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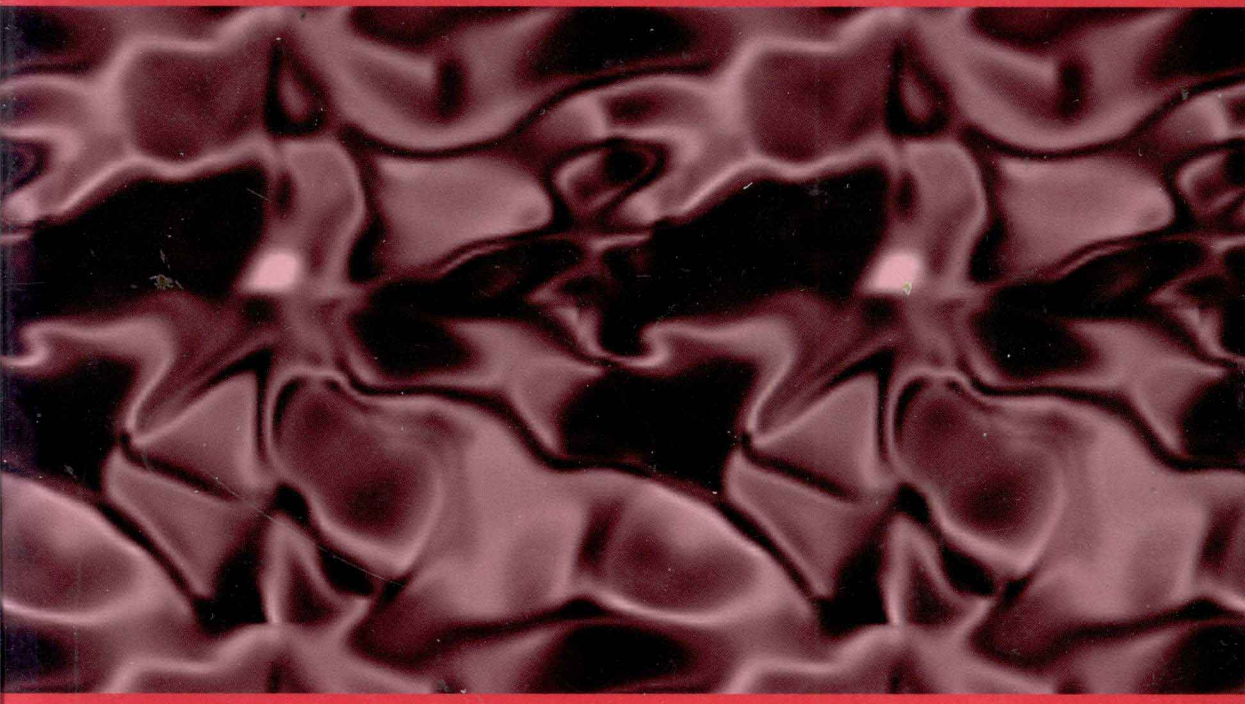
VOLUME II

Edited by **Mario J. Rizzo**



ECONOMIC APPROACHES TO LAW 29

Austrian Law and Economics Volume II

Edited by

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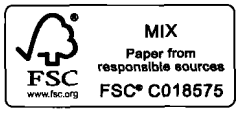

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Contents

Part I
Common Law, Balancing and Efficiency

[1]

LAW AMID FLUX: THE ECONOMICS OF NEGLIGENCE AND STRICT LIABILITY IN TORT

*MARIO J. RIZZO**

THE economic efficiency approach to the analysis of the common law, particularly the law of torts, has been growing rapidly in recent years and shows no sign of abatement. Nevertheless, some very fundamental analytic problems have not even been recognized in this literature, much less solved. It is the purpose of this essay to raise these problems in the context of the perennial conflict between negligence and strict liability. The first and major part of this paper will consist of a detailed study of the efficiency rationale for negligence law. Next, we shall analyze some of the economic aspects of a system of strict liability. The overall conclusion is that efficiency, as normally understood, is impossible as a goal for tort law. The law cannot and should not aim toward the impossible. Consequently, both the normative and positive justifications for the efficiency approach to tort law must be rejected. Our reasons for this conclusion can be divided into static and dynamic considerations. The most important by far, however, are the dynamic factors: Precisely because we live outside of general competitive equilibrium and in a world of unpredictable flux, the efficiency case for negligence must fail. In such a world, it is impossible to compare alternative liability systems in terms of judicial cost-benefit analysis or "fine tuning." Instead, they must be analyzed in terms of institutional efficiency—the certainty and stability that these rules impart to the social framework. A static world of general equilibrium would make an efficient tort law possible, and yet render it unnecessary; in such a world, markets would be universal. A dynamic world, however, demands the certainty and simplicity of static law.

I. NEGLIGENCE

Traditional, noneconomic definitions of negligence are generally based on such intrinsically vague concepts as the lack of "due care" or the absence of

* Assistant Professor of Economics, New York University. I am indebted to the Institute for Humane Studies and the Scaife Foundation for financial support of my research. I am also indebted to Michael Becker, Richard Epstein, William Landes, Richard Posner, and Paul Rubin for comments on previous versions. Responsibility for errors remains mine alone.

the level of care that *would* be undertaken by the "reasonable man." The economic efficiency approach attempts to make this concept more rigorous. Negligence can be defined in economic terms as the behavior of the utility-maximizing individual when he bears less than the full social costs of his activity. To make such a definition operational the analyst must be able to measure, with tolerable accuracy, the relevant social costs. This is no simple task; and if our thesis is correct, it is fundamentally intractable. Nonnegligence refers to the behavior that *would* be undertaken by the rational agent if he were made to bear the full social costs associated with his conduct. This formulation brings into sharp relief the counterfactual nature of the predictions involved. Hence, the kind of evidence that would shed light on these counterfactual hypotheses is, at best, indirect.

The efficiency approach requires not only the testing of hypotheses about the defendant's negligence, but also investigation into the (contributory) negligence of the plaintiff. If, however, the doctrine of contributory negligence is to be interpreted as a lesser-cost avoider defense,[1] our task is still not complete. If we find that both defendant and plaintiff have been negligent, we must still determine which party could have avoided the accident at less cost. Therefore, we are driven to compare two counterfactual hypotheses: if A were required to bear the full social costs attached to his behavior he would have avoided the accident at $X, and if B bore the full costs he would have avoided it at $Y. Now if $X is less than $Y, the efficiency framework implies that A ought to be made liable for the harm resulting from the accident. The issue is not to compare or evaluate what *has* happened but, rather, to speculate about what *might* have happened in two alternate worlds and then to compare the outcomes.

In purely formal terms, the efficiency reformulation of the law of negligence seems to make it more precise, but the *operational* precision of this approach hinges on the ease with which the empirical counterparts to the theoretical categories can be determined. Even so committed an efficiency theorist as Harold Demsetz has recently admitted that "it is so difficult to know what the underlying efficiency considerations are . . . ."[2] If, therefore, the promise of adding greater precision to the concept of negligence is to be realized, there must be some method of *testing* the relevant hypotheses. Although the recent literature has not formulated the central question in these terms, testing is, nevertheless, crucial. Let us briefly consider three possible methods of testing hypotheses about efficient liability assignment.

[1] Richard A. Posner, Economic Analysis of Law 123-24 (2d ed. 1977).

[2] Harold Demsetz, Ethics and Efficiency in Property Rights Systems, in Time, Uncertainty, and Disequilibrium: Exploration of Austrian Themes 97, 106 (M. Rizzo ed. 1979). Demsetz apparently believes, however, that it is still possible to at least approximate efficient outcomes.

The first and second we shall examine in greater detail later in this essay, and the third has been analyzed in depth elsewhere.[3]

The most attractive method of testing claims about negligence and cheaper-cost avoidance is to let the economic agents "speak" for themselves. Suppose that A may have been negligent in not undertaking certain precautions while driving; in economic terms, the (expected) value of the costs of such precautions may fall below the (expected) social benefits. The best way to test this hypothesis is to place liability for the harm which may ensue on A. A will be forced to internalize the relevant costs and to make a cost-benefit calculation based on information that his own self-interest has led him to acquire. However, testing the defendant's negligence precludes testing the plaintiff's negligence; this method will work only when, on other grounds, the nonnegligence of one party has already been established. These are the pure adaptation problems which we shall subsequently discuss.

The second method is probably far too loose and unsystematic to deserve designation as a testing method at all. It consists simply of looking at a situation and guessing what the underlying efficiency considerations might be.[4] Strictly speaking, this is merely the first step of a test—a conjecture which is in need of corroboration or refutation. It may be argued, however, that these are not merely wild guesses, but are based on common, everyday empirical observations. This is the crux of the problem: such data are totally insufficient and misleading. The serious *conceptual* problems in identifying an efficient assignment of liability make this kind of observation without much merit. Furthermore, the whole notion of efficiency has often been used so imprecisely as to inject a large arbitrary element in the specification of an efficient outcome. Both of these important points will later be elaborated.

The final method does not guide us in choosing the efficient liability assignment, but claims that *whatever* method is initially used only the efficient rules will survive.[5] This rests on the contention that inefficient rules will be litigated and, therefore, altered because of the utility-maximizing decisions of private litigants. Once a rule becomes efficient, however, litigation will cease. The test thus consists of imposing liability in a particular way and then observing whether the rule survives. If it does, it was efficient; if it does not, it was inefficient. A number of very significant objections, however, have been raised against this view.[6] In particular, it is clear that litigation of

[3] Mario J. Rizzo & Frank S. Arnold, The Tendency toward Efficiency in the Common Law (1978) (unpublished manuscript, New York Univ.)

[4] See Posner, *supra* note 1, *passim*.

[5] George L. Priest, The Common Law Process and the Selection of Efficient Rules, 6 J. Legal Stud. 65 (1977); and Paul H. Rubin, Why Is the Common Law Efficient?, 6 J. Legal Stud. 51 (1977).

[6] William M. Landes & Richard A. Posner, Adjudication as a Private Good, 8 J. Legal Stud. 235 (1979); and Rizzo & Arnold, *supra* note 3.

a legal rule depends on whether change in the rule is expected to be toward greater or lesser efficiency, which in turn, depends on the attitudes of the judiciary. To the extent that their "bias" is toward efficiency, many efficiency-enhancing litigation opportunities will emerge.[7] Therefore, the ability of a judge to recognize an efficient rule has an impact on this process, by providing, as it were, the proper environment for efficiency-enhancing litigation to occur.[8] Even this conclusion, however, is based on several stringent assumptions, including agreement of both plaintiff and defendant on the probability of a win or a loss in the given case.[9] In any event, we shall take as our working hypothesis that the "Darwinian" mechanism cannot be solely, or even mainly, relied upon to produce efficient legal rules. Therefore, the informational problems in identifying empirically optimum liability assignments are of crucial importance.

II. Simple Negligence: Adaptation

This section will analyze some economic aspects of the simplest negligence cases: the pure adaptation problems,[10] which concern only the existence of a duty and not its location.[11] To be more precise, the only question is whether the defendant ought to have been more careful, not whether the plaintiff ought to have done anything differently. The issue is restricted in this way ultimately because of asymmetrical information. Suppose the court can more easily determine the negligence or nonnegligence of the plaintiff than of the defendant.[12] In some contexts, the costs of ascertaining whether due care had been undertaken might be lower with respect to the plaintiff's conduct.[13] When this is so and the plaintiff is considered nonnegligent, placing liability on the defendant can both yield valuable information and provide the economically proper incentives. We shall illustrate these points in four important cases.

In *Bolton v. Stone*[14], a woman was struck on the head by a cricket ball as she was walking just outside of her house. The ball had emanated from a nearby cricket field which had never before been the source of such an

[7] See Rizzo & Arnold, *supra* note 3, at 12-13.

[8] As Priest denies. See Priest, *supra* note 5, at 72.

[9] See Rizzo & Arnold *supra*, note 3, at 20-21.

[10] Abraham Harari, The Place of Negligence in the Law of Torts 147-67 (1962).

[11] *Id.* at 101.

[12] The assumption that the court can easily determine the economic nonnegligence of any party is one that is made provisionally and only in this section. Later our critique becomes more fundamental and this assumption is accordingly dropped.

[13] Obviously, the ascertainment costs can be lower with respect to the defendant. However, this type of case is not being considered here.

[14] [1951] A.C. 850.

accident. Although treated by the court as an ordinary negligence question, it is more precisely an adaptation problem.[15] The woman is clearly viewed as a virtually passive bystander who could not conceivably be characterized as negligent. The only question is: should the defendant have done anything differently? Lord Reid's analysis here is particularly interesting. In determining whether the defendant had been negligent, it is proper to examine "not only how remote is the chance that a person might be struck but also how serious the consequences are likely to be if a person is struck."[16] This is merely the expected value of the harm and is perfectly consistent with one-half of the famous Hand formula.[17] However, Lord Reid continues immediately, ". . . . but I do not think that it would be right to take into account the difficulty of remedial measures. If cricket cannot be played on a ground without creating a substantial risk, then it should not be played there at all."[18] The question of whether the "remedial" or precautionary measures cost more than their expected benefits (prevention of the harm) is not one with which the court should concern itself. If there is a "substantial risk," then the owner of the cricket field ought to make the cost-benefit calculation himself. If he is held liable for the harm, he may decide to put up a higher fence or even to stop playing cricket there at all. While Reid indicates that he would have held for the plaintiff had the risk been substantial, the fact that the risk was "extremely small" means that the plaintiff is not entitled to recover. The defendant's behavior was completely nonnegligent.

There are two inconsistent lines of thought in this decision. First, within the class of substantial risks the defendant ought to be made liable regardless of the "difficulty of remedial measures." Here the onus of the cost-benefit analysis is his. The second line of thought (and the actual holding) is that within the class of small risks, the plaintiff cannot recover. From this perspective, the court determines the reasonableness of the behavior.

In pure adaptation cases like this, placing liability on the defendant (the causal agent), regardless of degree of risks, provides a means of testing the hypothesis of nonnegligence. If the defendant had been held liable and continued to behave in the same way, the court's hypothesis would have been corroborated. If, however, the defendant began to increase his level of care, the hypothesis would have been falsified. A "strict liability" approach here would have obviated the need for a judicial cost-benefit analysis and, paradoxically, would have tested the claim of nonnegligence.

[15] Harari considers this a coordination problem rather than one of adaptation. See Harari, *supra* note 10, at 172.

[16] Bolton v. Stone, [1951] A.C. at 867.

[17] See U.S. v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947); Richard A. Posner, A Theory of Negligence, 1 J. Legal Stud. 29 (1972).

[18] Bolton v. Stone, [1951] A.C. at 867.

Re Polemis is another important example of the adaptation issue.[19] Longshoremen, servants of the defendants, were unloading cargo on the plaintiff's ship. One of them dropped a plank into the ship's hold which contained benzine vapor. A spark created by the plank ignited the vapor, and the ship was destroyed by flames. The court held that the handling of the plank was negligent because *some* harm to the ship was foreseeable. Although the burning of the ship itself was not foreseeable, it was nonetheless the "direct" consequence of a negligent act. Therefore, the defendants were fully liable for the destruction of the ship. From the efficiency point of view, the decision would seem incorrect. Liability would not increase the defendants' precautionary activity because unforeseeable contingencies will not motivate behavior. The defendants should have been held liable for, say, a dent in the hold because against that contingency they would have exercised due care, but nothing would be accomplished by holding them liable for the fire.

Although the court couched its decision in terms of the "directness" of the harm, this case can be viewed as an effort to test the negligence hypothesis.[20] As long as there is any indication that the defendants were negligent, because of, say, the foreseeability of a dent in the hold, liability ought to be imposed on them for the ship's destruction by fire. The assertion that the fire was unforeseeable was only an *hypothesis* and, as such, is quite possibly incorrect. Whether the fire was foreseeable is something for which a test can be provided. If the defendants must pay, then they can strike the cost-benefit balance and determine for themselves the category of foreseeable harms. What is unforeseeable to the court may possibly be foreseeable to defendants anxious to avoid liability.

Vincent v. Lake Erie Transportation Co. raises the important adaptation issues in a somewhat different context.[21] The steamship Reynolds was held fast to a dock by the defendant's servants during a violent storm. The force of the wind and the waves constantly drove the ship against the dock. This resulted in $500 worth of injury to the plaintiffs' dock. *Vincent* was not treated as a negligence case, nor as one in which the behavior of the defendant inflicted *net* social costs. Indeed, "the defendant prudently and advisedly availed itself of the plaintiffs' property for the purpose of preserving its own more valuable property."[22] The court, nevertheless, held that the defendant was liable for damages. The reasonableness of the defendant's behavior did not prevent recovery by the plaintiff.

[19] *In re* Polemis and Furness, Withy & Co., [1921] 3 K.B. 560.

[20] Remember that there was never any question of the plaintiff behaving differently with respect to the harm.

[21] 109 Minn. 456, 124 N.W. 221 (1910).

[22] *Id.* at 460, 124 N.W. 222.