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WHAT LEGAL SCHOLARS CAN LEARN FROM LAW AND ECONOMICS

ANTHONY OGUS*

> It is a general, and in my opinion deplorable, characteristic of legal scholarship that normative analysis vastly preponderates over positive.
>
> —*Richard A. Posner*[1]

INTRODUCTION

The task I have set myself in this Article is to offer some general observations on how legal scholars can benefit from law and economics.[2] Most lawyers who are aware of the subdiscipline—and there are an increasing number of these—tend to identify it with propositions like, "judges or the legislature ought to adopt rule X in situation Y because it is the efficient solution to the problem." Such propositions are, of course, conclusions to normative analysis and, as such, are vulnerable to criticism which was already familiar twenty years ago and which has never been refuted: the law reflects values and goals other than that of allocative efficiency.[3] This does not imply that the analysis is misguided or unimportant, since awareness of what is an efficient legal rule in any given situation can contribute much to legal policymaking; at the minimum, policymakers who pursue noneffi-ciency goals should be made aware of the welfare costs of doing so.

* Professor of Law, University of Manchester; Research Professor, University of Maastricht. I am grateful for comments on this Article made by Judge Richard Posner and participants at the Special Workshop on Law and Economics and Legal Scholarship, 21st IVR World Congress, Lund, Sweden (August 12–18, 2003).

1. Richard A. Posner, *The Economic Approach to Law*, 53 TEX. L. REV. 757, 768 (1975).

2. It is a companion to, but very different from, my contribution to the New Palgrave Dictionary, Anthony I. Ogus, *Law-and-Economics From the Perspective of Law*, *in* 2 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 486 (Peter Newman ed., 1998), which adopted a largely chronological approach.

3. Ronald Dworkin, *Why Efficiency?: A Reply to Professors Calabresi and Posner*, 8 HOFSTRA L. REV. 563 (1980); Guido Calabresi, *The New Economic Analysis of Law: Scholarship, Sophistry, or Self-Indulgence?*, 68 PROC. BRIT. ACAD. 85 (1982). I am unconvinced by the recent attempt in LOUIS KAPLOW & STEVEN SHAVELL, FAIRNESS VERSUS WELFARE (2002), to discount notions of fairness by arguing that they are simply part of the social welfare function. *See* Daniel A. Farber, *What (If Anything) Can Economics Say About Equity?*, 101 MICH. L. REV. 1791 (2003) (reviewing KAPLOW & SHAVELL, *supra*).

But obsession with the efficiency goal[4] has tended to divert attention away from the power and insights of positive analysis.

The quotation which heads this Article comes from a paper written by Posner in 1975, in which he argues that the economic analysis of law can and should serve as a corrective "increasing our knowledge about the legal system."[5] The observation leads to a double irony: first, that most of the law and economics literature appears to have been normative in character; and second, that Posner's own work has been a primary inspiration for it. Both aspects can be explained by the ambiguity as to what is meant by "positive" law and economics analysis.[6] Drawing on the conventional understanding of the term within economics,[7] I construe it to mean the application of economic methodology to predict the impact of law and legal institutions on behavior.[8] I argue in Section I that, in this sense, Posner's observation—that the positive, predictive contribution of law and economics is still undervalued—is still justified, and that lawyers, because so often they fail to understand the nature of the interaction between law and market phenomena, can derive much insight from it.

Others, including Posner himself,[9] have sometimes given a special meaning to "positive law and economics": a prediction that the law has an economic function and, in particular, that the common law serves as an "instrument for promoting economic efficiency."[10] It is confusing to incorporate within the framework of positive analysis a normative concept—"efficiency"—especially when there is no agreement on the criterion as to what is "efficient"; and empirical verification of the predictive hypothesis is necessarily problematic.[11] For this reason it may be preferable to refer to this type of analysis as "inter-

4. Or rather goals, since in only a minority of law and economics publications is it made clear whether the author is using the Pareto or Kaldor-Hicks criterion for efficiency.

5. Posner, *supra* note 1, at 768.

6. *See* Paul Burrows & Cento G. Veljanovski, *Introduction: The Economic Approach to Law*, *in* THE ECONOMIC APPROACH TO LAW 17–21 (Paul Burrows & Cento G. Veljanovski eds., 1981).

7. MILTON FRIEDMAN, ESSAYS IN POSITIVE ECONOMICS 4 (1953).

8. *See* Michael Trebilcock, *The Value and Limits of Law and Economics*, *in* THE SECOND WAVE OF LAW AND ECONOMICS 12–17 (Megan Richardson & Gillian Hadfield eds., 1999).

9. Richard A. Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 287–97 (1979); and see, for example, the title to the paper, William M. Landes & Richard A. Posner, *The Positive Economic Theory of Tort Law*, 15 GA. L. REV. 851 (1981).

10. Posner, *Some Uses and Abuses of Economics in Law*, *supra* note 9, at 289–90.

11. Burrows & Veljanovski, *supra* note 6, at 19.

pretive" or "explanatory."[12] Whatever it is called, this type of analysis has clearly made a major contribution to modes of legal scholarship which center on promoting the coherence and systematic orderliness of the law. As I shall attempt to demonstrate in Section II, because law and economics cuts across traditional legal conceptual structures as well as legal systems and cultures, it provides a valuable tool for understanding the relationship between different parts of the legal system and between different systems. More controversially, I shall also contend that an economic interpretation helps to resolve the ambiguities and uncertainties that inevitably arise when legal entitlements are based on notions of morality and corrective justice.

I. POSITIVE LAW AND ECONOMICS

A. Behavioral Incentives

Much of the law creates obligations for actors (individuals or firms) to behave, or not to behave, in certain ways. The obligations form part of a large variety of regimes, each with its own set of sanctions which are expected to induce the desired outcome. Supposing that a policymaker is concerned with ascertaining what regime or regimes would be preferable to achieve a given behavioral outcome, positive law and economics can provide a major input. It does so by treating all the regimes as pricing mechanisms, adding to the cost of an activity and thereby reducing the demand for it. Then, to compare the impact on behavior of the different mechanisms, it adopts a predictive model, for example that the actor will comply when

$$U < qE + pD$$

U being the utility the actor derives from noncompliance; qE representing the probability and the associated costs of the relevant act being detected by an enforcement agent; and pD being the probability of a formal condemnation or conviction and its associated costs, including notably the prescribed sanction.[13] In relation to the possible

12. I prefer these designations to the more frequently encountered "descriptive law and economics." *Cf.* FRANK H. STEPHEN, THE ECONOMICS OF THE LAW 3–5 (1988).

13. The model distinguishes between the costs resulting from detection and formal condemnation respectively, because in many regimes optimal enforcement strategy implies that the latter stage should not be reached. P. Fenn & C.G. Veljanovski, *A Positive Economic Theory of Regulatory Enforcement*, 98 ECON. J. 1055 (1988).

regimes available, the policymaker will then wish to explore four principal variables: the administrative costs of enforcement (distinguishing between the costs of any process and those of imposing the sanction); the attributes of the sanction (how likely it is to satisfy the condition $pD > U$); the incidence of informal costs (qE, which may compensate for any deficit in pD); and the level of information available to actors regarding $qE + pD$, since without such information the model is inoperative.

I have attempted in the following table to summarize how the variables are likely to operate in relation to the different sanction regimes.

	Process costs	Imposition costs	Adequate sanction	Informal costs add-on	Actors' information
Fine	high	low	generally	generally	medium
Prison	high	high	generally	generally	medium
Community	high	high	sometimes	generally	medium
Confiscation	medium	low	sometimes	generally	medium
Tort damages	medium[a]	medium	sometimes	sometimes	medium
Punitive damages	high	medium	generally	generally	low
Injunction	high	high/ medium[b]	generally	sometimes	medium
Restitution	medium	low	rarely	rarely	medium
Contractual invalidity	medium	low	sometimes[c]	rarely	low
Administrative penalty	low	medium	generally	rarely	medium
Tax/charge	low	medium	sometimes	rarely	high
Market exclusion	high	low	generally	generally	low
Name and shame	medium	low	sometimes	always	medium
Social norm	low	low	sometimes	always	high

[a] Includes settlement of claims.

[b] Medium if there is negotiated release.

[c] When there is significant investment in the transaction.

Of course, the level of generality in the classifications, as well as the subjectivity involved in the judgments, reduces their usefulness. But if they were to be applied to identify the system which may be presumed to achieve the desired behavioral inducement at lowest cost, then combining a low score in the second and third columns with a high score in the remaining three columns would provide some answer.

The methodology involved in this analysis is, of course, highly familiar from the economics of crime and law enforcement literature,[14] although its application to some of the regimes involved in the comparison may be more original. Why should it be of value to lawyers? We should note, in the first place, that in thinking about deterrence, lawyers certainly pay heed to the level of sanctions and the problems of inadequate enforcement, but nevertheless often fail to recognize the interplay between the two variables which lies at the heart of the economic model. So also, there is a tendency to focus excessively on the criminal law, thereby overlooking, or at least undervaluing, the incentive effects generated by other legal instruments. The neglect is unfortunate because, in terms of administrative costs, the criminal justice process is particularly expensive.[15]

A second, and related, point is that lawyers typically give insufficient attention to "informal costs" (***E***). Social norms constitute one important source of these informal costs.[16] It is difficult to generalize on the size of the costs since so much depends on the character and context of the norm. The probability of incurring disapproval consequent on contravention of the norm will also vary enormously, but since there are likely to be more individuals interested in observing compliance with social norms than those directly involved in the en-

14. *See* A. Mitchell Polinsky & Steven Shavell, *Public Enforcement of Law*, *in* 5 ENCYCLOPEDIA OF LAW AND ECONOMICS: THE ECONOMICS OF CRIME AND LITGATION 307 (Boudewijn Bouckaert & Gerrit De Geest eds., 2000) (hereinafter ENCYCLOPEDIA OF LAW AND ECONOMICS); Erling Eide, *Economics of Criminal Behavior*, *in* ENCYCLOPEDIA OF LAW AND ECONOMICS, *supra*, at 345.

15. This is a consequence of the higher level of procedural protection afforded to defendants. For an economic analysis of the justification for this higher level of protection, see Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399, 410–17 (1973); and, for another interpretation, see Keith N. Hylton & Vikramaditya S. Khanna, *Toward an Economic Theory of Pro-Defendant Criminal Procedure* (Boston Univ. Sch. of Law, Law & Econ. Working Paper No. 01-02, 2001), *available at* http://papers.ssrn.com/paper.taf?abstract_id=265795.

16. *See generally* Symposium, *Social Norms, Social Meaning, and the Economic Analysis of Law*, 27 J. LEGAL STUD. 537 (1998); and, for a comparison with legal norms, Steven Shavell, *Law Versus Morality as Regulators of Conduct*, 6 AM. J.L. & ECON. (forthcoming).

forcement of legal rules, we can perhaps attribute a higher value to p in the former case. In any event, the costs of enforcement are significantly lower, since by definition no formal proceedings are involved. To counter such advantages, it should be noted that a significant degree of uncertainty typically exists as to the content of the social or moral norms, thus creating ambiguity regarding their application to specific situations.

Informal costs may also be consequent upon condemnation by, or involvement in, formal legal processes. These may be characterized either as stigma costs, where the publicity consequent on the finding affects primarily the social reputation of the actor; or as market costs, if commercial reputation is damaged and demand for the actor's products or services is reduced. The former depends critically, of course, on the social standing and network of the individual concerned. Commercial reputation plays a key role in certain industrial sectors, particularly if traders have an interest in maintaining an ongoing relationship with customers and thereby acquiring their goodwill.[17] In consequence, informal costs may, in some contexts at least, be more important than formal costs.[18]

B. *The* Ex Ante, Ex Post *Dilemma*

Much of the practice of law involves some form of dispute resolution and of course, particularly in a common law system, judicial rulings play a significant part in the interpretation and development of the law. I do not wish here to enter into the classic debate about the impact of levels of generality or specificity in legal rules and therefore also of the degree of discretion conferred on adjudicators.[19] But one aspect deserves attention in the present context: adjudication, for the purpose of determining an appropriate outcome, typically involves investigating an individual dispute *ex post*; and the adversarial approach favored in common law jurisdictions tends to

17. Carl Shapiro, *Consumer Information, Product Quality, and Seller Reputation*, 13 BELL J. ECON. 20 (1982).

18. Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear From Committing Criminal Fraud*, 36 J.L. & ECON. 757 (1993).

19. The classic paper is Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974). For an interesting recent contribution to the literature, see Katharina Pistor & Cheng-Gang Xu, *Incomplete Law—A Conceptual and Analytical Framework and its Application to the Evolution of Financial Market Regulation* (Columbia Law Sch. Center for Law & Econ. Studies, Working Paper No. 204, 2002), *available at* http://ssrn.com/abstract_id=310588.

force attention away from the generality of the issues involved to the merits of the opposing claims. In contrast, the economic approach invariably adopts an *ex ante* approach, exploring how the generality of actors respond to given legal rules. As such, it can provide a valuable corrective to bias or myopic reasoning that can arise in *ex post* decisionmaking.[20]

An obvious starting point would be the problem of hindsight bias: individuals tend to overstate the predictability of events that have already occurred.[21] As such it can obviously lead to flawed decisions regarding causation or the level of care to be expected of actors.[22] By insisting on *ex ante* risk assessment, law and economics provides a necessary corrective. The point is straightforward and requires no elaboration. I wish, instead, to move to an independent, but related problem: when making decisions *ex post* on the basis of a principle or interpretation which seems to them to be appropriate to resolve the individual dispute, judges sometimes fail to appreciate what impact this is likely to have *ex ante*, but which an economic analysis would be adept at predicting.

An example can be taken from insolvency law. Judges and policymakers have struggled to formulate rules and procedures for bankruptcy which are, on the one hand, "just" to creditors and, on the other hand, reduce the costs to the various stakeholders involved in financial distress.[23] Critical also, but often ignored in the analysis, is the impact the arrangements have on corporate behavior *ex ante*: if they are too lenient, managers may be encouraged to engage in suboptimally risky ventures; creditors may demand higher rates of interest, or be unwilling to lend; and investment patterns may change.[24]

20. Michael J. Trebilcock, *Economic Analysis of Law*, *in* CANADIAN PERSPECTIVES ON LEGAL THEORY 103–07 (Richard F. Devlin ed., 1991).

21. Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, *in* BEHAVIORAL LAW AND ECONOMICS 95 (Cass R. Sunstein ed., 2000).

22. Lawyers might not, of course, respond as "typical" individuals, but I have (sadly) to report that in a coursework assignment, given as part of my undergraduate law and economics course, more than a few students exhibited the bias. They were asked to comment on an accident killing thirty-one people and arising from a decision made by a railway company not to invest in more sophisticated signaling equipment which, on the evidence accepted by the company, would have saved one life over a period of twenty years. A number of students seemed to assume that because the accident had happened, the statistical evidence relied on by the company had been shown to be unreliable.

23. *See, e.g.*, R.M. GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW (2d ed. 1997).

24. Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy Reform on Investment Incentives*, 72 WASH. U. L.Q. 1159 (1994); Anthony I. Ogus & Charles K. Rowley, *Prepayments and Insolvency* (1984) (published by the United Kingdom Office of Fair Trading).

Take, next, contract law and the English case of *Williams v. Roffey Bros. & Nicholls Ltd.*[25] A carpenter who had contracted with builders to undertake certain work for them found that, because of financial difficulties, he was unable to complete it at the agreed price and he negotiated an increase. The builders subsequently argued that the agreement to pay the increase was not enforceable because it was not supported by consideration: they had sustained no benefit from paying more (in economic terms, it was not a Pareto-efficient contract). The court disagreed. By enabling the work to be finished on time, and without the hassle of enforcing the original contract, the builders had secured a benefit. Now, whatever be the merits of this decision (and with reference to the parties themselves, it appears to have been a good one), the judges failed to ask the question which would have been at the heart of an economic analysis:[26] What incentive effects would the suggested interpretation of principle have on contracting behavior generally? The evident problem is that, if contract modifications are too readily enforceable, then individuals may be led to believe that there is little risk in underpricing in order to attract custom (in which case, though the subsequent modification may be in the interest of both parties, it is not Pareto efficient, because of the negative externalities generated).

Appreciation of the likely *ex ante* impact of a rule or ruling generally requires some understanding of the market conditions applicable in the situation and the predictable response of actors to them. It is a well-trodden path for positive law and economics scholars, but may be less familiar territory for lawyers. Given the foundational status of Coasean ideas,[27] the former are likely to be adept at predicting how parties will find consensual arrangements capable of bypassing the rules or rulings when it is in their mutual interest to do so, whereas lawyers may attribute a higher normative quality to the pronouncements.[28]

25. Williams v. Roffey Bros. & Nicholls (Contractors) Ltd., [1991] 1 Q.B. 1 (C.A. 1989).

26. *Cf.* Antony W. Dnes, *The Law and Economics of Contract Modifications: The Case of* Williams v. Roffey, 15 INT'L REV. L. & ECON. 225 (1995).

27. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

28. An empirical study, Ward Farnsworth, *Do Parties to Nuisance Cases Bargain After Judgment? A Glimpse Inside the Cathedral*, *in* BEHAVIORAL LAW AND ECONOMICS, *supra* note 21, at 302, 310, has shown that lawyers rarely envisage bargaining around court orders as postulated in Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). More familiar, perhaps, is the device of entering into one category of contractual relationship (*e.g.*, a license) in order to avoid the regulatory requirements of another (*e.g.*, leasehold). *See, e.g.*, Street v. Mountford, [1985] A.C. 809 (H.L.).

Judicial attempts to identify, and then to regulate, "unfair" terms in a contract illustrate well how a failure to understand market conditions can not only hinder good decisionmaking, but may also lead to outcomes opposite to those which were intended. In *A. Schroeder Music Publishing Co. v. Macaulay*,[29] a young pop musician had entered into a standard form contract with a publishing house. The contract contained terms highly favorable to the publishers including one which effectively tied the musician to the publishers for a long period, if a song was successful. The House of Lords held that the clause was unenforceable being in unreasonable restraint of trade. At the heart of the judges' reasoning was the conviction that contracts issued on a "take-it-or-leave-it" basis were "a classic instance of superior bargaining power" which could be exploited to force unwanted terms on the other party.[30] They were typically "the result of the concentration of particular kinds of business in relatively few hands."[31]

Law and economics analysis has exposed the weaknesses in these traditional arguments.[32] The essence of the matter is not whether the terms of the contract were presented on a "take-it-or-leave-it" basis, but whether alternatives were available in the market. A standard form is not, by itself, a reliable indicator of a cartel or undue market concentration; they are regularly used in many highly competitive industries. Provided that there is a sufficient number of active consumers who do compare the terms offered by different suppliers and whose demand the latter will need to attract, the terms should meet the preferences of consumers as well as suppliers.[33]

An investigation of the market conditions in the *Schroeder* case would have revealed the existence of adequate competition among music publishers.[34] It would also have provided an obvious economic explanation for the apparently onerous terms in the contract: given the relatively low rate of success of unknown pop composers, pub-

29. A. Schroeder Music Publ'g Co. Ltd. v. Macaulay, [1974] 3 All ER 616 (H.L.).

30. *Id.* at 624 (Diplock, L.).

31. *Id.*

32. See, particularly, the studies of M.J. Trebilcock, *The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords*, 26 U. TORONTO L.J. 359 (1976); M.J. Trebilcock & D.N. Dewees, *Judicial Control of Standard Form Contracts*, *in* THE ECONOMIC APPROACH TO LAW 93, *supra* note 6; Michael J. Trebilcock, *An Economic Approach to the Doctrine of Unconscionability*, *in* STUDIES IN CONTRACT LAW 379, 390–421 (Barry J. Reiter & John Swan eds., 1980).

33. Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630 (1979).

34. Trebilcock & Dewees, *Judicial Control of Standard Form Contracts*, *supra* note 32, at 101–02.

lishers have to derive an increased profit from those who are successful to cover the costs of publication. Clearly if the attempts to secure such a profit are rendered unenforceable, publishers will be unable to publish songs from unknown composers unless they are confident of success—an outcome which is unlikely to be beneficial to the individuals whose interests the judicial intervention was intended to protect.[35]

C. *Comparative Law and Rule Formulation*

There has been a revival of interest in comparative law in recent years, mainly as a consequence of the globalization of markets and the perception that there are benefits to be obtained from the harmonization, or at least approximation, between different legal systems.[36] Comparative lawyers have been slow to adopt the methodology of law and economics,[37] but there have been important publications in the last few years.[38] In my own work, I have explored the hypothesis that some degree of competition between national legal orders, arising primarily as a consequence of greater freedom of international trade and greater freedom in choice of law rules, helps to explain the relationship between the evolution of legal principles in different jurisdictions,[39] and that "legal culture" is best understood as an economic network, established by practicing lawyers in order to create barriers to that competition.[40]

35. For another example, also a House of Lords decision, see *George Mitchell (Chesterhall) Ltd. v. Finney Lock Seeds Ltd.*, [1983] 2 A.C. 803 (H.L.), and the interesting commentary by HUGH COLLINS, REGULATING CONTRACTS 273–74 (1999).

> In order to reach decisions that conform to sophisticated assessments of substantive unfairness informed by sociology and economics, legal adjudication has to incorporate these frameworks of analysis into its reasoning. In so doing, however, the legal analysis corrupts or misreads those other discourses, so that it misses their full subtlety.

Id.

36. *See, e.g.*, VEREINHEITLICHUNG UND DIVERSITÄT DES ZIVILRECHTS IN TRANSNATIONALEN WIRTSCHAFTSRÄUMEN [HARMONIZATION AND DIVERSITY IN CIVIL LAW FROM A TRANSNATIONAL ECONOMIC PERSPECTIVE] (Claus Ott & Hans-Bernd Schäfer eds., 2002).

37. Perhaps because comparative law has been dominated by European, rather than North American, scholars.

38. *See* UGO MATTEI, COMPARATIVE LAW AND ECONOMICS (1997). See also the Global Jurist electronic journals, http://www.bepress.com/gj/.

39. Anthony Ogus, *Competition Between National Legal Systems: A Contribution of Economic Analysis to Comparative Law*, 48 INT'L & COMP. L.Q. 405 (1999).

40. Anthony Ogus, *The Economic Basis of Legal Culture: Networks and Monopolization*, 22 OXFORD J. LEGAL STUD. 419 (2002).

Here I wish to consider how law and economics can contribute to what is more central to the work of comparative lawyers: an understanding and evaluation of differences between the national legal principles governing identical factual situations. A regular finding of comparativists is that a given difference is more apparent than real, in the sense that the same outcome is reached but by a different legal route. So, for example, if a reader, as a consequence of following negligent advice regarding investments given in a newspaper, sustained financial losses, she would not be able to recover damages in English law because there is no duty of care in relation to negligent misrepresentations extending beyond "special relationships."[41] In France, there is no equivalent principle, but the reader would probably be denied compensation on the different ground that there is an insufficiently strong causal link between the negligence and the loss.[42]

Law and economics can enrich comparative study of this kind in two different ways. First, by predicting what consequences would have occurred if the newspaper had to pay compensation, it can help in an understanding of why the legal systems might reach the same outcome.[43] Information provided by a newspaper generates some positive externalities; third parties can benefit without paying. If it is held liable for negative externalities (losses caused by the advice), without being compensated for these positive externalities, it will be unwilling to provide the information. Secondly, we can explore the cost implications of the two different legal methods of reaching the outcome (no liability). The English approach is more of a hard and fast rule, leaving little discretion for its application to marginal cases; and the greater certainty generates savings in transaction costs and administrative costs. At the same time, the very rigidity of the rule may lead to welfare losses where, in a particular case, there are insufficient positive externalities to justify restricting the internalization of negative externalities. The greater flexibility inherent in the French application of a causation test can accommodate some variation in legal outcome, and thus a saving of these welfare losses, but, because

41. Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd., [1964] A.C. 465, 483, 486 (H.L. 1963).

42. See the decision in S. Jur. II, 217 (Trib. Seine 1931), and comparison of the two legal systems in D. Marshall, *Liability for Pure Economic Loss Negligently Caused—French and English Law Compared*, 24 INT'L & COMP. L.Q. 748, 786–87 (1975).

43. William Bishop, *Negligent Misrepresentation Through Economists' Eyes*, 96 L.Q. REV. 360 (1980).

of the uncertainty arising from the more general rule, with an increase of transaction and administrative costs.[44]

Of course, in some situations the differences between two legal systems may be real, and not just apparent, in that the outcomes diverge. Law and economics can here predict what economic consequences flow from the difference. We can use the example of an individual who purchases a chattel from someone who does not have a good title, perhaps because he is a thief. English law, in general, protects the original owner;[45] in France, a bona fide purchaser typically has better title.[46] The following analysis predicts that the French approach increases the value of the chattel.[47]

In the case of the purchase of (say) a jewel, the buyer is willing to pay for it

$$U - pL - qM$$

where U represents the value (the utility) of the jewel to her; pL the losses resulting from the risk of the seller not having good title to pass; and qM the losses resulting from the risk that, after purchase, the jewel will be lost or stolen and eventually bought by a third party. As summarized in the table below, we can expect that in France, provided it is a bona fide purchase, pL will be trivial; but qM may give rise to significant losses. The reverse is true under the traditional English approach, where pL will be the significant risk. In these circumstances, the purchaser will be motivated to allocate resources to reduce the risk, and will do so if the cost is less than the benefit, the reduction in losses engendered by such action. In France, this will be C_O, the cost of the owner taking care to prevent loss or theft; in England, it will be C_P, the cost to the purchaser of making inquiries into the title held by the seller.

	Principal risk	Cheapest risk avoidance method
French law	pL	owner takes care at cost C_O
English law	qM	purchaser investigates title at cost C_P

44. *See generally* Ehrlich & Posner, *supra* note 19.

45. Sale of Goods Act, 1979, c. 54, § 21(1) (Eng.). For exceptions, see ROY GOODE, COMMERCIAL LAW 451–85 (2d ed. 1995).

46. C. CIV., art. 2279 (Fr.), and see ANTHONY OGUS & MICHAEL FAURE, ÉCONOMIE DU DROIT: LE CAS FRANÇAIS 56 (2002).

47. *See* ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 152–54 (1988).

If the aim is to maximize the value of the jewel to the purchaser ($U-pL-qM$), then, assuming that pL is approximately equivalent to qM,[48] we need a law which induces the cheaper of the avoidance methods, C_O or C_P. This will vary according to the circumstances, but in most cases intuition suggests that investigating title will be more expensive than taking care.[49] If that is the case, the jewel will have a greater value under the French rule than under the English rule.

II. EXPLANATORY LAW AND ECONOMICS

For the second part of this Article, I turn to the alternative form of positive economic analysis of law, which I consider to be more appropriately designated "explanatory law and economics" and which explores the hypothesis that the law (or at least common/customary law) generates allocatively efficient outcomes. I do not wish, here, to enter into the debate regarding its theoretical basis or its methodological dimensions, although we should recognize that, for reasons already given,[50] it is more controversial than that which I have called positive law and economics. Notwithstanding, or perhaps because of, this, it has proved to be of great interest to legal scholars.

Why should this be so? In my opinion, it is principally because it is seen as making a major contribution to the traditional central task for legal scholarship, promoting coherence and systematic orderliness in the law. I illustrate the contention with two areas of analysis. In the first, I seek to demonstrate how an efficiency interpretation can provide a firmer foundation and less ambiguity than notions of morality or corrective justice, which are often asserted to be the basis of the legal rules. In the second, I show how the economic approach provides a valuable method for classifying and structuring the law. Both areas of discussion draw on Coasean reasoning.

48. This might not be the case. *See* William M. Landes & Richard A. Posner, *The Economics of Legal Disputes over the Ownership of Works of Art and Other Collectibles*, *in* ECONOMICS OF THE ARTS: SELECTED ESSAYS 177 (Victor A. Ginsburgh & Pierre-Michel Menger eds., 1996) (noting that the French rule increases the value of the stolen item to the thief and thus also the probability of theft and the owner's protection costs).

49. The possibility of insuring against the risk should not affect the analysis, because the insurance contract and the premium paid should induce taking action to avoid the risk, if that is cheaper.

50. See *supra* text accompanying note 11.

A. *Efficiency as a Rationalizing Device*[51]

Many legal entitlements are expressed in language apparently reflecting morality or corrective justice (*e.g.*, good faith, proportionality, reasonableness, fiduciary relationships, unjust enrichment, due process), and yet exploration of the principles often reveals a deep ambiguity in the normative framework, rendering the law unpredictable and incoherent. Interpreting the entitlements in the light of allocative efficiency goals can provide the law with a firmer foundation, albeit by sacrificing the moral dimension.

A major part of the law, both civil and criminal, is concerned with attributing consequences to causes and thereby delineating the limits of responsibility. Within the civil law, the notion of corrective justice is typically invoked to explain why responsibility is primarily ascribed to those who *inflict* harm on others.[52] In the context of liability based on negligence, most legal systems therefore draw a distinction between acts (malfeasance) and omissions (nonfeasance) and reveal some caution in imposing responsibility for the latter. The strength of the reluctance to impose positive duties to act nevertheless varies significantly between different jurisdictions.[53] If corrective justice ideas are the basis of the law, this is not surprising since moral values are unlikely to be homogenous. So, for example, the traditional common law, with its emphasis on individual liberty, has a narrower range of liability for omissions[54] than (say) French law, with its more collectivist approach.[55] But the question of where to draw the line to accord with presumed moral values has proved to be problematic.

Take English law which adopts the fundamental principle that a failure to act as the Good Samaritan and rescue another person is not actionable. This is qualified by recognizing situations in which there is a positive duty to prevent harm, notably where there exists some form of pre-tort relationship between the parties, such as that between employ-

51. This Section draws on my paper, Anthony Ogus, *Inglaterra sin Pescado y Patatas Fritas, o qué más Deberíamos Haber Descubierto en el Ensayo de Coase Sobre Costos Sociales* [*England Without Fish and Chips, or What More Should We Have Discovered in Coase's Social Cost Paper?*], 3 REVISTA ARGENTINA DE TEORÍA JURÍDICA (2000), *available at* http://www.utdt.edu/departamentos/derecho/publicaciones/rtj1/pdf/TraduccionOgusfinal.pdf.

52. There are a variety of approaches which can be labeled "corrective justice"; for more detail on the concept in this context, see TORT LAW (Ernest Joseph Weinrib ed., 1991).

53. Jean Limpens et al., *Liability for One's Own Act*, *in* 11 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW 36–43 (André Tunc ed., 1979).

54. B.S. Markesinis, *Negligence, Nuisance and Affirmative Duties of Action*, 105 L.Q. REV. 104 (1989).

55. JEAN CARBONNIER, 4 DROIT CIVIL: LES OBLIGATIONS 392–97 (21st ed. 1998).

ers and employees,[56] professionals and their clients,[57] or that of adjacent landowners,[58] and the defendant has knowledge adequate to meet the contingency. But commentators have found it difficult to formulate the principle of corrective justice on which this distinction is based; it is still more difficult to prescribe how cases in the gray area outside familiar categories should be determined.[59]

Much clearer guidance on the appropriate liability rule can be derived from the economic approach. The starting point must be the notion of reciprocal conflict of resource uses, which lies at the heart of the Coasean analysis and which suggests that there is no *a priori* reason for assuming that the inflictor of harm is "responsible" for any misallocation. Of course, this contrasts strikingly with the traditional legal approaches.[60] As Ackerman has appositely observed, the general value of the analysis to lawyers is that it "urges a conception of causation that recognizes how a multiplicity of factors, operating over a lengthy period of time, contribute to our legal discontents."[61] What then of the particular problem of omissions? The analysis invites us to reject any distinction between misfeasance and nonfeasance. Taken to its logical conclusion, that would seem to lead to the absurdity that any single accident can be attributed to an infinite number of passive agents, any one of whom could have prevented it and therefore who could potentially be made liable. But we do not have to travel so far to arrive at meaningful insights.

We need to inquire how the efficient solution *might* have been reached by market transactions.[62] Approaching the problem in this way, we can see how one party might be willing to provide the level of precaution which meets the preferences of the other party—the potential victim—at a price which the latter is prepared to pay. There might be an explicit agreement to deal with the risk, for example if someone is employed to act as a lifeguard and is paid a fee reflecting the cost to that individual of providing the level of safety desired by the potential vic-

56. Costello v. Chief Constable of the Northumbria Police, [1999] 1 All ER 550 (C.A. 1998).

57. Carr-Glynn v. Frearsons, [1999] Ch. 326 (C.A. 1998).

58. Goldman v. Hargrave, [1967] 1 A.C. 645 (P.C. 1966).

59. *See e.g.*, Tony Honoré, *Are Omissions Less Culpable?*, *in* ESSAYS FOR PATRICK ATIYAH 31 (Peter Cane & Jane Stapleton eds., 1991).

60. Paul Burrows, *A Deferential Role for Efficiency Theory in Analysing Causation-Based Tort Law*, 8 EUR. J.L. & ECON. 29 (1999).

61. BRUCE A. ACKERMAN, RECONSTRUCTING AMERICAN LAW 52 (1984).

62. Judge Posner recently adopted such reasoning in *Stockberger v. United States*, 332 F.3d 479, 483–84 (7th Cir. 2003).

tim. But more often it will function within a broader-based contractual setting. An employer assumes responsibility for positive steps to secure the health and safety of employees, the cost (in part, at least) being offset against wages and other benefits provided.

We can see now why there is a tendency to impose liability for omissions on the employer and others involved in a pre-tort relationship with the victim. Even if there was no explicit assumption of the responsibility, the existence of the relationship and the relevant knowledge of the defendant would suggest this was likely to be the cheapest way of dealing with the risk. The law performs the useful economic function of imposing the solution which the parties themselves would rationally have reached if they had been able to make an appropriate contract.

What then of the Good Samaritan, *i.e.*, the casual bystander?[63] The person in distress may have the opportunity to make a contract with a potential rescuer. If the victim had no alternative recourse, the terms of the agreement should be reviewed to ensure that the rescuer has not exploited the monopoly situation;[64] otherwise the contractual solution is appropriate. Suppose, however, that a contract is not feasible because, for example, the victim is unconscious or, to prevent harm, an act of assistance is necessary before the victim becomes aware of her plight. Consistent with the reasoning above, we should here expect the law to imitate the efficient contract that would have been made if it had been possible. Especially if the assistance could have been effected at low cost, that would seem to imply imposing a duty to rescue, a solution not accepted by English law.

Further consideration may nevertheless furnish arguments against such a duty. We should first note that there may be a technical legal problem in the rescuer obtaining compensation from the victim for the cost of rescue.[65] If there is little prospect of payment, that will reduce the supply of potential rescuers not motivated by altruism.[66] A second point is that the duty imposed on the rescuer may reduce the incentive on the victim to take care.[67] Next, in identifying what, in the circumstances,

63. For a full discussion, see William M. Landes and Richard A. Posner, *Salvors, Finders, Good Samaritans, and Other Rescuers: An Economic Study of Law and Altruism*, 7 J. LEGAL STUD. 83 (1978).

64. On the doctrine of economic duress, see *Pao On v. Lau Yiu Long*, [1980] A.C. 614, 635–36 (P.C. 1979).

65. The doctrine of agency of necessity is relatively limited in English law. *See* LORD GOFF & GARETH JONES, THE LAW OF RESTITUTION 461–98 (5th ed. 1998).

66. Landes & Posner, *supra* note 63, at 119–27.

67. Donald Wittman, *Optimal Pricing of Sequential Inputs: Last Clear Chance, Mitigation of Damages, and Related Doctrines in the Law*, 10 J. LEGAL STUD. 65, 89 (1981).

would have been the efficient contract, we must be careful to adopt a sufficiently broad perspective of the relevant costs and benefits. In particular, there is a danger of underestimating the costs of imposing a positive duty to act. Take, first, the costs to an individual. In general, it is cheaper for someone already engaged in an activity to take steps to constrain risks arising from it than for a passive agent to respond to a risk created by another. This is because the active agent has already selected that activity which presumptively generates for herself the greatest utility: the added cost of taking care in that activity might be relatively small. In contrast, the passive agent, to engage in the risk-controlling activity, must sacrifice all other profitable activities—in short, her opportunity costs may be considerable. Secondly, in a situation where any one of a number of individuals could have controlled the risk, account must be taken of the nontrivial psychic costs which would be incurred by all those subject to a legal duty to act and, in aggregate, such costs might be relatively large.[68]

I have explored the issue of negligent omissions at some length because it is necessary to show that it is not easy to formulate an appropriate liability rule. Some caution in relation to omissions liability is justifiable because the costs of requiring passive agents to engage in a particular activity may be significantly high. But there are also cases where the cost of intervention to a particular passive agent would be small relative even to active agents. By identifying situations in which the parties would, if transaction costs had not inhibited them, reasonably have entered into a transaction to deal with a given risk, the analysis lends coherence to the determination of the liability issue.

B. Classifying and Structuring the Law

As I indicated earlier, a major function of legal scholarship is to ensure the coherence of the law. This has particular importance for common law systems which, unlike the codified civil law systems, have evolved without formally structuring legal principles in any meaningful way other than through the antiquated and arbitrary writ system. Formal structure may appear to be largely a technical matter, but it is not. Take the following simple, but also fundamental question: an individual sustains a loss as a consequence of an event which constitutes both a tort and a breach of contract. Supposing that the principles governing liability differ between the two regimes, which is

68. Liability here also creates problems of distributional justice: the "why me?" objection.

to prevail? It is (to me) amazing that common law systems find it difficult to give a clear answer to that question.[69] Civil law systems, or at least some of them, may do better than this, but they also seem ill equipped to handle analogous questions, for example whether a principle of corporate law is mandatory, or rather may be varied, and thus is, in effect, a default rule. A schema for structuring the law in a valuable way, and thereby meaningfully addressing questions like these, can be derived from what is explicit or implicit in the foundational law and economics papers of Coase, Calabresi, and Melamed.

If we proceed with the assumptions of individual autonomy and utility maximization, we must accept, with Coase,[70] the primacy of transactions (contracts) over torts in dealing with assets (property), except where those transactions are the result of significant informational asymmetry or give rise to externalities which because of transaction costs cannot be internalized.[71] Torts, along with implied terms in contracts, in addition to dealing with these instances of market failure, may of course operate to reduce the transaction costs of contracting, but in this capacity they are modifiable and thus operate as default rules. Then, as regards corporate law, adopting the perspective of Coase's 1937 paper,[72] we can view the firm as a nexus of contracts, individuals seeking to advance their welfare through transactions with others. The analytical framework (individual autonomy subject to qualifications of market failure) can then lead us to a classification of the principles of corporate law into default and mandatory rules, acquiring thereby a better understanding of the key issues in legal development.[73]

As the author of a book on regulation,[74] I know only too well the problems of classifying that subject. And again it is not simply the trivial issue of the library shelf on which the book should be placed. The economic framework for classification[75] facilitates clear thinking in relation to two key steps in policy debates concerning regulation:

69. Tony Weir, *Complex Liabilities*, *in* 11 INTERNATIONAL ENCYCLOPEDIA OF COMPARATIVE LAW ch. 12 (André Tunc ed., 1983).

70. Coase, *supra* note 27.

71. Thus justifying the French principle of *non-cumul* of contractual and delictual liability, and derogations from it. OGUS & FAURE, *supra* note 46, at 103–04.

72. R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937).

73. BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE, AND OPERATION (1997).

74. ANTHONY OGUS, REGULATION: LEGAL FORM AND ECONOMIC THEORY (1994).

75. Ironically, clarification is not provided by economists themselves. Because they are often unaware of the key distinction between private and public law, they sometimes treat "regulation" as synonymous with law in general.

Why regulate? And what regulatory/legal form is appropriate? As regards the first of these, and pursuing the logic of Coasean analysis, it suggests that we inquire into whether the administrative and transaction costs associated with a regulatory response to market failure are lower or higher than the private law response.[76] In relation to the second question, the same cost inquiry can be applied to different regulatory forms; for example, licenses, standards, information disclosure, or financial instruments.[77]

The analytical framework used by Calabresi and Melamed in their famous 1972 paper[78] has proved to be equally important. Their distinction between liability rules and property rules cuts across traditional legal categories but provides an essential tool for understanding the different ways in which the law protects entitlements, and for recognizing the cost implications on choices between them. The identification of inalienable rights extends the framework beyond economic methodology but enables us to accommodate criminal law within the Coasean-inspired schema by explaining why certain assets are taken outside the scope of transactional dealings.[79]

CONCLUSION

In this Article I have sought to show that legal scholars have (still) much to learn from law and economics. I have focused on the positive and interpretative function of the subdiscipline, rather than its (perhaps overexposed) normative dimension. And I have chosen to concentrate on some basic themes: the use of different legal forms as behavioral incentives; the *ex ante/ex post* dilemma of legal adjudication; rule formulation from a comparative perspective; efficiency as a rationalizing device for determining entitlements; and legal classifications. The analysis used in the examples I discuss will be familiar, but it is intended to highlight key features in law and economics reasoning which lawyers tend to ignore.

76. OGUS, *supra* note 74, at 25–28; *see, e.g.*, Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 13 J. LEGAL STUD. 357 (1984).

77. OGUS, *supra* note 74, at 150–60; *see, e.g.*, Steven Shavell, *The Optimal Structure of Law Enforcement*, 36 J.L. & ECON. 255 (1993).

78. Calabresi & Melamed, *supra* note 28.

79. For economic rationalizations of the criminal law generally, see Alvin K. Klevorick, *Crime as a Distinct Category of Behaviour*, *in* 1 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW, *supra* note 2, at 542–46.