

# NEVER CONFUSE EFFICIENCY WITH A LIVER COMPLAINT\*

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## INTRODUCTION

I write this with a mixture of loathing and fear. Loathing, because I generally believe that ungrounded discussions of methodology are not useful. I don't "do" method—or at least I don't do method well. Instead, I'm a "proofs in the pudding" kind of person. Better to have scholars from different disciplines attack a particular problem, and then assess which methodology produces the best purchase. Accordingly, I was much more excited to attend my last Wisconsin conference on "Changing Patterns in Business Disputing"<sup>1</sup> which included in its eclectic presentations the original Suchman/Bernstein debate about the

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\* This title is taken from the movie, *MARY POPPINS* (Disney 1964). Before Mary Poppins arrives, the mother and father (Winifred and George Banks) discuss a nanny (Katie Nana) who has just quit in exasperation:

Winifred Banks: I'm sorry dear, but when I chose Katie Nana, I thought she would be firm with the children. She seemed so solemn and cross.

George Banks: Winifred, never confuse efficiency with a liver complaint.

I thank my two-year-old son, Henry Jordan Ayres-Brown, for bringing this movie repeatedly to my attention.

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1. Held in 1993 at the University of Wisconsin-Madison.

organization of Silicon Valley law firms.<sup>2</sup> I am embarrassed to predict that this piece (and maybe this Symposium) will garner few citations. "Ad hominem" arguments deserve only slightly less respect than "ad discipline" arguments. Instead of engaging the substance of particular pieces, disciplinary arguments dismiss any work that is characterized as a discredited genre.

I am also scared to write this paper. I remember during the Madison conference on "Business Disputing" sitting next to my dear friend Lawrence Friedman while Bernstein was commenting on Suchman, and sensing Lawrence's visceral anger. I fear that for an economist to speak about sociology is almost by definition picking a fight: "Ah-ha, I knew it. Scratch Ayres, and you find a Posner."<sup>3</sup>

Nonetheless, I am honor bound to say a few words about economic and sociological approaches to law. I hope to (briefly) address three issues: economic hegemony; economists' views of sociology; and distinguishing characteristics of economics and sociology. And finally, I will suggest that the Suchman/Bernstein debate could profit by confronting Joseph Bankman's article, *The Structure of Silicon Valley Start-ups*.<sup>4</sup>

## I. THE HEGEMONY OF ECONOMIC ANALYSIS

### *Your Children Will Be Economists!*<sup>5</sup>

As a descriptive matter, economic analysis has been the dominant social science in analyzing legal issues.<sup>6</sup> Economists (and J.D./Ph.Ds)

2. The debate was subsequently published in part. Lisa Bernstein, *The Silicon Valley Lawyer as Transaction Cost Engineer?*, 74 OR. L. REV. 239 (1995); Mark C. Suchman, *Translation Costs: A Comment on Sociology and Economics*, 74 OR. L. REV. 257 (1995).

3. Compared to most law-and-economics types, I have good law-and-society credentials. I was a research fellow of the American Bar Foundation; an associate editor of *Law and Social Inquiry*; and have even had the luck to write with a famous sociologist. See IAN AYRES & JOHN BRAITHWAITE, *RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE* (1992). While Posner is demonized by many law-and-society types (and while I have criticized particular Posnerian arguments), let me make clear that I believe the world of letters is much richer because of Richard Posner. To the charge that there might be something Posnerian about me, I can only hope: "From your lips to God's ears."

4. Joseph Bankman, *The Structure of Silicon Valley Start-ups*, 41 UCLA L. REV. 1737 (1994).

5. I am of course paraphrasing a quote attributed to a Nikita Khrushchev address in which he said to capitalists: "We will bury you! Your children will be Communists!"

6. Hegemony is always relative. Macroeconomics has been described recently as being in "decline." John Cassidy, *The Decline of Economics*, NEW YORKER, Dec. 2,

are more likely to be hired to teach in law schools than other social science Ph.Ds. Most graduating law students do not know what the “law and society” movement is but have heard about “law and economics.”<sup>7</sup> Thanks to the Olin Foundation, many more dollars are spent promoting law and economics than other “law and” programs.<sup>8</sup> I have not provided empirical support for these empirical claims. And probably none of these assertions is valid if one only tested at Wisconsin. But I hope any knowledgeable audience would easily assent to their validity.<sup>9</sup>

I stress the relative hegemony of economics, because I predict it will powerfully affect the tone of this conference (the tone of both economists and sociologists). People tend to ascribe moral desert to the happenstance of their power. And as Marc Galanter points out, there is a certain, unadmirable “triumphalism” in much law and economics rhetoric.<sup>10</sup> It is difficult to speak truth to power, but speaking from a position of (undeserved disciplinary) power, I fear that no matter how I characterize a sibling social science, I will provoke anger. I hope by repeatedly emphasizing this framing dynamic that I might be able to destabilize the frame. Lest I be misinterpreted, I do not believe that the descriptive disciplinary dominance of economics connotes that it should be dominant or that it is a superior social science.

There is a second kind of hegemony that might make it harder for “law and economics” types to talk to “law and society” types. I would assert that most economics Ph.Ds teaching in law schools are second-

1996, at 50. But microeconomics is alive and well in law schools. Thus, in speaking about the “dominance of economics” it is helpful to carefully define the arena and the type of economics. Even the term “microeconomics” may not be sufficiently fine-tuned. It is true that the economics in “law and economics” is almost never macroeconomics. Mark Kelman, *Could Lawyers Stop Recessions? Speculations on Law and Macroeconomics*, 45 STAN. L. REV. 1215 (1993). However microeconomics in pure economics departments today means game-theory, while microeconomics applied to law is today a mixture of game-theory and applied (marginal) cost/benefit analysis. Ian Ayres, *Playing Games with the Law*, 42 STAN. L. REV. 1291 (1990).

7. To be more explicit, I assert that there is a much higher chance that a graduating law student could name three “law and economics” articles than name three “law and society” articles.

8. Jon Wiener, *The Olin Money Tree: Dollars for Neocon Scholars*, NATION, Jan. 1, 1990, at 12. The American Bar Foundation’s funding of law and society projects, however, may give the Olin Foundation a run for its money.

9. These are fighting words to many academics, who are willing to dispute on a priori grounds virtually any assertion (including this one). For the skeptical, some supporting quantitative evidence can be found in Robert C. Ellickson, *Bring Culture and Human Frailty to Rational Actors: A Critique of Classical Law and Economics*, 65 CHI.-KENT L. REV. 23 (1989).

10. Marc Galanter & Mark Alan Edwards, *Introduction: The Path of the Law* Ands, 1997 Wis. L. REV. 375.

ratiers in the sense that we (and I explicitly put myself in this category) did not have the ability to succeed as easily in the social science department of our training.<sup>11</sup> The desire to belong to clubs that will not have us as members creates a certain longing and unqualified respect among law and economics scholars for pure, high-brow economics—that thing that we cannot quite pull off ourselves. If this second type of hegemony makes us “applied types” into assertive cheerleaders for our methodology, then it might be easier for pure economists to build bridges with pure sociologists.

## II. ECONOMISTS’ VIEW OF SOCIOLOGY

### *Sociology Is Bad Journalism.*<sup>12</sup>

Your worst suspicions are true: some economists are openly hostile to sociology and talk about you behind your back. But the point of this execrable equation of sociology with bad journalism is to emphasize that I originally heard it from an historian, not an economist. The vast majority of economists ignore or are indifferent to sociology. Sociology is just not on most economists’ radar screens.<sup>13</sup> It is relatively rare for economic models to be structured to refute the received wisdom of sociology. This is not to say that most law and society articles attempt to take economics down a peg—only that it’s more likely for sociologists to cite economists than the other way around.<sup>14</sup>

Of those economists that do from time-to-time engage sociology, there are those who are Bridge-builders/Apeasers and those who are

11. To be sure, there are exceptions.

12. An anonymous historian’s description of sociology overheard at a Law and Society meeting. I believe this canard is supposed to mean that sociology has all the rigor of journalism, but with the interesting narrative of good journalism deadened by obscurantist jargon.

13. To be sure there are important exceptions. See, e.g., Robert H. Frank, *Melding Sociology and Economics: James Coleman’s Foundations of Social Theory*, 30 J. ECON. LITERATURE 147 (1992).

14. James N. Baron & Michael T. Hannan, *The Impact of Economics on Contemporary Sociology*, 32 J. ECON. LITERATURE 1111 (1994). This interesting empirical article shows an increase in citation of economic articles by sociologists during the 1970s, but no continuing increase during the 1980s. The authors conclude:

[E]conomics *has* influenced somewhat the research agendas of sociologists. . . . Yet we have seen that when sociologists do confront work in economics directly, they often treat economic models and analyses simply as straw men (e.g., human capital theory or Olson’s analysis of free-riding), or they borrow economic terms but abstract them from the economic model that gives them meaning (e.g., signaling and capital).

*Id.* at 1139.

Openly Hostile. In the former camp I would put myself,<sup>15</sup> John Donohue,<sup>16</sup> Jason Scott Johnston,<sup>17</sup> Robert Frank,<sup>18</sup> Peter Siegelman<sup>19</sup> and perhaps most quintessentially Robert Ellickson.<sup>20</sup> And notwithstanding her role in the Suchman/Bernstein debate, I would characterize Lisa Bernstein's scholarship as bridge-building, in part because she takes social norms (and their production) much more seriously than most economists.<sup>21</sup>

In the openly hostile camp, I would probably put the early Richard Posner. A brief comment of his in the *Law and Society Review* (responding to John Donohue) seems to have as an unstated premise that it is better to sharply distinguish the economic and sociological approaches—so that (in good Marxist fashion) we can more quickly discredit sociology and proverbially push the discipline into the sea:

The essential relevance of economics to law lies not in a particular theorem but in the fact that economics is the most advanced of the social sciences. . . . The wonder is that legal scholars continue to resist as vigorously as they do the use of economic models and methods in law.<sup>22</sup>

He seems to be goading sociologists when he waives the red flag of "baby selling" as the first example of "a cornucopia of interesting hypotheses on law" produced by law and economics scholars.<sup>23</sup> It would be tempting

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15. AYRES & BRAITHWAITE, *supra* note 3.

16. John Donohue, *Law and Economics: The Road Not Taken*, 22 LAW & SOC'Y REV. 903 (1988).

17. Jason Scott Johnston, *Law, Economics and Post-Realist Explanation*, 24 LAW & SOC'Y REV. 1217 (1990).

18. Frank, *supra* note 13.

19. See, e.g., W.L.F. Felstiner & Peter Siegelman, *Neoclassical Difficulties: Tort Deterrence for Latent Injuries*, 11 LAW & POL'Y 309 (1989); Peter Siegelman, *Shaky Grounds: The Case Against Antidiscrimination Laws*, 19 LAW & SOC. INQUIRY 725 (1994) (reviewing RICHARD A. EPSTEIN, *FORBIDDEN GROUNDS: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS* (1992)).

20. See Ellickson, *supra* note 9.

21. Lisa Bernstein, *Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996); Lisa Bernstein, *Social Norms and Default Rules Analysis*, 3 S. CAL. INTERDISCIPLINARY L.J. 59 (1993); see also Frank, *supra* note 13, at 149 ("Economists have largely ignored the existence of . . . norms; and when they have addressed them specifically, it has usually been to assert that rational agents would never follow them.")

22. Richard A. Posner, *Comment on Donohue*, 22 LAW & SOC'Y REV. 927, 927 (1988).

23. *Id.* at 928 ("Abrogating the laws against selling babies for adoption would reduce, not increase, the price that adoptive parents must pay to acquire a child.")

to stop here, for those sociologists who would like to comfortably return the favor of dismissing Posner's work. But unlike his early models, Posner's scholarship is not static. Recently Posner has become much more of a bridge-builder and is putting "social norms" at the center of his scholarship.<sup>24</sup>

### III. DISTINGUISHING CHARACTERISTICS OF ECONOMICS AND SOCIOLOGY

*Tus pesadillas son mis sueños.*<sup>25</sup>

I have painted a gloomy picture of economic hegemony coupled with open hostility, dismissal and—possibly most galling—indifference. With these background conditions (which I assert would be in our minds whether or not I made them explicit), attempting a cool, dispassionate discussion of the strengths and weaknesses of the two methodologies is quixotic. Nonetheless, I am heartened by Mark Suchman's excellent success at pulling off just this feat.<sup>26</sup> As a beginning scholar whose central scholarship was being gobbled up by the economics death-star, Suchman does a truly admirable job of being generous, open-minded and dispassionately substantive in describing differences between the two methodologies. I find myself in complete agreement with his nuanced discussion of three core oppositions:

First, economics and sociology often diverge in their views of individual action, with the former emphasizing rational self-interest while the latter emphasizes cultural rule-following. Second, economics and sociology disagree in their images of social interaction, with the former highlighting voluntary exchange while the latter highlights power and social constraint. Third, economics and sociology differ in their perspectives on systemic change, with the former stressing general equilibria while the latter stresses developmental trajectories, historical path-dependencies and local contexts.<sup>27</sup>

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24. See, e.g., Richard A. Posner, *Social Norms and the Law: An Economic Approach*, AM. ECON. REV. (forthcoming 1997).

25. "Your nightmares are my dreams." Anarchist graffiti observed in Ponferrada, Spain. JACK HITT, OFF THE ROAD: A MODERN-DAY WALK DOWN THE PILGRIM'S ROUTE INTO SPAIN 164 (1994).

26. Suchman, *supra* note 2.

27. *Id.* at 260.

In particular, Suchman focuses on the fact that the decision of whether or not to accept rational decision-making may not be as important as the decision of whether or not to take the individual as the central unit of analysis. Economists almost always focus on the individual while sociologists often argue that the group or the network is the level at which the behavioral organism is best understood.<sup>28</sup> Suchman rightly emphasizes that certain phenomena are largely invisible through the lens of particular methodologies, and that economics has difficulty seeing (read: modeling) non-atomized individuals embedded within social networks.<sup>29</sup>

In this section, I will try to supplement Suchman's three oppositions with three of my own.<sup>30</sup>

*Parsimony v. Reductivism.* In any argument some people are more likely to chime in "but it's really simpler than that," and other people are more likely to chime in "but it's really more complicated than that." I contend economists are more likely to be in the former group and sociologists are more likely to be in the latter.<sup>31</sup> To be sure, the mathematics of economic models can be quite complicated, but the models usually analyze the relationship among a small, highly stylized set of variables. Parsimony is merely the other side of the reductivism coin, and economists do not shy away from this bit of change. Or, like Posner, they redefine the term:

28. See, e.g., Mark Granovetter, *The Strength of Weak Ties*, 78 AM. SOC. REV. 1360 (1973); Harrison C. White et al., *Social Structure from Multiple Networks. I. Blockmodels of Roles and Positions*, 81 AM. J. SOC. 730 (1976).

There is increasing attention to networks by both pure economists and impure law-and-economics scholars. See, e.g., Joseph Farrell & Garth Saloner, *Installed Base and Compatibility: Innovation, Product Preannouncements, and Predation*, 76 AM. ECON. REV. 940 (1986); Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347 (1996); Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424 (1985); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995); Marcel Kahan & Michael Klausner, *Corporate Contracting: Standardization, Innovation and the Role of Contracting Agents* (1996) (unpublished manuscript, on file with the authors).

29. More concretely, Jennifer Brown has shown that the concept of "hope" is invisible to economists. See Jennifer Gerarda Brown, *The Role of Hope in Negotiations* (1997) (unpublished manuscript, on file with the author).

30. One might highlight others. Peter Siegelman, for example, has suggested to me that economists focus more on equilibrium effects of exogenous perturbations—or at least employ different equilibrium concepts.

31. For an analogous argument, see Paul Hirsch et al., *"Dirty Hands" Versus "Clean Models": Is Sociology in Danger of Being Seduced by Economics?*, 16 THEORY & SOC'Y 317 (1987).

The economist, in that dreaded term of academic opprobrium, is “reductionist.” There is a confusion of terms here. All science involves abstraction. Newton’s law of falling bodies abstracts from many of the particulars of bodies (for example, was the apple red?) in an effort to discover a law of nature—a law that describes the behavior of a wide variety of bodies (from apples to tides to stars) that differ in many of their particulars. We do not describe this as reductionism. We reserve that word for what we sense are unsuccessful efforts to explain one thing in terms of another—for example, ideas in terms of molecular changes in the brain. The economic analysis of law attempts to formulate general laws about behavior in and of legal systems. . . . It may someday be falsified (Newton’s law of falling bodies was falsified), it will no doubt be refined, but it is not reductionist.<sup>32</sup>

Interestingly, Posner’s reductive example (of explaining “ideas in terms of molecular changes in the brain”) seems eerily to fit sociologists’ criticism that economists’ focus on “atomized” choice is the wrong level of analysis. The question of whether theories should be complex turns on whether adding complexity sufficiently increases the descriptive power of the model to be worth the costs of thinking about the extra detail. Part of the disciplinary disagreement is that we tend to think that each other’s extra complexity (like Posner’s reference to the apple’s color) doesn’t improve the theories’ descriptive capacity at all. The harder question is how much of an increase in the R-squared is sufficient to justify going to the trouble of adding an additional variable to your model. One might say truth is truth and if an additional variable has an effect it should be added, but in a world with limited physical and cognitive resources, much depends on the costs and benefits of added precision. While I share economists’ preference for simplicity, I readily admit at the end of the day that I have no credible justification for this inclination.<sup>33</sup>

*Qualitative vs. Quantitative Empiricism.* At a recent Law and Society Association annual meeting, some playful attendees circulated a “Buzzword Bingo” card. Instead of numbers, each box on the bingo card had a law and society term or phrase—“situatedness,” “impact (used as a verb),” etc.—which could be marked when they were mentioned at

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32. Posner, *supra*, note 24.

33. For an example of economists’ fascination with “Occam’s Razor,” see David D. Haddock et al., *An Ordinary Economic Rationale for Extraordinary Legal Sanctions*, 78 CAL. L. REV. 1 (1990).

panels.<sup>34</sup> I was struck by the fact that very few of the boxes related to empirical testing (R-squared, t-test, etc.). The card reflects the relative decline of quantitative empiricism in the organization.<sup>35</sup> Indeed, as a regular attendee at both the law and society and law and economics annual meetings, it is clearly the case that law and economics meetings have a higher proportion of statistical papers. While many outsiders persist in claiming that law and economics never tests its theories, the claim is increasingly false.

Moreover, I believe that economics produces better quantitative empiricism than sociology. Let me quickly add that I think that sociology produces much better qualitative empiricism. But economists are much more responsible for methodological improvement in the analysis of quantitative data. In 1990, I was asked to comment on a sociology paper that was still reporting a series of simple correlations instead of running a multivariate regression. While I don't believe that "We (economists) will bury you," or that "Your children will be economists," I do assert that "Your children will report White Heteroscedastic-Consistent standard errors." If you are a quantitative sociologist and don't know what I'm talking about, you prove my point.<sup>36</sup> I predict, however, that the next generation of quantitative sociologists will not only know about White standard errors, but will routinely report them. More generally, I predict that more of the methodological innovations in crunching numbers will flow from economics to sociology.

Economists also tend to be skeptical about self-reported information—especially non-falsifiable self-reported information.<sup>37</sup> Since a norm of truthfulness untethered to narrow (often monetary) self-interest is largely absent from economic thinking, economists worry that surveys

34. A similar game—called Flamer Bingo—is played by some first-year law students who mark boxes on their card if particular students speak in class.

35. Because of concern over this trend, a special annual law and society prize for the best empirical article was proposed, but the Association's Board of Directors rejected the idea.

36. For the intrepid, see Hal White, *Heteroscedasticity-Consistent Covariance Matrix Estimators and a Direct Test for Heteroscedasticity*, 48 *ECONOMETRICA* 1817 (1980). A similar argument can be made with regard to Hausman's specification tests or Heckman's treatment of sample selection bias. See Jerry A. Hausman, *Specification Tests in Econometrics*, 46 *ECONOMETRICA* 1251 (1978); James Heckman, *Sample Selection Bias As a Specification Error*, 47 *ECONOMETRICA* 153 (1979).

37. Asking someone how much they paid for a car is potentially falsifiable; asking someone whether they feel justly treated is not. See TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* (1990) (for an example of non-falsifiable self-reporting). There are, however, counterexamples where economists rely on just this type of data. See, e.g., Daniel Kahnemann et al., *Fairness and the Assumptions of Economics*, 59 *J. BUS. L.* S285 (1986).

and qualitative ethnography may be distorted by self-interested reporting.<sup>38</sup> Better to observe how people behave than to ask them how or why they behave. While I share this economic inclination, I cannot justify it. The most persuasive empiricism is robust to a variety of methodological approaches and there are some things that can only be known qualitatively and/or through self-reporting. I predict that sociology will retain its lead in this important branch of positive social science.

*Explicitly Stating Normative Implications.* It is an anathema for historians or anthropologists to draw normative legal implications from their research. Economists are at the other end of the spectrum: we routinely make explicit what legal rules we prefer. To be sure, the most important contributions of law and economics concern positive predictions about how different legal rules will affect behavior. And readers that prefer equity or other norms over efficiency could often make use of these behavioral predictions to inform their own choice of law. Chicago-school authors seem to protest too much when they claim that they are primarily interested in "positive theories of law."<sup>39</sup> Indeed, a large portion of Richard Posner's massive opus can be seen as analyzing one-by-one every common law rule to test whether as a positive matter the common law tends to be efficient.

I don't think it necessary to argue whether law and economics has a hidden normative agenda,<sup>40</sup> because law and economists more than any other "law and" types wear their policy prescriptions on their sleeves. Economists have taken prescriptive positions on an incredible array of nitty-gritty legal rules (e.g., contributory negligence, the British rule, Mary Carter agreements, Rule 68, stock lockups). Sociologists do not seem to have as strong an aversion to policy analysis as historians or anthropologists, but my impression is that they are more reluctant to state their views than economists.<sup>41</sup> What I take to be a sociological aversion

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38. See, e.g., Richard O. Beil & David N. Laband, *The American Economic Association Dues Structure*, 10 J. ECON. PERSP. 179 (1996) (showing that economists underreported their income to reduce their subscription price).

39. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); WILLIAM M. LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* (1987).

40. Charles O'Kelly has brought to my attention that I have unwittingly played a role in disguising my normative claims as being merely positive. In playing out the implications of my analysis, I often infer what types of laws "efficiency-minded" lawmakers would want. One could try to argue that this is merely a predictive assertion about what a particular type of lawmaker would prefer. But such an argument is sophistry. I use this compact phrase to suggest that efficiency *should* play a role in lawmaking (however, by no means the only role).

41. This impression may be mistaken. See, e.g., JOHN BRAITHWAITE, *CRIME, SHAME AND REINTEGRATION* (1989).

to taking normative positions leaves the sociological analysis of law a little ungrounded.<sup>42</sup>

Unlike the economist's preference for quantitative data, I believe the economist's preference for explicitly drawing policy conclusions is praise worthy. Explicitly stating what might turn on your analysis provides an important justification for why this topic deserves to be studied. At least on this point, Marx was right. A scholar's job is not merely to ponder the world, but to consider whether we can make it better. Even if we reject an author's policy prescription (and I usually do), at least we understand concretely why we should care about studying these phenomena (as opposed to the number of hairs in my navel). I do not mean to imply that sociologists' interests are equivalent to such a trivial pursuit, but the reader often needs to do the work to understand why the research has a presentist implication.

#### IV. BANKMAN'S ANALYSIS OF SILICON VALLEY START-UPS

At the risk of diminishing marginal returns, I will end by adding my own two cents to the Suchman/Bernstein debate. As an initial matter, I heard Bernstein making more of a lawyerly point than an economic point (although I concede she uses the gear-head vernacular). Suchman expressed surprise that Silicon lawyers were not acting like the prototypical "hired gun."<sup>43</sup> I understood Bernstein's main response to be that we shouldn't be surprised that transactional lawyers behave differently than litigators. Practicing lawyers (even those practicing outside of Silicon Valley) wouldn't be surprised. Instead they might say that Suchman was using the popular conception of all lawyers as "hired guns" as a bit of a straw person. Denuded of the economics jargon, I think Bernstein has a valid point.

But surely this is a venal sin. Who among us (especially as beginning scholars) has not used a straw person or two to motivate our analysis? Suchman's work without this trop remains incredibly rich, both in detail and interpretation. My only nagging worry is that Suchman himself might have been surprised that transactional lawyers turned out to be facilitators. This concerns me because it suggests that Suchman went into the project without a basic knowledge of law practice. I don't believe this to be the case. But it reminds me of two other examples of

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42. Sociologists might argue that the normative analysis of nitty-gritty rules is not the appropriate level of generality. But now who is being reductive (i.e., refusing to engage details)?

43. Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 L. & SOC. INQUIRY 679 (1996).

law and society types being overly surprised at, or unaware of, facts commonly (and consciously) known by lawyers. In one case, a leading law and society scholar of the legal profession casually asked me why lawyers who billed two thousand hours a year (forty hours per week) complained of being overworked. In the other case, Kristin Bumiller was surprised at the way prosecutors of sexual offenders revictimize rape victims by bringing out the details of the crime on direct examination.<sup>44</sup> But the lawyer in me (knowing the practical constraints of establishing proof beyond a reasonable doubt) wants to ask: Why are you surprised? What would you have the prosecutors do? To be sure, law and economics types routinely display appalling ignorance of basic information known to market participants.<sup>45</sup> But sociologists are supposed to be particularly good at doing their ethnographic homework. Being surprised about rudimentary facts that every lawyer knows is worrisome. In contrast, I perceive that when economists are surprised it is more often about effects that the market participants themselves do not know.<sup>46</sup>

The second sin of Suchman is that he did not have the good sense to use my suggestion of exploiting Joe Bankman's wonderful article on Silicon Valley start-ups in responding to Bernstein. This is even more venal. Suchman should be much less concerned about criticism of the form "why didn't you write the response I wanted you to write?" But let me take a few moments to show why Bankman's data is a particularly good lens through which to distinguish economic and sociological approaches to law (and Bankman's study is centered on Silicon Valley to boot).

Bankman uncovers a huge anomaly for "transaction cost engineer" theories. Without going into the details, Bankman shows that start-ups could reduce their taxes if they were organized as subsidiary corporations

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44. Kristin Bumiller, *Fallen Angels: The Representation of Violence Against Women in Legal Culture*, 18 INT'L J. SOC. L. 125 (1990); Kristin Bumiller, *Violence and Intimacy: The Social Construction of Rape* (1987) (paper given at "Feminism and Legal Theory: Women and Intimacy," a conference at the University of Wisconsin-Madison, exploring testimony of women during rape trial).

45. In a famous example, Douglas Baird in Chicago's law and economics seminar pointed out that an economics paper on bankruptcy had failed to take account of the "absolute priority rule"—at which point Frank Easterbrook ostentatiously threw the paper into the trash while pronouncing "Next!"

46. For example, in my recent work with Peter Cramton on the FCC's auctioning of paging licenses, our discovery that giving 50 percent bidding credits to minority-owned firms could *increase* the government's auction revenue clearly came as a surprise to both the FCC and to proponents of affirmative action. Ian Ayres & Peter Cramton, *Deficit Reduction Through Diversity: How Affirmative Action at the FCC Increased Auction Competition*, 48 STAN. L. REV. 761, 770-71 (1996).

or limited partnerships. But bizarrely (from the vantage point of lawyers as “transaction cost engineers”) the start-ups choose to organize as independent corporations—thus causing most firms to lose the tax deduction worth millions (and in many cases tens of millions) of dollars:

[A]n expense that has an after-tax cost of \$1 to [a limited] partnership might cost a newly-formed corporation \$1.40. A newly-formed company thus pays a premium of 40% on every single expense it incurs: Rent is 40% higher, salaries are 40% higher, and so on. In light of this decidedly adverse tax treatment, one might expect that speculative ventures would rarely, if ever, be carried out by a newly-formed corporation, but instead would be carried out by existing corporations, or be organized as partnerships. In fact, in the biotechnology, electronics, and computing industries centered south of San Francisco and around Route 128 near Boston (collectively, “Silicon Valley”), new ventures are organized in a way that does not follow this tax logic. In Silicon Valley, notwithstanding the concomitant loss of tax benefits, a substantial number of new ventures are carried out by newly-formed corporations.<sup>47</sup>

Taxes are the quintessential transaction cost. If lawyers can't induce start-ups to adopt a pareto-dominating legal form, why would we expect them to be able to control other types of transaction costs?:

The organization of Silicon Valley ventures poses a challenge to those who study and write tax policy. A fundamental tenet of tax policy is that, over time, the market will organize itself so that assets will be held, and activities carried on, in a manner that maximizes the tax benefits associated with those assets or activities. In Silicon Valley, however, investment is carried out in a way that virtually ensures the loss of the most important tax benefit available—the deductibility of business expenses.<sup>48</sup>

Bankman painstakingly shows that limited partnerships can produce identical non-tax legal consequences. Moreover, both the law firms and the venture capital firms are concentrated repeat players who have everything to gain from picking up the millions of dollars left on the

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47. Bankman, *supra* note 4, at 1738.

48. *Id.*

ground. Bankman considers and persuasively rejects several economic explanations.

In the end, he turns to an approach that resonates strongly with Suchman's characterization of sociological theory and empiricism. Like Suchman, Bankman goes to his subjects and asks "what gives?" While he is careful not to endorse any single explanation wholeheartedly, his leading contenders are clearly not traditional Gilson/Bernstein "transaction cost engineering" stories:

Attention to tax benefits from early losses runs counter to the expansive mind-set of investors and venture capitalists. "By their very nature," one lobbyist stated, "the kinds of people who are going into these things are very optimistic people—they don't think about tax benefits."

The belief that tax benefits are of little importance to venture capitalists because of the "big score" is held by some of the most sophisticated Silicon Valley decision-makers. Don D., for example, is a former chief financial officer of a large Silicon Valley company turned venture capitalist who has a doctorate in economics from a leading university. When asked about the lack of attention to taxes, Don replies, "Let me tell you what [a leading venture capitalist] told me at the start of my career. 'If this [investment] makes as much money as I think it will, screw the taxes.'"<sup>49</sup>

The best explanations concern just the types of path-dependencies and network effects that are hallmarks of leading branches of sociology:

Other explanations for the organizational structure of start-ups are perhaps more surprising. These explanations reveal an industry shaped by tradition, idiosyncratic investor preferences, and behavior that is hard to reconcile with any strong form of efficient market hypothesis. . . .

. . . [T]he present structure is favored by tradition, or, to put the matter somewhat differently, by an inertial combination of present practice and collective-action problems.<sup>50</sup>

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49. *Id.* at 1764 (alterations in original).

50. *Id.* at 1767.

This start-up corporation anomaly shows the limits of economic analysis because we see behavior that seems wildly at odds with what economists would define as rational decision-making.

Yet even here economics does not need to fall completely silent. While Bankman considers all the self-reported economic explanations (and several unreported as well), I wish he had given more to the possibility of a “signaling” or “screening” explanation.<sup>51</sup> Bankman considered how partnerships might be taken as a perverse signal from venture capitalists to managers:

“Management gets spooked by partnership interests,” according to one venture capitalist.

. . . .  
 . . . [T]he use of an unconventional organizational structure might be taken by an employee as a signal that a venture capitalist will not “play by the rules” or follow convention in other areas as well. An employee might worry that he will repeatedly be placed in similar situations . . . .<sup>52</sup>

But Bankman does not adequately consider how the choice to incorporate might be a way for managers to signal to venture capitalists a higher likelihood that the firm will succeed.<sup>53</sup>

The choice to incorporate has the potential of credibly distinguishing high and low quality projects. Since managers routinely provide their own funds for the initial period of operation,<sup>54</sup> they have more to lose if they organize as an independent corporation. Choosing the corporate form is a credible way for managers to convey their private information

51. The power of signaling explanations is persuasively shown by Eric Posner's contribution to this Symposium. Eric A. Posner, *Altruism, Status, and Trust in the Law of Gifts and Gratuitous Promises* 1997 Wis. L. REV. 567.

52. Bankman, *supra* note 4, at 1751-52.

53. Alternatively, one might view a venture capitalist's requirement that a start-up organize as an independent corporation as a *screening* device to assure that higher quality entrepreneurs apply for funds. The difference between screening and signaling devices turns on whether the informed or uninformed player makes the first move. ERIC RASMUSEN, *GAMES AND INFORMATION* 28 (1989). If we assume that the manager has private information about the prospects of the start-up, then in a signaling game, managers with high quality projects would take actions to distinguish themselves from managers with low quality projects. In a screening game, the venture capitalists (who initially lack the information) would take action (such as requiring start-up incorporation) that would tend to separate the high from low quality projects. From Bankman's description, the incorporation of start-ups is so ubiquitous that it is difficult to distinguish whether incorporation is a venture capitalist requirement (screening device) or managers' choice (signaling device).

54. Bankman, *supra* note 4, at 1758.

about the likelihood of success because—even though the signal creates an added operation expense (more taxes)—the cost of signaling is higher for low quality firms than high quality firms. An additional \$10 million in deductions (at a 40% tax rate) costs a high quality firm (with a 50% probability of success) \$2 million, while it would cost a low quality firm (with only a 10% probability of success) \$3.6 million.

Signaling, however, is often not about efficiency. Poor quality firms may not sit idly by as high quality firms incur modest additional expense to attract venture capital. Instead poor firms may mimic modest signals, forcing high-quality firms to inefficiently oversignal.<sup>55</sup> The discrete nature of institutional forms might also exacerbate the problem of oversignaling. Instead of choosing among a continuum of institutional forms, managers may have to make more of an all-or-nothing choice about whether its organization can pass through deductions to offset present income.

These thoughts on signaling do not amount to more than armchair theorizing. Unlike Bankman or Suchman, I have not picked up either the phone or my carcass to talk with market participants. But given Bankman's unwillingness to crown an individual winner in the "it takes a theory to beat a theory" contest, I propose signaling as a dark horse (plausible, but not probable) entrant. Sociologists might instead take away from this narrative that economics does not provide true falsifiable predictions because ex post economists can (and do) explain anything. The weakness of this argument is in viewing economics as monolithic. My signaling story, while economic, is in competition with (and in this context superior to) the "lawyer as (successful) transaction cost engineer" thesis.<sup>56</sup>

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55. This argument is developed with a more explicit model in Ian Ayres, *The Possibility of Inefficient Corporate Contracts*, 60 U. CIN. L. REV. 387 (1991).

56. Gilson or Bernstein as advocates of the engineering approach might argue that the adverse selection of low quality firms taking venture capital imposes a transaction cost on high quality firms—and that once again lawyers choose the corporate form to mitigate this transaction cost. But the possibility of oversignaling still does not fit comfortably within the engineering framework. Pooling equilibria in which high quality firms are forbidden from acting to distinguish themselves may produce higher gains of trade. *Id.* at 399. For similar results that pooling might produce higher payoffs than individually rational separation, see Philippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORGANIZATION 381 (1990); Morten Hviid, *Default Rules and Equilibrium Selection of Contract Terms*, 16 INT'L REV. L. & ECON. 233 (1996).

## CONCLUSION

*With friends like you, . . .*

The fear and loathing abide. In trying to speak honestly about economists' (plural) views of sociology, I worry that I have revealed more about myself than about the world.<sup>57</sup> And I worry that even to air these canards is to legitimate them. Maybe I shouldn't be trusted. I do think economics produces more sophisticated quantitative empiricism and is likely to continue to be the source of advances in statistical methodology.

This piece itself is easy to dislike or dismiss. A rambling after-dinner speech. More apborisms than arguments.<sup>58</sup> It does not have the characteristics of good scholarship. And somewhat ironically it falls prey to many of the criticisms that have been leveled against sociology. For instance, where are the more normative implications?

Well, okay, here's one. We should stop having conferences like this. Down with ad discipline argumentation.<sup>59</sup> Departmental affiliation is not a good enough proxy to be very useful in assessing the quality of scholarship. Bankman's piece is the best work on Silicon Valley (pace Mark) not because it is economics or sociological but because it is neither—in the important sense that it is willing to openly consider the most plausible theories regardless of disciplinary dressing.

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57. For every one of my generalizations one could give counter examples. At times, I have tried in footnotes to do just this, but I would welcome conference participants to help set me straight.

58. There is an intentionally "flipable" quality to my cutesy apborisms.

59. The obsession that some scholars have with nonconsequential labeling is misguided. The Symposium discussion included a heated debate about whether Richard McAdams' fine work on status production was economics or not. *See, e.g.,* Richard H. McAdams, *Relative Preferences*, 102 *YALE L.J.* 1 (1992). Our collective response to such questions should be "who cares?" or more precisely, "what turns on the answer?" At the Symposium, Robert Ashford seemed intent on asking whether professors have a fiduciary duty to their students. But what he should be asking are substantive questions like whether bad teachers should be jailed or fined or shamed. Similarly, instead of asking whether conference participants are willing to describe themselves as socio-economists, Ashford should ask questions such as whether we should have additional conferences organized by broad-minded interdisciplinary scholars.

