



# A Philosophical Approach to the Economic Analysis of Contract Law

**J**ODY KRAUS HAS DEVOTED MUCH OF HIS SCHOLARLY CAREER to understanding the field of contract theory. In Kraus's view, contemporary contract theory began when Christopher Columbus Langdell joined the Harvard Law School faculty in 1870 and decided to teach contracts. At that time contracts treatises were organized largely on the basis of the traditional common-law "forms of action." Although the forms of action had been abolished more than 20 years earlier, Langdell was the first legal academic to attempt to understand how contract doctrines together might comprise a distinct area of law apart from their common procedural ancestry. When Langdell examined the contracts cases, he claimed to discern a set of legal rules that were logically deducible from coherent legal principles.

Langdell's inspired and historic attempt to understand contract law as a principled and coherent body of law marked the inception not only of the

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modern American understanding of contract doctrine but of contemporary contract theory as well. By the time Jody Kraus joined the University of Virginia Law School faculty in 1990, the core of Langdell's understanding of American contract law remained viable, but Langdell's vision of a unifying contract theory had endured half a century of withering criticism.

Legal Realists and Critical Legal Studies scholars argued that express judicial reasoning was mere window dressing, causally irrelevant to which party prevailed in a dispute. According to the Realists, results actually turned on informal commercial practices or the psychological idiosyncrasies or policy preferences of judges. According to CLS scholars, the rhetoric of judicial decisions masked decisions based on politics. Pluralists, in turn, argued that express legal reasoning was relevant to deciding common-law cases but that no single theory could comprehend all the disparate values that necessarily bear on those decisions. For pluralists, case outcomes resulted from wise judgment, based on years of judicial experience, about how to reconcile the multiple and often incommensurable values at stake in adjudication. Legal Realism, CLS, and pluralism each argued, against Langdell's most basic conviction, that no area of law, including contract law, could be rationalized under a set of coherent, let alone morally defensible, principles.

Against this accumulating skepticism, two theoretical movements emerged side-by-side in the last quarter of the 20th century. Building on long traditions and recent developments in moral and political philosophy, Charles Fried wrote his now classic monograph, "Contract as Promise." In Fried's view, the basic core of American contract law could be explained and justified by the principle of autonomy: that everyone has equal value and therefore an equal right to make, revise, and pursue their life plans subject to the equal right of others to do the same. Contract law maximizes individual autonomy by enabling individuals to undertake obligations to one another, thereby expanding their life choices, without fear of detrimental reliance. The legal enforcement of promises ensures that promise-breakers compensate their victims for the harm they cause.

At the same time Fried was unifying contract law under the single moral

principle of autonomy, Richard Posner and others had begun the economic analysis of law. Posner argued that contract law could be explained and justified by a single principle of efficiency. According to Posner, contract law should be understood as part of a broader legal effort to provide individuals with incentives to take efficient precautions and to enable them to transfer resources to higher-valued uses. Specifically, Posner argued that much of contract law consisted of “default” rules that allocated contractual risks to the party who could bear it at least cost, even if that party had not agreed to bear it. Posner ultimately claimed that much of law, and virtually all of contract law, could be explained and justified as a mechanism for efficiently allocating resources.

Both the autonomy and efficiency theories of contract share Langdell’s conviction that contract law can be explained and justified as an objectively reasoned and principled institution. They would therefore seem to be kindred spirits, united by their unequivocal rejection of the theory-skepticism that dominated much of the 20th century. When the economic analysis of law first emerged, however, autonomy theorists such as Jules Coleman and Ronald Dworkin leveled deep philosophical objections to its explanatory and normative credentials. After an initial round of responses by Posner and others, the autonomy theorists returned seemingly decisive replies. Indeed, even Posner appeared to concede that he had no satisfactory defense of the central idea of efficiency as a normative criterion for evaluating legal regimes. Yet despite the apparent victory of the autonomy theorists, the economic analysis of contract law continued unabated. Indeed, there is no question that economic analysis has been and continues to be the dominant mode of analysis of American contract law. While a few autonomy theorists of contract have continued to labor in relative obscurity, their theories have never achieved prominence or significant influence in the American legal academy.

When Kraus first started teaching law, the dialogue between autonomy and efficiency theories was one-way. The autonomy theorists continued to raise fundamental flaws with economic analysis. The economic analysts ignored those criticisms and continued to produce analyses that became

the legal academy's received wisdom for contract doctrines. The core motivation of Kraus's scholarship is to understand contract theory from Langdell through today's debate between autonomy and efficiency. His scholarship, just as his teaching, is marked by intense intellectual rigor, curiosity, and a willingness to take a fresh look at academic debates that seem stalled.

Kraus began with two contemporary puzzles. The first is why the economic analysis of contract law has thrived despite its failure to provide a sustained, let alone compelling, response to the trenchant objections autonomy theorists have leveled against it. The second is why autonomy theories, despite their evident rigor and eminent philosophical credentials, have not captured a greater audience in the American legal academy. Over the years, Kraus's scholarship has expanded to use the lens of contract theory to examine the nature of legal theory in general.

Already a trained philosopher, Kraus had developed views in political philosophy before he came to the legal academy. His first scholarly efforts were devoted to refining those views, which he published in his first book, *The Limits of Hobbesian Contractarianism* (1993). That book focuses on the power of hypothetical consent to justify the exercise of political coercion. Not coincidentally, one of the central normative claims of economic analysis at that time was that hypothetical consent could justify a number of legal doctrines and decisions. Kraus argued that, upon careful analysis, even the most sophisticated efforts to explain the normative force of hypothetical consent failed. Later, in "Political Liberalism and Truth," 5 *Legal Theory* 45 (1999) Kraus argued that John Rawls' final attempt to provide a justification for coercion could not avoid taking positions on the controversial philosophical questions on which it claimed to remain agnostic.

Before comparing autonomy and efficiency theories directly, Kraus first deepened his understanding of economic analysis by practicing it. In "Decoupling Sales Law from the Acceptance-Rejection Fulcrum," 104 *Yale L.J.* 129 (1994), Kraus provided an original economic analysis of the central doctrines of Article 2 of the U.C.C., arguing that current law should be revised to facilitate more efficient transactions. In "Legal Design and the Evolution of Commercial Norms," 26 *J. Legal Stud.* 377 (1997), Kraus

challenged the conventional view that the evolution of informal commercial practice would produce efficient practices. That idea was based on an analogy to the concept of “survival of the fittest” in biological evolutionary theory. Using a state-of-the-art theory of the evolution of social norms, Kraus demonstrated that inefficient evolution was not only possible but likely, given the actual mechanisms for cultural evolution that would operate on commercial norms. Just as biological evolution has produced countless biological mechanisms that are obviously inferior to mechanisms humans can design, so too commercial practices are often sub-optimal. As a result, Kraus rejected the received view that commercial law should without exception simply incorporate informal commercial norms. Instead, Kraus argued that legal scholars should question the efficiency of informal practice and that law-makers should welcome careful attempts to design new commercial law regimes.

Drawing on his understanding of philosophical theories of explanation and justification, Kraus then turned directly to analyzing the relationship between autonomy and efficiency contract theories. In “Reconciling Autonomy and Efficiency in Contract Law: The Vertical Integration Strategy,” *Philosophical Issues*, supplement to *Nous* (2000), and “Legal Theory and Contract Law: Groundwork for the Reconciliation of Autonomy and Efficiency in Contract Theory,” 1 *J. S. Pol. & Legal Phil.* 385 (2002), he traced the fundamental conflict between autonomy and efficiency theories of contract law to the well-known divide between two different kinds of moral theory. Kraus argued that “[a]s normative theories, economic contract theories would seem to be logically incompatible with autonomy contract theories for the same reason that consequentialist moral theories are logically incompatible with deontological moral theories: The former claim that moral justification is solely a function of consequences, while the latter claim that moral justification is logically independent of consequences.”

Kraus then identified three strategies for reconciling these two approaches. The first is *the convergence strategy*, which “attempts to demonstrate that efficiency and autonomy contract theories happily con-

verge in their normative assessment of most contract doctrines, even though they do so on logically incompatible grounds.” The second is *the horizontal independence strategy*, which reconciles both kinds of theories “by construing them as making either different kinds of claims or claims about different kinds of things.” For example, autonomy theories might claim only to evaluate the justification of contract law, while economic theories might claim only to explain the content of contract law. Alternatively, autonomy theories might claim to explain the express reasoning in contracts cases, while economic theories might claim only to explain case outcomes. Finally, *the vertical integration strategy* reconciles efficiency and autonomy contract theories by construing them as logically distinct elements within one unified theory. Ultimately, Kraus supports a vertically integrated contract theory in which there is a “division of theoretical labor” between autonomy and efficiency principles. Kraus argues that efficiency theories should play the role of providing fine-grained, institutional prescriptions for the resolution of hard cases, in part because the vagueness of key moral concepts in autonomy theory often disable them from accomplishing that task. On the other hand, Kraus claims autonomy theories should play the role of providing the moral justification of contract law because they are rooted in a philosophically credible moral theory. Unlike autonomy theories, economic theories derive their justificatory force entirely from the principle of efficiency, which long ago was discredited as a free-standing moral principle.

In “Philosophy of Contract Law,” Jules L. Coleman and Scott Shapiro, eds., *The Oxford Handbook of Jurisprudence and Philosophy of Law* (Oxford University Press, 2002), Kraus identified four methodological commitments that divide and define contract theories. The first issue is whether express judicial reasoning should be viewed as legal theories or as legal data for theories to explain. Economists offer theories to explain outcomes and pay less attention to judicial explanation, while philosophers focus on the reasoning offered by judges as the starting point for their own accounts. The second methodological issue is the relative priority accorded to explaining and justifying contract law. Kraus claims that “[t]he primary

goal of deontic theories is to demonstrate that contract law is a morally and politically legitimate institution, rather than to explain how contract law determines outcomes in particular cases. In contrast, economic theories are principally concerned with explaining how contract law determines outcomes in particular cases.” The third methodological issue is whether the theory aspires to explain the distinctiveness of contract law. As Kraus explains, philosophers are much more concerned about what makes contract law distinct than are economists. The fourth methodological issue dividing autonomy and efficiency theories is whether they take an *ex post* or *ex ante* perspective on adjudication. Deontic theories take an *ex post* perspective because they view adjudication as an occasion to resolve a dispute by vindicating pre-existing rights. In contrast, economic theorists take an *ex ante* perspective by viewing adjudication as an occasion for prospective regulation.

Kraus concludes that these four differing methodological commitments effectively demonstrate that autonomy and efficiency theories of contract are not really competing theories. Since their conceptions of what contract law is (express doctrinal statements versus outcomes), what contract theories should do (explain versus justify contract law, explain or explain away the distinctiveness of contract law), and the object of adjudication (retrospective dispute resolution versus prospective regulation) are so different, these theories cannot be meaningfully compared. Thus, for example, when efficiency theories analyze the doctrine of consideration differently than autonomy theories, there is no meaningful disagreement over the doctrine of consideration. Instead, the real debate is the over the methodological presuppositions to which each theory is committed.

Building on his previous views, Kraus then turned to the autonomy theorists’ most trenchant criticism of efficiency-based explanations of contract and tort law. In “Transparency and Determinacy in Common Law Adjudication: A Philosophical Defense of Explanatory Economic Analysis,” *— Va. L. Rev. —* (forthcoming 2007), Kraus defends economic analysis against the claim that it fails what philosophers have labeled “the transparency criterion.” That criterion holds that a legal theory’s explanation must



provide a plausible account of the relationship between the reasoning it claims judges actually use to decide cases and the express reasoning judges provide in their opinions. The deontic theorists claim that the economic analysis cannot satisfy the transparency criterion because the judicial reasoning in contracts cases is usually cast in deontic moral terms.

Kraus claims that efficiency theories can account for the divergence between the non-consequentialist, moral language of judicial opinions and the consequentialist nature of economic analysis by offering an evolutionary theory of how the terms in judicial opinions acquire their meaning. In brief, Kraus's claim is that while contract and tort law might have first evolved with the aspiration to apply common deontic moral concepts to resolve disputes, the common law's focus on hard cases, in which the moral answer is unclear, forced judges to turn to consequentialist reasoning. Since no clear moral answer resolved the disputes before them, judges naturally used adjudication as an opportunity to set a sensible precedent for regulating future conduct. As the common law evolved, judges came to use deontic moral language to express essentially consequentialist reasoning. The difference between the plain meaning of express judicial reasoning and the best (economic) theory of the outcome of judicial decisions using that reasoning is therefore only superficial. According to economic analysis, the real meaning of express judicial reasoning in hard cases is given by economic, not deontic moral, theory.

Kraus also argues in this article that legal explanatory theories are subject not only to the transparency criterion but also to two additional criteria, which he calls "determinacy" and "normative force." The determinacy criterion holds that reasons fully explain an outcome only if they determine it, and that all else being equal, more determinate explanations are to be preferred to less determinate explanations. Since Kraus argues that economic theories are better at explaining case outcomes than deontic theories, they are preferred by the determinacy criterion. The normative force criterion holds that the reasons that explain an outcome must also constitute a plausible justification for the outcome. Kraus argues that while deontic theories can trace the normative force of their reasons directly to

credible moral theories, economic analysis need not make the unsustainable claim that its normative force derives from the justificatory power of the principle of efficiency. Instead, economic analysis can claim that its reasons justify outcomes because of the role the principle of efficiency plays in the overall set of institutions sanctioned by the normative political theory justifying political authority. Kraus recently expanded on the determinacy criterion in “Determinacy and Justification in Adjudication,” 48 *Wm & Mary L. Rev.* 4 (forthcoming 2007).

Finally, in “The Jurisprudential Origins of Contemporary Contract Theory,” a work in progress, Kraus returns to the classic “death of contract” debate famously begun by Grant Gilmore. Gilmore’s claim was that Langdell and his fellow travelers in classical contract theory fraudulently represented the content of contracts precedents in order to provide precedential authority for what was, in fact, a wholly novel theory of contract law. Kraus argues that Gilmore’s entire critique rests on the assumption that the precedential authority of cases resides in their express judicial reasoning rather than their outcomes. Yet Langdell and the classical theorists clearly believed the precedential authority of cases resides in their outcomes alone, and that express judicial reasoning is just one theory of the doctrinal precedent set by those outcomes. Building on that insight, Kraus demonstrates that the economic analysis of law is Langdell’s contemporary legacy. The economic analysis of contract law is equally committed to Langdell’s twin jurisprudential convictions: that case outcomes are the legal data express reasoning seeks but sometimes fails to explain and that contract law can be explained and justified by unifying it under a single set of coherent principles. In short, Kraus shows that the economic analysis of contract law is the classical theory of our day.

So how does Kraus answer the puzzles of autonomy and contract theory? Economic analysis has thrived, despite its failure to respond to deep philosophical criticism, because it does a better job of explaining outcomes. Since lawyers and law professors prize the ability to explain and predict outcomes above all else, the success of economic analysis in explaining common-law cases explains its dominance in the legal academy.

That also explains why autonomy theories have failed to gain traction. Despite their sophisticated and superior normative credentials, they fail to explain the outcomes in hard cases and so are perceived to be of little value in the classroom or the courtroom.

Ultimately, the best theory of contract law will, Kraus argues, combine the insights and virtues of both theories to produce a unified account that both explains and justifies much of contract law. Given his training in philosophy and his mastery of economic analysis, as well as his openness to what each approach has to offer, Kraus himself is uniquely positioned to provide that account. ❁

EXCERPT

## The Jurisprudential Origins of Contemporary Contract Theory

(Working Paper, 2006)

IN *HARRIS V. WATSON* (1791), LORD KENYON HELD THAT “NO ACTION would lie at the suit of a sailor on a promise of a captain to pay him extra wages, in consideration of his doing more than the ordinary share of duty in navigating the ship.”<sup>1</sup> His decision was based expressly on a “principle of policy:” “if sailors were ... in times of danger entitled to insist on an extra charge on such a promise as this, they would in many cases suffer a ship to sink, unless the captain would pay any extravagant demand they might think proper to make.” In *Stilk v. Myrick* (1809), Lord Ellenborough held that an action did not lie on a captain’s promise to pay the remaining sailors the wages of two sailors who had deserted the ship in a foreign port.<sup>2</sup> One report of *Stilk* quotes Lord Ellenborough as stating “I think *Harris v. Watson* was rightly decided, but I doubt whether the ground of public policy, upon which Lord Kenyon is stated to have proceeded, be the true principle on which the decision is to be supported. Here, I say, the agreement is void for want of consideration.”<sup>3</sup> In 1920, Samuel Williston, the author of the first modern treatise on contracts and then-future Reporter of the First Restatement of Contracts, agreed with Lord Ellenborough, citing both *Harris* and *Stilk* for proposition in §130 of his treatise that a performance or promise to perform any obligation previously existing under a contract with the promisee is not valid consideration.<sup>4</sup> In his classic 1974 monograph, *The Death of Contract*, Grant Gilmore claimed “there is no conceivable way in which *Harris v. Watson* can be taken to have been decided on consideration theory.”<sup>5</sup> According to Gilmore, either Lord Ellenborough actually decided *Stilk* on the public policy ground stated in

*Harris* but his reasoning was misreported, or he intentionally misinterpreted the ruling in *Harris* because he was “an owner’s man all the way who would use any theory, however far-fetched– even ‘want of consideration’– to strike down seamen’s wage claims.”<sup>6</sup> As to why Williston cited *Harris* and *Stilk* as authority for Restatement §130, Gilmore remained agnostic between the possibilities of “deliberate deception” and “unconscious distortion.”<sup>7</sup>

An “owner’s man all the way,” “deliberate deception,” and “unconscious distortion?” Those were fightin’ words in 1974 and they still are today. Gilmore was taking aim at Williston’s efforts to marshal cases as precedential authority for the “bargain theory of consideration,” which together with the objective theory of intent comprised the doctrinal core of the 19<sup>th</sup> century classical conception of contract law. The doctrine of consideration holds that promises are not legally enforceable unless supported by consideration. The bargain theory, famously championed by Oliver Wendell Holmes,<sup>8</sup> defines consideration as a performance or return promise that is “bargained for,” and states that a performance or return promise is bargained for if it is “sought by the promisor in exchange for his promise and ... given by the promisee in exchange for that promise.”<sup>9</sup> Gilmore claimed that Langdell single-handedly “launched the idea that there was—or should be—such a thing as a general theory of contract,” that Holmes created the “broad philosophical outline” of that theory, and that Williston fraudulently legitimated the theory in the “meticulous, although not always accurate, scholarly detail” of case law.<sup>10</sup> *Stilk* and *Harris* are Exhibits A and B in Gilmore’s brief to expose Williston’s fraud.

Gilmore’s specific claim is that Holmes and Williston<sup>11</sup> committed fraud by citing cases for doctrinal propositions that were unsupported by, and in some cases contradicted by, the express judicial reasoning of those cases. Once Gilmore purports to demonstrate the gap or inconsistency between the classical theorists’ reading and the express reasoning of a case, he concludes the classical theorists engaged in either deliberate deception or unconscious distortion. The conclusion is a non-sequitur. Gilmore’s critique presupposes that an interpretation of a case is proper

only if it constitutes a plausible interpretation of the express judicial reasoning in the case. In contrast, Holmes and Williston implicitly presuppose the view that the doctrine a case sets as a precedent is the one that best explains its outcome, whether or not that doctrine is also a plausible interpretation of, or even consistent with, the express reasoning offered by the deciding judge. On their view, the express reasoning in a case is merely a theory, rather than constitutive statement, of the doctrinal precedent set by that case. The bare outcomes of cases, and not the express reasoning in cases, provide the data that doctrinal theories must explain and justify. On this view, the outcome is the only component of a case's precedential authority that is exclusively within the control of the deciding judge. Even the outcome's correct characterization for purposes of identifying a case's precedential authority, beyond the mere description of which party prevailed, is determined by the doctrinal interpretation that best explains why the prevailing party won. For convenience, I will refer to this as the view that the precedential authority of cases resides in their outcomes alone, or the precedents-as-outcomes view for short. In contrast, if precedential authority resides in express judicial reasoning, the doctrine established by a case is identical to the justification for the outcome of that case expressly articulated by the judge who decided it, whether or not that justification provides an adequate or consistent, let alone compelling, explanation for that outcome.

Acknowledgment of the existence and plausibility of these competing views of the nature of precedential authority defuses Gilmore's incendiary charge that the classical theorists engaged in fraud or negligent misrepresentation. Instead, it exposes a much deeper disagreement, submerged below the surface of Gilmore's complaint, over the role of express judicial reasoning in the proper interpretation of precedent, and over the role of *stare decisis* in transforming bad precedents into good law. In this Essay, I re-examine Gilmore's case against the formalists and argue that it is constructed almost entirely on the suppressed premise that the precedential authority of cases resides in their express judicial reasoning. Against all but one of Gilmore's charges of improper citation of legal authority, the

classical theorists can effectively defend their citation as proper by arguing that their interpretation of the case provides the best explanation and justification of its outcome, regardless of its relationship to the express judicial reasoning in the case. Against the remaining charge, the classical theorists' view of *stare decisis* explains why they would insist that a doctrine entailed by their conception of contract law is a valid part of American contract law even though a well-known contrary line of cases left the question concededly unsettled. This re-examination, then, demonstrates that Gilmore's conclusions simply beg the question against the classical theorists' implicit view of the nature of precedential authority and the role of *stare decisis*. Gilmore's debate with the classical theorists only appears to be over the substantive doctrinal content of late 19<sup>th</sup> century contract law. Although he evidently didn't realize it, Gilmore's real disagreement with the classical theorists is over the nature of precedential authority. And that debate was never engaged because neither Gilmore nor the classical theorists explicitly articulated, let alone defended, their views of precedential authority. ❧

## ENDNOTES

- 1 *Harris v. Watson*, 170 Eng. Rep. 94 (1791).
- 2 *Stilk v. Myrick*, 6 Esp. 129, 170 Eng. Rep. 851; 2 Camp. 317, 170 Eng. Rep. 1168 (1809).
- 3 2 Camp. 317 (1809).
- 4 Samuel Williston, 1920, 1 *Williston on Contracts*, §130.
- 5 Grant Gilmore, 1995, *The Death of Contract*, 29. Ronald K.L. Collins ed., Columbus: Ohio State Univ. Press 2d ed.
- 6 Gilmore, *The Death of Contract*, 30 n.57.
- 7 Gilmore, *The Death of Contract*, 30.
- 8 Holmes wrote that “it is of the essence of a consideration, that, by the terms of the agreement, it is given and accepted as the motive or inducement of the promise. Conversely, the promise must be made and accepted as the conventional motive or inducement for furnishing the consideration. The root of the whole matter is the relation of reciprocal conventional inducement, each for the other, between consideration and promise.” Oliver Wendell Holmes, Jr., 1963, *The Common Law*, 293-41-2. Mark DeWolfe Howe ed., Cambridge, Mass: Belknap Press of Harvard Univ. Press.
- 9 Restatement (Second) of Contracts §71(1). The first Restatement of Contracts incorporated the bargain theory of consideration in §75 by defining consideration for a promise as “an act other than a promise ... or a return promise bargained for and given in exchange for the promise.” Restatement of Contracts §75.
- 10 Gilmore, *The Death of Contract*, 15.
- 11 Gilmore never provides an example of a case that Langdell allegedly misinterpreted. Instead, he claims Langdell’s theory of contract simply lacked sufficient precedent.



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