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http://lsr.nellco.org/nyu_lewp/392

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Empirical Analysis of Legal Theory

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Abstract: Empirical analysis of dispute resolution terms in commercial contracts provides information about theoretical issues in contract law. These clauses are adopted at a time when the parties share an interest in maximizing the value of the contract. The analyst can examine the pattern of contracting behavior and infer that the choices made by sophisticated parties will tend to represent efficient arrangements.

Introduction

Empirical analysis of legal phenomena falls into two broad categories. The first type of analysis is a form of sophisticated reportage. The researcher compiles or obtains a data set of information pertinent to a particular area of legal activity. The researcher organizes the information and presents it with a view towards teasing out information that might be obscured in the raw data. When the data are in the form of a sample, the researcher uses inferential techniques to predict the characteristics of the broader population. This type of analysis often involves hypothesis testing but it is not primarily theoretically driven; its main purpose is to present information in a way that can be useful for courts, policy makers, or other researchers. Studies of attorneys’ fees in class action settlements typically have this form; the researchers’

1 Many of the ideas in this paper were presented at the research seminar, “Does the Law Deliver?,” Regensburg, Germany, June 11-14, 2014, and will be published in a forthcoming volume of the Journal of Institutional and Theoretical Economics. For helpful comments I thank the conference participants and especially the commentators, Martin Wells and Gerhard Wagner.
major interest is not to test any particular theory, but rather to compile the data and present it in a way that can help courts and litigants in assessing appropriate fee awards.2

The second type of analysis goes beyond reportage by exploring theoretically driven hypotheses. Most empirical analysis of law has this form, simply because theoretical questions are of greatest concern to scholars and policy makers. The researcher tests relationships among variables based on hypotheses about how one variable is likely to influence another. Much of this work has a public policy dimension. The dependent variable is typically some measure or proxy associated with normative judgments. For example, the dependent variable might be a measure of crime rates; the normative value (implicit or explicit) is that crime is bad. The explanatory variables will include some variation in social policy, either over time or across sections of the data – for example, information on increases or decreases in incarceration rates. The effectiveness of the social policy can be assessed by evaluating whether, controlling for other factors, the policy increases or decreases the rate at which crimes are committed.

Eisenberg and Miller’s investigation of corporate contracts represents a third sort of inquiry – one that is limited in scope but that, within the ambit of its application, offers the potential to shed light on issues of public policy. The data base was a collection of contracts contained as exhibits to 8-K forms lodged in the SEC’s EDGAR archive for a six month period in 2002 (for corporate combinations, one extra month was included). The EDGAR archive is an on-line compilation of electronic securities law filings by public companies. It offers the

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benefits of being convenient, easily accessed, and word-searchable with legal research services. Form 8-K is the SEC’s template for reports of material events at public companies; it is used to provide a current report that supplements or updates information filed in the issuer’s annual or quarterly filings. Often, events requiring submission of a Form 8-K involve contracts between the reporting firm and some other party – securities purchase contracts, settlements of disputes, employment contracts for senior executives, underwriting contracts, merger agreements, securities underwriting agreements, major contracts with vendors or customers, and much else besides. These contracts are often filed as exhibits to a firm’s 8-K report. The result is that the EDGAR database is a rich source of information about contracts involving public companies.

Eisenberg and Miller extracted more than two thousand contracts from the EDGAR archive and coded them for a wide variety of information. In addition to information about the issuer and counterparty, type of contract, etc., the data set included information about clauses for managing disputes arising under the contract: choice of law and choice of forum provisions, jury trial waivers, arbitration clauses, attorney fee clauses, clauses regarding specific performance remedies, and clauses regarding how the contract is to be interpreted (among others). In a number of papers, Eisenberg and Miller probed this data set for information about how the parties provided (or did not provide) for subsequent disputes under the contract.

These papers are largely reportage: they describe the nature of the data and the relationship among variables without testing any overarching theory. They do offer research and null hypotheses for purposes of applying inferential statistics, but few of these relate to a basic question of legal theory. The objective of the research was not to test theoretical hypotheses but rather to offer an informative description of an interesting data set.
The contracts under study were important to the parties. We know this because companies file 8-K reports only when there has been an event that, in the judgment of the firm, has a material impact on its financial performance. If the 8-K report attaches a contract as an exhibit, this is evidence that the reporting company, which is best situated to evaluate the matter, believes that the contract is material to its financial condition. Reporting companies also tend to relatively large – otherwise it is not worth spending the money to list and distribute securities to the public. The contracts in the data set thus tend to be significant, not only in relation to the condition of the reporting firm, but also in terms of the absolute amounts at stake. Taken together, these features indicate that the parties have an interest in paying attention to the contract and its terms.

Because the contracts are made by sophisticated parties seeking to advance their interests, it is reasonable to assume that the contract terms agreed to by the participants are designed to maximize the overall value of the deal. The efficient term is the one that generates the greatest contract surplus. Even if the term arguably favors one party over another, the parties can adjust the mutual costs and benefits through manipulation of the price term in order to assure that both parties are made better off.

One other feature of the data set is significant from a methodological point of view. The key terms under consideration are adopted *ex ante* – they relate to dispute resolution at a time when no dispute exists. Typically, at the time of the contract, neither party intends to breach. Moreover, if there is a breach, the parties do not know whether they will be a plaintiff or a defendant, or even what the dispute will be about. They may project forward and anticipate possibilities, but these future contingencies are usually unknown. The *ex ante* feature of these contract terms embeds a level of generality into the agreement. The terms govern many possible
future events. The observed terms, therefore, tend to lack the idiosyncratic features that might impair their representativeness, as could be the case if the dispute were known at the time of the contract.

Added together, these features of the data set allow empirical analysis to serve a somewhat unusual purpose. To obtain information about efficient contracting terms, we can look at what sophisticated parties do. We don’t need to perform economic modeling; we can simply look empirically at the observed pattern of behavior. This is the sense in which the Eisenberg-Miller studies represent an unusual form of methodology. The descriptive analysis provides normative information pertinent to public policy. No proxy for good or bad outcomes is needed. The following discussion outlines some of the payoffs made possible by this form of analysis.

A. Corporations

The Eisenberg-Miller methodology sheds interesting light on a longstanding debate about the relative merits of Delaware vis-à-vis other states when it comes to corporate law matters. Several scholars have argued that Delaware’s observed dominance in the market for corporate charters is due to the high quality of the Delaware judiciary and to the consistency, clarity and reliability of Delaware corporate law as compared with the laws of other states. Is this analysis borne out by the empirical evidence? Since the parties have very broad discretion to select the law governing their contracts and the forum which will adjudicate disputes under the contract if they arise, one would expect, given Delaware’s purported advantages over other states, that sophisticated contracting parties will select that state’s law and forum in a high percentage of contracts. To what extent is this expectation borne out by the data?

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As for choice of law provisions, Delaware law was indeed selected frequently in Eisenberg’s and Miller’s data set of merger contracts – 32% of the time. New York was a strong contender, however, with its law being chosen 17% of the time. Despite their large populations and significant economies, California (12%) and Texas (2%) were underrepresented. Yet the apparent dominance of Delaware law in these merger contracts may be overstated. Delaware law was selected in only 53% of the cases where the acquiring firm was a Delaware corporation; in contrast New York law was selected in 83% of cases involving New York acquiring firms and California law was selected in 75% of contracts involving California acquiring firms.4

As might be expected, there was a correlation between choice of law and choice of forum: merger contracts that selected a state’s law were disproportionately likely also to opt into courts in that state. Where there is variation, however, the data generated interesting observations. For example, merger contracts that selected Delaware law opted for a Delaware forum 71% of the time, compared with significantly higher percentages for New York (90%) and California (92%). The data suggests a surprising lack of enthusiasm for Delaware as a provider of dispute resolution services in merger cases.

These attitudes towards Delaware are even more pronounced in the broader data set including both merger and other contracts. For contracts generally, New York was the leader in choice of law. Its law was selected for 46% of the contracts, while Delaware law was selected in only 15% of the contracts.5 Similarly, Delaware did not compare favorably with New York when it came to forum selection clauses. In cases where the parties selected a forum and opted into Delaware law, Delaware was the designated forum in 69% of the contracts in the broader

4 However, the relatively small numbers bespeak caution about drawing strong conclusions from the New York and California data.
data set; the comparable figure for New York was 96%. The data on general contracts thus provide further evidence that sophisticated parties often prefer New York over Delaware as a provider of dispute resolution services.

B. Contracts

An important issue in contract law concerns the optimal degree of formality in contract interpretation and enforcement. The traditional view of contract law, associated with Samuel Williston (1861-1963), favors formal, objectively-defined rules, on the theory that the clarity and consistently maximize the ability of the parties to structure their affairs in mutually beneficial ways. The competing view, associated with Arthur Linton Corbin (1874-1967), sees the goals of contract law being to enforce the intentions of the parties and to further other important social policies. The Williston-Corbin debate has been revived in recent years by the work of law and economics scholars such as Alan Schwartz and Robert Scott, who claim that the formalist approach offers superior efficiency payoffs for commercial contracts. Others defend the contextual approach. Which view is correct? Theory generates interesting arguments but few compelling answers. Empirical work can shed additional light on the issue.

The most relevant contrast here is not between Delaware and New York, but rather between New York and California. Unlike Delaware, New York and California are commercial powerhouses. When it comes to contract law, however, there are significant differences between

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6 Ibid.
these large states. Across a wide range of contract doctrines, New York adopts a formalist approach to contract law while California uses a contextual, policy-based approach.\textsuperscript{9}

The evidence from the Eisenberg-Miller data favors New York’s approach to contract interpretation and enforcement. Nearly half of the contracts in the data set chose New York law to govern disputes, and nearly half of the contracts that contained forum selection clauses opted for courts in New York. California, on the other hand, was distinctly unpopular: many fewer contracts opted for California law or a California forum than would be expected given the size and commercial importance of that state. For example, 67% of contracts selecting New York law did not manifest other core connections with New York (place of business, place of incorporation, or attorney locale); in contrast, only 21% of the contracts selecting California law failed to manifest other core connections with California.\textsuperscript{10} In other words, when the contracting parties reached out to select a governing law, they overwhelmingly chose New York and avoided California. Similarly, New York state and federal courts were selected in 41% of the contracts that specified a forum; California was selected in only 7% of such contracts.\textsuperscript{11} More than 96% of contracts that selected New York law also selected a New York forum as compared with only 71% of contracts that selected both California law and a California forum.\textsuperscript{12} The testimony of sophisticated parties whose interest is to select efficient contract terms indicates a preference for New York over California law – thus providing empirical support for the Schwartz-Scott argument about optimal contract law systems.

C. Arbitration

Binding arbitration is an important mechanism for dispute resolution. It enjoys the favor of an important federal law, the Federal Arbitration Act,\textsuperscript{13} and has received generous interpretations from the U.S. Supreme Court.\textsuperscript{14} Advocates for arbitration promote its many supposed virtues as compared with litigation: it is cheaper and faster; the decisions by expert arbitrators are likely to be more accurate than decisions by non-expert juries; its procedures are more flexible and adaptable to the needs of the situation; and so on. But does arbitration really offer overwhelming advantages over adjudication? Theoretical analysis is incapable of offering an answer.

The Eisenberg-Miller methodology sheds light on the debate about arbitration by asking whether sophisticated parties whose incentive is to adopt efficient terms will or will not select arbitration over litigation. Selecting into arbitration in the United States is a simple matter of including such an agreement in the contract. Because it is virtually costless to include such a clause, one might hypothesize that if arbitration offers the signal benefits touted by its advocates, commercial contracts would uniformly include arbitration provisions.

This is not what the Eisenberg-Miller data reveal. Only 11\% of contracts in the data set opted for mandatory arbitration.\textsuperscript{15} Arbitration clauses were somewhat more common in cases involving non-US parties, as might be expected given that a foreign counterparty may be suspicious of the fairness or capacity of American judicial procedures; but even contracts involving a foreign party involved low rates of arbitration clauses (20\%). Since the omission of

\textsuperscript{13} 9 U.S.C. § 10.
an arbitration clause remits the dispute to the judicial process, the data suggest that arbitration may not offer the full array of benefits promoted by its sponsors.\textsuperscript{16}

A different debate about arbitration concerns the increasing use of arbitration clauses in consumer contracts. Business interests claim that they include such clauses in order to assist customers with small claims to assert their rights while avoiding the expense and inconvenience of litigation. Consumer advocates, on the other hand, tend to see a more nefarious motive at play. A mandatory arbitration clause – especially if combined with a waiver of class treatment – effectively precludes one of the few viable consumer remedies against defective or dangerous products: the class action. In the view of consumer advocates, arbitration clauses in consumer contracts are essentially wolves in sheep’s clothing: while pretending to protect consumers against defective products, they actually deprive consumers of rights previously enjoyed to participate in class-wide litigation and relief. Who has the better of the argument?

The empirical approach favors consumer advocates. Using a sample of 26 consumer contracts and 164 non-consumer contracts from the same large public companies, Eisenberg, Miller and Sherwin find that more than three-quarters of consumer agreements contained arbitration clauses but less than 10\% of the firms’ material, non-consumer non-employment contracts included such clauses.\textsuperscript{17} Based on this evidence, the authors suggest that the frequent use of arbitration clauses in consumer contracts is probably an effort to preclude aggregate consumer litigation rather than as an effort to promote fair and efficient dispute resolution.

\textsuperscript{16} These results generated a vigorous response by arbitration advocates, who, while not disputing the Eisenberg-Miller results, argued that the contracts contained in their data were not representative of the larger universe of commercial agreements. See Christopher R. Drahozal and Stephen J. Ware, Why Do Businesses Use (or Not Use) Arbitration Clauses?, 25 Ohio State Journal on Dispute Resolution 433 (2010); Christopher R. Drahozal and Quentin R. Wittrock, Is there a Flight from Arbitration?, 37 Hofstra Law Review 71 (2008).

**Juries**

The United States is one of the few countries in the world to utilize jury trials in civil cases. In federal courts, the right to a civil jury is guaranteed by the Seventh Amendment to the United States Constitution; similar guarantees exist in the states. Nevertheless the civil jury is controversial. Business interests attack juries on a variety of fronts, claiming that panels drawn from the general population will not understand complex or technical business deals; that juries decide issues on the basis of emotion rather than evidence; that they often award outlandish damages; that juries are biased against business interests, and so on. But are these critiques valid?

The Eisenberg-Miller methodology allows for an empirical investigation of the pros and cons of civil juries. In all but two states, contracting parties can opt out of a civil jury simply by including a clause to that effect in their contracts. If juries are as inadequate as opponents paint them to be, then one would expect to see a high rate of opt outs from jury trials in the data set of large commercial contracts. This, however, is not what Eisenberg and Miller find.\(^\text{18}\) Jury trial waivers are found in only 20% of the contracts studied. This figure underestimates the frequency of jury trial waivers to some extent because it doesn’t include mandatory arbitration clauses which also dispense with the jury; but even classing arbitration clauses as jury trial waivers, the opt-out rate was only 29%.

These data suggest that despite the powerful anti-jury rhetoric, businesses do not display any particular hostility towards juries in their actual behavior, at least when it comes to contracts with one another. Because failing to waive a jury trial effectively establishes that a jury will be empaneled at the request of either party, the empirical results indicate that for nearly three-

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quarters of the contracts, the parties accepted that a jury could resolve disputes under the contract. This finding suggests that, contrary to a widespread perception about the alleged inadequacies of juries in complex business cases, sophisticated actors may perceive that juries add value to dispute resolution.¹⁹

Attorneys’ Fees

The United States is home to a somewhat complex set of background rules on compensating attorneys in litigation. These rules generally govern fees in litigation unless the parties elect to vary them by contract. Under the “American Rule,” applicable in all states other than Alaska, each side pays its own attorney regardless of outcome; under the “English Rule,” applicable only in Alaska, the loser pays the winner’s reasonable attorneys’ fee.²⁰ Also in play are “fee-shifting” rules, common in many public-interest contexts, which provide that losing defendants pay the reasonable fees of successful plaintiffs, but that losing plaintiffs don’t pay the defendants’ fees.

The past decades have witnessed a protracted but inconclusive debate about the virtues of different systems for compensating attorneys in litigation. Plaintiffs’ advocates usually prefer fee-shifting statutes or, in the case of class actions, the American Rule which entitles them to a share of the common fund generated on behalf of the class. Defense interests and others who are concerned about litigiousness in American culture often advocate for some version of a loser-pays, English rule system. This debate, which has been played out at the level of policy, has a theoretical analog in which competing models of litigation generate different inferences about

¹⁹ Eisenberg and Miller also discovered state-by-state variations in the frequency of jury trial waivers. Over 80 percent of the contracts designating Illinois as a forum contained jury trial waivers whereas less than half the contracts designating New York as a forum, and only about one-third of the contracts designating California, Texas, or Florida as a forum, contained waiver clauses. Jury waivers, however, were not more common in international contracts.

²⁰ The term “English Rule” is a misnomer reflecting American parochialism, since what U.S. law sees as an English institution is in fact the prevailing pattern in most of the world.
the virtues of fee regimes.\textsuperscript{21} The problem for theory, however, is that despite the sophistication displayed in these studies, their conclusions are either inconsistent with one another or else are based on so many assumptions as to leave the reader in a state of paralysis.

The Eisenberg-Miller methodology holds some promise to loosen this theoretical Gordian Knot.\textsuperscript{22} In a study of fee clauses in the contracts data base, these authors find that the parties did, in fact, frequently opt out of the American Rule: more than 60\% of the contracts contained a clause which deviated from the background rule that each party paid its own fees. The rate of opting out from the American Rule significantly exceeded the opt-out rates from other background rules in Eisenberg and Miller’s studies. The analysis of attorneys’ fee clauses thus provides evidence that the American Rule is not always seen as value enhancing by many sophisticated contracting parties.

\textbf{Remedies}

Although common law and civil law rules of contract law are largely consonant with one another, one difference concerns the officially preferred remedy for breach. In Anglo-American systems, the traditional rule is that specific performance is granted only when money damages


are shown to be inadequate. In continental Europe, a common formulation is that the non-breaching party has the option to select either money damages or specific performance, without needing to prove the inadequacy of damages as a condition for obtaining injunctive relief. Contemporary scholarship has recognized that these differences may be less salient than first appears, but this does not detract from the theoretical puzzle: as between damages and specific performance, which remedy generates the greatest social value? This issue has been a fruitful issue in contract theory, but again the results of attempts at formal modeling are inconclusive.23

The Eisenberg-Miller methodology allows for an empirical investigation of these questions. Parties to a contract may not be able to dictate what relief the court may award in the event of breach. They may, however, place a thumb on the scale by stipulating that the conditions for injunctive relief will be present if the contract is breached – that is, that damages will be inadequate to provide relief and that the non-breaching party will have no adequate remedy at law. Eisenberg and Miller’s study, forthcoming in the Journal of Empirical Legal Studies,24 reveals that such clauses occur frequently in the data base. Thus sophisticated parties demonstrate, by their behavior, that they do not consider damages to be an optimal remedy in a


significant number of cases. Beyond this, the study uncovered substantial diversity in the adoption of specific performance clauses. High rates of such clauses were found in merger agreements (53.4 percent) and assets sale agreements (45.1 percent) but much lower rates are observed in loan agreements. It appears, therefore, that treatment of specific performance in corporate contracts is more complex than conventional theories allow.

**New Questions**

In addition to providing evidence on theoretical issues, Eisenberg and Miller’s data set opens new questions for investigation. Among the most intriguing observations in the Eisenberg-Miller studies is the relationship between choice of law and choice of forum provisions. One might predict that contracts containing choice of law clauses would also contain choice of forum provisions. The two types of clauses are closely related; and if the parties go to the effort to declare a governing law, it seems that they might easily also select a forum.

This is not what Eisenberg and Miller observe. Choice of law provisions were ubiquitous in their data sets. Every one of 412 merger contracts specified the law governing disputes under the contract; and the broader data set revealed a similar pattern.\(^\text{25}\) The near-universal practice of selecting a law to govern the contract suggests that the parties considered the certainty and predictability of specifying the applicable law to be a value-enhancing feature. Yet the same considerations did not induce the parties to select a forum in nearly as many cases. For merger contracts, the parties specified a forum in only 53% of the contracts. For contracts generally, the parties specified a forum in only 39% of the contracts.\(^\text{26}\)


The contrast between the universal use of choice of law provisions and the much less common use of forum selection clauses is curious, especially since practicing attorneys often remark that the selection of the forum is often more important as a practical matter than the selection of a governing law. The revealed pattern presents a challenge for theory: why do parties select the law much more often than they select the forum?27

Limitations

The foregoing discussion has outlined the value of using contracts among sophisticated parties as a means for illuminating questions of legal theory. But there are also limitations to this technique. The approach works best for major contracts between sophisticated parties with relatively equal bargaining power, and for analysis of topics such as *ex ante* dispute resolution provisions where the parties, not knowing the details of a future dispute, have little incentive to skew the agreement away from the efficient outcome. When these conditions are absent, we cannot be as confident that the contract terms selected will represent efficient solutions to bargaining problems. The approach is also limited by the data: results pertinent to one set of contracting parties or one period of time may not necessarily provide accurate information about efficient contract terms involving other parties or other settings. Most fundamentally, the Eisenberg-Miller approach only has value if its essential premise holds: parties to commercial contracts bargain towards efficient contract terms. If this premise is not true, then little information of theoretical value can be obtained from the data set. Despite these limitations, the approach illustrated in Eisenberg and Miller’s studies holds promise to shed light on heretofore intractable issues in legal theory.

27 One hypothesis for the contrast is that forum selection clauses are likely to be contentious issues in contract bargaining, and also that a party’s insistence on a particular forum may signal to the counterparty that the first party considers a contract dispute to be likely.