulation of the distribution of new securities by ensuring that companies disclose sufficient information in order to allow investors to make an informed decision about whether or not to purchase securities. Similarly, antitrust law such as the *Sherman Antitrust Act* and the *Clayton Antitrust Act* were created to prevent the anticompetitive behaviour of firms of the time, such as the Standard Oil Company, that were seen to be damaging to the economy as a whole. In these cases, self-interested market actors engaged in behaviour, including entering into agreements, that resulted in negative externalities which were subsequently addressed through new forms of regulation.

In one sense, Schwartz and Scott's argument for institutional specialization is convincing: externalities can be more effectively handled through specialized institutions. But they neglect a critical element of the specialization principle, as they utilize it: if contract law does ignore externalities, other institutions will be *reactive* and not *proactive* in the sense that they respond to social harms only after they materialize rather than aim to prevent them from happening in the first place. We are faced with a choice. One could argue that we ought to prefer institutional arrangements that promote unrestrained self-interested behaviour in the private arena, with other institutions playing catch-up to regulate harms that periodically arise as a result; call this the "Reactive Approach". Conversely, one could argue that we should prefer that broad standards of market conduct be imposed in order to temper self-interest and prevent, or at least moderate, social harms before they occur; call this the "Proactive Approach". The Reactive and Proactive Approaches to negative externalities reflect fundamentally different pictures of society. The former places greater value on profit maximization at the cost of suffering harms that may eventually arise and can be responded to only once they have materialized. The latter accommodates growth in the market subject to limitations that are aimed at preventing the cultivation of behaviour that would create harm in the first place. The question of which of these two approaches we ought to prefer is a question about the values of the community and how they are reflected in its legal and political institutions. In either case, the position must be defended; it cannot simply be assumed. Schwartz and Scott's argument for institutional specialization implicitly endorses the Reactive Approach without defending that choice.

The Reactive/Proactive dimension of the principle of institutional specialization has implications at a lower level of abstraction; it can also motivate normative arguments for and against specific contract doctrine. Consider the obligation to act in good faith in contract law. The doctrine has its origins in the common law but has come to be codified in sections of the UCC and expressed as a principle in

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the *Restatement (Second) of Contracts*.[48] The UCC provides that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."[49] Good faith is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing."[50] Importantly, the obligation to act in good faith is mandatory and cannot be disclaimed by agreement between the parties.[51] Similarly, the *Restatement* provides that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement".[52] Very generally, the concept has been employed by U.S. courts to ensure that parties do not try to regain what they have bargained away as part of the contract when things go badly and to ensure that one party, through a failure to cooperate, does not prevent another from performing under the terms of the contract.[53] Unlike the law in continental jurisdictions, U.S. contract law does not require parties to bargain in good faith; American contract law requires parties to act in good faith only once a contract has been created, whereas continental contract law requires parties to negotiate in good faith prior to formation.[54] Similarly, in a recent judgment, the Supreme Court of Canada held that the general principle of good faith underlying contract law gives rise to a common law duty of good faith in performance, which requires parties to be honest with each other in relation to the performance of their contractual obligations.[55] A comprehensive analysis of when the doctrine of good faith has been applied and how it has been interpreted is beyond the scope of this paper; the issue is how it would be evaluated under the Reactive and Proactive Approaches.

Schwartz and Scott's efficiency-based theory rejects the obligatory standard of good faith in contract law. As discussed above, they claim that general standards, such as "'reasonably,' 'conscionably,' 'fairly,' [and] 'in good faith,'" fail to satisfy the evaluative criterion of efficiency because they do not provide parties with ex ante guidance and they create unacceptable moral hazard.[56] Further, they argue that "[t]he rules regulating contracts between business firms thus should be mandatory only when the parties' contract creates an externality or is the product of market failure"[57]; dismissing any other justification as a form of "paternalism" that "override[s] the parties' expressed preferences out of concern for the parties' welfare."[58] The examples of acceptable mandatory rules that Schwartz and Scott offer reflect the Reactive Approach to addressing externalities through institutional design: externalities such as price-fixing should be prevented by mandatory anti-competition laws and the failure of the market to protect consumers

48. Peter Linzer & Joseph M Perillo, eds, *Corbin on Contracts*, revised ed, vol 6 (Lexis Nexis, 2010) at § 26.8.
49. UCC § 1-304 (2014).
50. *Ibid* at § 201(b)(20).
51. *Ibid* at § 302(b).
52. *Restatement (Second) of Contracts* § 205 (1981).
53. Linzer, *supra* note 48 at § 26.8.
54. *Ibid* at § 26.9.
55. *Bhasin v Hrynew*, 2014 SCC 71, [2014] 3 SCR 295 [*Bhasin*].
56. Schwartz & Scott, "Limits of Contract Law", *supra* note 5 at 601.
57. *Ibid* at 618.
58. *Ibid* at 610.

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should be remedied through strict liability rules in tort.[59] Again, they do not offer an account of how to prevent potential externalities or market failures such as those that culminated in the Global Financial Crisis; in both examples, institutions respond to a known social harm or failure in the market arising from the profit-motivated behaviour of firms. For Schwartz and Scott, a mandatory rule is justified if it prevents an externality, but only one that we can point to, not one which we might foresee. Thus, their efficiency-based theory of contract and its commitment to the Reactive Approach has no room for a standard of general application requiring parties to act in good faith.

In contrast, the Proactive Approach points to a different conclusion. The aim of the Proactive Approach to contract law would be to prevent externalities by designing doctrine that does not promote the type of behaviour that may lead to social harms. For example, the failure of investment dealers to disclose conflicts of interest when creating and marketing OTC derivatives, the broker's omission of material risks about a company when issuing new securities, and the manufacturer's failure to clearly label the products it manufactures with their associated risks all reflect bad faith dealing in which self-interest motivates the non-disclosure of material facts at the time of contract formation. Rather than waiting until after the harm to OTC derivative counterparties, purchasers of securities, and consumers of commercially manufactured products materializes, and addressing it through OTC regulations, securities law, and consumer protection/strict liability in tort, the Proactive Approach would recommend an evaluative standard of general application, such as good faith, which imposes a requirement of ethical behaviour on contracting parties. Accordingly, the Proactive Approach to externalities would support not only the mandatory application of a good faith standard (as is currently the case in U.S. and Canadian common law) but would extend the application of such a standard to negotiations and dealings prior to contract formation (as is the case in continental law). Such a standard would require parties to an agreement to deal with honesty and in a fair manner with their counterparty, both during negotiations and after a contract has been made. The economist might object that such an ambiguous standard would cause firms to act more cautiously, take fewer risks and therefore diminish the effectiveness of the market in creating wealth.[60] But this is precisely the point: the question is whether a highly efficient market which may, from time to time, create harms that, once realized, require an institutional response is better than a somewhat less efficient market that aims to prevent those harms from ever happening in the first place.

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59. *Ibid* at 609-10.

60. The Supreme Court of Canada considered the claim that a good faith standard would create uncertainty that would negatively impact on commercial contracts. The Court stated that "[r]ecognizing a duty of honesty in contract performance poses no risk to commercial certainty in the law of contract. A reasonable commercial person would expect, at least, that the other party to a contract would not be dishonest about his or her performance." Because of the bijural nature of the Canadian legal system, the Court pointed to the experience under the *Civil Code of Québec* which "recognizes a broad duty of good faith which extends to the formation, performance and termination of a contract" to respond to the worry of uncertainty. See *Bhasin*, *supra* note 55 at paras 80-83.

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The aim of this Part is not to advocate for one view over the other, though I think there are good arguments to be made in favour of the Proactive Approach; rather I have argued that the manner in which Schwartz and Scott employ the institutional specialization principle to answer the negative externalities objection is incomplete. They fail to acknowledge the institutional dynamic of the Reactive Approach to the problem of externalities, which their theory adopts. Consequently, they simply assume, rather than argue for, an important question of political value.

Part II

The value objection to Schwartz and Scott's efficiency-based theory of contract argues that the law should promote values other than just profit-maximization. A common criticism leveled at economic theories of law is that the normative aim of maximizing aggregate wealth comes at the cost of ignoring other values such as distributive justice. Schwartz and Scott accept that distribution and fairness are valid and legitimate aims that should be pursued through legal institutions, just not through contract law.[61] Thus, the structure of their argument in answer to the value objection is the same as to the externalities objection: they rely on the institutional specialization principle to argue that "efficiency is the only institutionally feasible and normatively attractive goal for contract law that regulates deals between firms" because other institutions are better-suited to realizing other valid social aims.[62]

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61. Others have defended the view that distributive justice does have a place in contract law. Anthony Kronman argues that "contract law should be used to implement distributional goals whenever alternative ways of doing so are likely to be more costly or intrusive". Anthony T Kronman, "Contract Law and Distributive Justice" (1980) 89 Yale LJ 472 at 474. Much of Kronman's argument is in answer to libertarian claims that redistribution away from voluntary transactions is never justified; his arguments in this respect are less pertinent for my present argument because Schwartz and Scott do not deny that redistribution is a legitimate aim. Kronman also rejects liberal arguments that redistribution should be achieved solely through a system of taxation because it is the least intrusive and most neutral means. He argues that taxation may not always be the most neutral (taxes discriminate in the sense that they treat different people differently) or the least intrusive (taxes "cast a shadow" over every economic decision). Ultimately, Kronman believes that the question of whether taxation or contract law is the best means for realizing distributional aims is an empirical one that "will depend, in any particular case, on circumstantial factors; neither method is inherently superior to the other." (*Ibid* at 475). Kronman's view that there is no reason in principle to seek justice only through taxation is consistent with the argument I develop here, but narrower: where Kronman allows that it is possible to seek justice through contract law, my argument below attempts to show that, in designing a just legal system, the principles of justice *cannot* be dispensed with when justifying a legal institution such as contract. See also Aditi Bagchi, "Distributive Justice and Contract" in Gregory Klass, George Letsas & Prince Saprai, eds, *Philosophical Foundations of Contract Law* (Oxford: Oxford University Press, 2014) 193. Bagchi argues that the inclusion of distributive concerns in contract law is not justified on instrumental grounds (i.e., that contract law should be used to achieve just distributive effects); instead, because contract law itself is contingent on political institutional arrangements, the principles of justice condition the content of rules governing contractual exchange. By contrast, the argument I develop here attempts to critique the economists' view on its own terms—that is, I assume institutions are instrumentally justified, and discuss institutional design in light of that background assumption.

62. Schwartz & Scott, "Limits of Contract Law", *supra* note 5 at 546.

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The clearest example of this is a market economy, based on private property and contract, coupled with a redistributive system of taxation. The former is designed to increase total wealth, while the latter distributes that wealth according to some principle of economic justice. According to the logic of Schwartz and Scott's argument, the sole institutional role of commercial contract law is to maximize profit and, because firms are better at maximizing profit, "a contract law that regulates firms should be the contract law that firms would prefer generally to apply";[63] any redistributive concerns should be addressed by the tax system alone.[64] Their approach to the institutional specialization principle isolates and assigns each legitimate social aim to a particular institution; there is no room for the values promoted by one to bleed into another. Thus, Schwartz and Scott espouse what I will call "Strong Form" institutional specialization, pursuant to which different social values are strictly compartmentalized. This allows them to develop a theory of contract law with the *exclusive* aim of promoting profit maximization.

However, Strong Form institutional specialization presents a challenge to Schwartz and Scott's theory. The basic argument is that it is untenable to design legal institutions to promote only the self-interested motivations of legal subjects

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63. *Ibid* at 549.

64. This claim has been vigorously defended by Kaplow and Shavell. They provide three arguments for why distributive concerns may be ignored when analyzing legal rules and claim that the appropriate social goal is "'wealth maximization': maximizing the total dollar value of, or willingness to pay for social resources." Kaplow & Shavell, *Fairness*, *supra* note 3 at 35. First, as a matter of analytical convenience, economists develop stylized models in which the distribution of income is assumed to not affect social welfare in a particular domain (e.g., accident prevention and incentives in tort law); this permits a beneficial form of academic specialization where "each work seeks to make a contribution without necessarily being concerned with all aspects of the enterprise". (*Ibid* at 32, n 35). Second, they claim that "many legal rules probably have little effect on the distribution of income." (*Ibid* at 33). Third, even where legal rules may have distributive effects, they can be ignored because "distributional objectives can often be best accomplished directly, using the income tax and transfer (welfare) programs." (*Ibid*). It is more efficient to realize distributive aims through taxation rather than through legal rules because it is less distortionary: redistribution through legal rules entails both the inefficiency of redistribution generally (due to adverse effects on work incentives) and the additional cost associated with adopting less efficient legal rules, whereas redistribution solely through the tax system suffers from the single distortion of the labour-leisure choice in the market. (*Ibid* at 33-36). See also Louis Kaplow & Steven Shavell, "Why the Legal System Is Less Efficient than the Income Tax in Redistributing Income" (1994) 23:2 J Legal Stud 667.

For an economic efficiency-based critique, see Chris Sanchirico, "Deconstructing the New Efficiency Rationale" (2001) 86:5 Cornell L Rev 1003. Sanchirico argues that the double-distortion reasoning is flawed for two reasons. First, the double-distortion argument is a non-sequitur because legal rules have a differential or distributive effect even where the application of the legal rule does not turn on taxable attributes; it only considers the redistribution of income and not the distributive impact on parties on a non-income basis. Second, even in respect of the redistribution of income the argument is problematic because, in making their argument, Kaplow and Shavell fail to account for the fact that distortions may counteract each other; the overall impact of distortions cannot be understood as a simple additive exercise. See also Richard S Markovits, "Why Kaplow and Shavell's 'Double-Distortion Argument' Articles are Wrong" (2005) 13:3 George Mason L Rev 511. For a behavioural economics-based critique, see Christine Jolls, "Behavioral Economics Analysis of Redistributive Legal Rules" (1998) 51 Vand L Rev 1653. Jolls points to empirical evidence to weaken Kaplow and Shavell's assumption that redistributive legal rules and taxation have equal distortionary effects on work incentives. The argument I develop here is not based on the relative efficiency of legal rules versus taxes.

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and expect those same legal subjects to support and comply with institutions with aims, such as distributive justice, that are contrary to their self-interest. What does it mean to say that this is untenable? The difficulty manifests in two ways.

First, any normative justification of a legal institution must consider the negative effects that such a rationale may have on the motivation of individuals to support just institutions. The problem of moral motivation presents an important challenge to the demands that justice places on individuals. This problem persists even where the demands of justice are placed on institutions; individuals must be motivated to support the establishment and maintenance of just institutions. But Strong Form institutional specialization exacerbates this psychological difficulty by its insistence on a strict partition of aims: it promotes self-interested aims in certain realms and quarantines other-regarding aims into specific institutional spaces.

My argument against Strong Form institutional specialization is similar in spirit to G.A. Cohen's critique of John Rawls' institutional theory of justice. Cohen's target is the Rawlsian view that the principles of social and economic justice apply only to those political institutions that comprise the basic structure of society.[65] While his argument is subtle and complex, one of its themes is that it is untenable to, on the one hand, accommodate (or promote) the selfish motivations of individuals, and on the other, expect those same individuals to support just institutions. Therefore, Cohen concludes that, as a matter of normative political philosophy, principles of justice ought to apply both to society's institutions and to the choices that individuals make within those institutions.[66] Thomas Nagel identifies the division of moral labour between individuals and institutions as a challenge to the stability of liberal societies; attempts to externalize the impartial demands of justice through institutions depend on the internal motivation of individuals acting within such institutions to sustain them.[67] One of Nagel's central insights is identifying the way in which the stability of political and legal institutions rests on how they reconcile the impersonal standpoint of the collective with the personal standpoint of the individual; an ideal theory would have us design institutions which would "allow everyone to be publicly egalitarian and privately partial."[68] But, Nagel concludes, such an ideal is a "pipe dream" when it comes to actual legal and economic institutions and the individual motivation necessary to support and sustain them.[69] While these debates are engaged at an abstract level of normative political theory, the arguments are germane to the value objection to Schwartz and Scott's contract theory: the assumption that competing values can be partitioned and pursued through targeted institutions, and that the goal of welfare maximization, narrowly understood, can be pursued through one institution without having a corrosive effect on the goals pursued by another, is problematic.

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65. GA Cohen, "Where the Action Is: On the Site of Distributive Justice" (1997) 26:1 Phil & Pub Affairs 3.
66. *Ibid* at 3.
67. Thomas Nagel, *Equality and Partiality* (Oxford: Oxford University Press, 1995) at ch 6, 9, 10.
68. *Ibid* at 86.
69. *Ibid*.

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This point can be illustrated with an example. Schwartz and Scott's claim is that contract doctrine should be designed with the sole aim of facilitating the satisfaction of firms' preferences, in order to maximize the aggregate social welfare, because institutions like tax law can take care of redistributing those welfare gains. The picture that they paint is one in which contract law facilitates and encourages firms to maximize profits while expecting those same firms to support and comply with redistributive systems of taxation. However, experience shows that, as a descriptive matter, this is a difficult position to defend. Commercial firms actively advocate against the creation of redistributive tax laws. For example, hedge-fund managers legally structure their compensation as "carried interest" to benefit from capital gains treatment under tax law and consequently lower rates of taxation. Political lobbying by the financial industry has obstructed efforts by the Obama administration to eliminate this loophole.[70] In the 112th Congress, approximately 2,221 organizations spent an estimated $773 million on tax lobbying to ensure that such tax benefits remain part of the tax law.[71] The example of tax lobbying shows that Schwartz and Scott's assumption of Strong Form specialization, that legal theory can institutionally isolate competing policy goals, is unrealistic.[72] In other words, when we justify commercial contract law on the basis that it should solely promote the self-interested, wealth-maximizing behaviour of firms, we cannot ignore the effects that justification may have on those same firms that are expected to support just systems of tax and transfer: in terms of psychological motivation, company directors may tend to employ the same reasoning in their attitude to the tax law, resulting in just the sort of lobbying that is commonplace. Others have similarly argued that a normative theory of law must account for the ways in which legal institutions influence individuals' moral motivation and agency.[73] The

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70. Several attempts have been made to amend the carried interest provisions of the *Internal Revenue Code*. Congressman Levin twice introduced bills in Congress to amend the provision: see US, Bill HR 2834, *To amend the Internal Revenue Code of 1986 to treat income received by partner for performing investment management services as ordinary income received for the performance of services*, 110th Cong, 2007; and US, Bill HR 1935, *To amend the Internal Revenue Code of 1985 to provide for the treatment of partnership interest held by partners providing service*, 111th Cong, 2009. Further, in each of the 2010, 2011, 2012, 2013 and 2014 US Federal Budgets, the Obama White House proposed eliminating the beneficial tax treatment of carried interest. Copies of the Obama White House Budget proposals are available online: US Government Publishing Office, *Budget of the United States Government*, 1996-2016 www.gpo.gov/fdsys/browse/collectionGPO.action?collectionCode=BUDGET.

71. See Lee Drutman & Alexander Furnas "Untangling the webs of tax lobbying" (15 April 2013), *Sunlight Foundation*, online: www.sunlightfoundation.com/blog/2013/04/15/tax-lobbying/.

72. Nagel observes that "there is a definite tendency in liberal societies for the better off—not merely a rich minority but the majority who are not poor—to resist the pursuit of socioeconomic equality beyond a rather modest level. This is partly due to the distorting influence on democratic politics of large concentrations of wealth, but it also reflects a more general psychological disposition." See Nagel, *supra* note 67 at 59.

73. Seana Shiffrin has argued that any normative theory must account for the effects that the public justification of a legal institution may have on the moral agency of legal subjects. She argues that the law "should not, as a general matter, be inconsistent with leading a life of at least minimal moral virtue." Because of the close relationship between contract and promise, Shiffrin's claim is that any normative theory of contract law should not compel an individual to act in a way that is inconsistent with her promissory morality. See Seana Valentine Shiffrin, "The Divergence of Promise and Contract" (2007) 120:3 Harv L Rev 708 at 718. Liam Murphy has interpreted Shiffrin's argument as an articulation of a more general principle "that all

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argument I develop here builds on those claims: a normative theory of a legal institution must account for its impact on the ethical lives of individuals, and this impact is more severe when a normative theory relies on the principle of Strong Form specialization in its defense.

The second way that Strong Form institutional specialization is problematic is that it promotes systemic design that is internally incoherent. A normative theory of law must also consider how the justification of one legal institution affects the way legal subjects are motivated to *comply* with other institutions in the same system. Put another way, a legal institution (e.g. contract law) should not be designed to solely promote one aim (e.g. wealth maximization) which is inconsistent with the legitimate aims of other institutions (e.g. distributive justice). Whereas the problem articulated above related to how the rationale for a legal institution impacts on the individual's motivation to support a just legal system (i.e., the individual's motivations in an extralegal context), the concern here is over the effects that such a rationale would have on an individual's motivation to comply with other legal institutions within the same legal system (i.e., the individual's motivations within legal contexts). What I am suggesting here is this: the design of a particular legal institution should not negatively impact on the goals of the broader legal system of which it is one part. When constructing a normative theory of contract law, we must consider the values that other legal institutions are designed to promote and offer a justification for contract that is not wholly inconsistent with those other aims. Contract law must be justified in a way that does not compromise the integrity of the legal system as a whole.

This argument can be illustrated with another example in tax law, highlighting how the problem of tax lobbying differs from the problem of tax avoidance. While firms may act self-interestedly when entering into private agreements of exchange, they may also act self-interestedly when complying with the redistributive rules of taxation. For example, firms such as Apple invest in aggressive tax avoidance planning in order to arrange their affairs in a way that minimizes their share of the tax burden.[74] By engaging in tax avoidance schemes, firms frustrate the redistributive aims of tax laws, eroding the tax base, while still remaining in technical compliance with those laws. This problem is exacerbated by a system designed around Strong Form specialization. A legal system that promotes behaviour through one legal institution that is directly at odds with the aims of another institution suffers from an internal incoherence that undermines the aims of the

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acceptable normative legal theories will satisfy the following instrumental criterion: the proposed legal structure must not unduly interfere with people living well, ethically speaking." Murphy's defense of this claim is that "[i]t is myopic to think that we can ignore the law's effects on people's ethical lives—its effects on how they act in extralegal contexts—since there is not going to be any law pursuing aims, or at any rate, any just law pursuing just aims, if people do not make the extralegal decisions necessary to support the maintenance of just institutions over time." See Liam Murphy, "Contract and Promise", online: (2007) 120:3 Harv L Rev Forum 10 http://harvardlawreview.org/2009/10/contract-and-promise/.

74. US, *Offshore Profit Shifting and the U.S. Tax Code—Part 2 (Apple Inc.): Hearing Before the Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs,* 113th Cong, (United States Government Printing Office, 2013), online: http://www.gpo.gov/fdsys/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf.

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system as a whole. If, on the instrumental view, what matters is the output of the system as a whole, the design of the system and its constituent parts must also be approached holistically.

The two objections are connected: we do not want a legal system that is internally incoherent because it would intensify the problem of moral motivation. If the legal system encourages individuals to, on the one hand, act self-interestedly, and on the other, act morally, it adds to the psychological burden of acting rightly in two contexts: it may have negative effects on the individual's motivation to support just institutions (i.e., effects on behaviour outside of the law) and it may have negative effects on the individual's motivation to comply with just institutions (i.e., effects on behaviour inside the law). The Strong Form institutional specialization espoused by Schwartz and Scott exacerbates this problem for the individual because it advocates for a stricter partition between areas of law that expect us to be attentive to impartial moral demands, and areas of law that induce us to act purely on the basis of partial self-interest.

An alternative way to think about the institutional division of labour, one which alleviates the tension between institutions with competing aims, is "Weak Form" specialization. A Weak Form approach recognizes that, while it may be more effective to target particular values through separate legal institutions, such institutions should, at a high level of generality, be structured around principles that are not wholly incompatible with one another. Of course, to make this claim one would also need to provide an account of the range of political and moral values that are legitimately pursued through the law. I offer here only the core commitment of the argument for Weak Form specialization at an abstract level: if we accept, as Schwartz and Scott do, that some of our legal institutions should promote other-regarding aims such as redistribution, the altruistic spirit of such values cannot be completely dispensed with in other areas of the law.

Institutional responses to the problem of tax avoidance described above can help illustrate this idea. One solution to the problem of tax avoidance that has been adopted by some countries is a more general, standard-based anti-avoidance rule.[75] For example, while taxpayers may have arranged their affairs in strict compliance with the rules, they may be denied a tax benefit if they have engaged in an avoidance transaction. An "avoidance transaction" is any transaction that results "directly or indirectly, in a tax benefit, unless it may reasonably be considered to have been undertaken or arranged primarily for bona fide purposes other than to obtain the tax benefit."[76] The strategy is to import a general evaluative standard into tax laws that requires legal subjects to deliberate on the other-regarding aims and goals of the institution rather than simply approaching the rules in a purely selfish manner. Anti-avoidance standards in tax law can be seen as imposing a market ethic or standard of conduct similar to the good faith

75. See, e.g., *Income Tax Act*, RSC 1985, c 1 s 245 [*ITA*] and *Income Tax Assessment Act* 1936 (Cth) Part IVA. Although the United States does not have a general anti-avoidance rule, two judicially created doctrines of "economic substance" (which has recently been codified as IRC (1986) § 7701(o)) and the "business purpose" test have served as general anti-avoidance rules.

76. *ITA*, *ibid* at s 245.

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doctrine in contract law discussed above. While the requirement to deal fairly and in good faith is not designed to achieve distributive goals through tax law, it does ask that parties to a contract give thought to and consider the interests of their counterparty when negotiating the terms of their agreement. In this way, Weak Form specialization allows for institutions that are aimed at achieving particular goals, without entirely quarantining any single legal institution from the underlying values of the legal system.

One objection to this approach is that it would result in a shift of the institutional burden from legislator to judge and, as a result, raise questions of legitimacy. Rules permit ex ante determination of the law; standards require ex post determinations of the law. A legal subject must interpret a legal standard in order to determine how it will apply before choosing to act on it. One may engage in moral reflection on the content of that standard, or one may interpret it in a self-interested manner and not turn one's mind to moral considerations at all. In either case, a *legal* determination of the content of the standard will only be made, after the person has acted, by an adjudicator. This raises deep and important questions about democratic legitimacy: should courts be making such determinations? These concerns go beyond the scope of this article, but there are compelling arguments on both sides of the issue. For example, in his article on the connection between law and the protection of human dignity, Jeremy Waldron—himself one of the most prominent critics of judicial review in earlier work[77]—has argued that the adjudicatory process and the opportunity for engaging in argumentation "are indispensable to the package of law's respect for human agency."[78] He argues that the legal determination of general standards through the adversarial process of the courts reflects the "respect for the freedom and dignity of each person as an active intelligence", which law and legality rest on.[79] For the purposes of this paper the point is this: we ought to turn our minds to the moral question involved in the argument for institutional specialization, and the democratic legitimacy point is only one issue to consider. It is at least an open question whether legitimacy considerations would lead us to reject or favour Weak Form specialization of the kind I discuss.

Conclusion

Schwartz and Scott's normative contract theory is a compelling example of the reductionist project of economic analysis of law. They develop a provocative argument for why commercial contract law should be limited to helping firms maximize profit. However, the persuasiveness of their argument rests on several critical assumptions. In this paper I have put pressure on the assumptions that contract theory can ignore (i) the bad things that firms do when maximizing profit and (ii) the other legitimate political values that legal institutions ought to

77. See Jeremy Waldron, "The Core of the Case Against Judicial Review" (2006) 115:6 Yale LJ 1346.
78. Jeremy Waldron, "How Law Protects Dignity" (2012) 71:1 Cambridge LJ 200 at 214.
79. *Ibid*.

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promote. Both these assumptions rely heavily on the specialization principle. I have argued that, while the specialization principle appears plausible, it raises rather than resolves some deeper and more fundamental questions. There are a number of choices open to us in the design of our institutions, and Schwartz and Scott's suggestion that society ought to promote potentially harm-creating behaviour through contract law because other institutions will manage those potential harms is only one of these. I have argued that their approach, which I called the Reactive Approach, is assumed rather than defended, and have suggested that an alternative, the Proactive Approach, must also be considered. The latter approach says that society should design institutions that discourage such behaviour in order to preclude harms from materializing in the first place. Further, there is a deep tension in claiming that moral aims such as distributive justice are legitimate and important but that contract law should not ask legal subjects to act fairly or morally; the assumption that it is reasonable to believe that we can impose just institutions on legal subjects who are encouraged to act selfishly in other institutional arenas and expect to live in a just society is deeply problematic. While my criticisms of Schwartz and Scott are at the more abstract level of theory, they also have implications at the doctrinal level. An obligatory standard of conduct, such as a duty to deal in good faith, is an example of how legal rules can shape a social practice and its consequences in a way that is overlooked by economists such as Schwartz and Scott. There are significant institutional implications of stating that a particular legal institution can be normatively justified without regard to the broader set of values that a legal system is designed to promote; such a position itself requires justification and cannot simply be assumed.

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