

The Economic Structure of Tort Law: Market-based or Command and Control?

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The purpose of this paper is to criticize the current standard economic analysis of tort law for their not taking law seriously. I would argue that the core of a modern legal system such as the rule of law, normativity or system-wide effects, should be taken into account in the economic analysis of law otherwise economic models cannot explain anything interesting or significant in the real legal institutions. In this paper I will show this should be done from transaction cost perspective.

There are 8 parts in this paper.

Part one is introduction.

Part 2 is about comparison of no liability rule and strict liability rule. In standard model, these two rules have been seen as symmetric. I would argue they are not if we see them from system wide perspective.

Part 3 is concerning intentional torts. I would criticize the Landes and Posner model. They put the injurer's gains in the model. I will show the emptiness of this model.

Part 4 is about why the law differentiates interests from rights. Part 5 is about Good Samaritan. In these two parts, I will show a clear right allocation offers a more precise and more coherent explanation of these legal phenomena.

Part 6 is about reasonable man standard. Contrast to Landes and Posner and Shavell, I would argue those people who are physically or technologically more capable to prevent harm should enjoy lower, not higher, negligence standard.

Part 7 is about nature of negligence. I would argue negligence should be seen as the norm developed simultaneously in society. It should not be seen as a deterrence which can be manipulated by courts.

Part 8 is conclusion.

I.

Tort law is a branch of private law. The function of private law is to facilitate market transactions. Only in rare circumstances should courts intervene to make decisions for autonomous individuals. However, most of economic analysts have modeled tort law from public law perspective. Under this approach, people are responsible for not complying with some specific physical or technological standard which would have been set by courts based on trade off between the injurer's precaution costs and the victim's expected damage. This is a kind of command and control which assumes that courts like firms shall bypass market to direct resources' use. Due to the characteristics of judicial process, however, courts are just not institutionally good at this.¹

A typical economic model of tort law is like this:²

$$L(x,y) = p(x,y)D + A(x) + B(y) \quad \text{-----}(1)$$

In the equation, $A(x)$ and $B(y)$ represent the victim's and the injurer's precaution costs respectively; $p(x,y)D$ means the victim's expected damage which would be reduced by victim's x units of care and the injurer's y units of care; $L(x,y)$ is the social loss. To minimize social loss, the conditions of $A_x = -p_x D$ and $B_y = -p_y D$ should be met. When the precaution measures taken by the victim or the injurer are limited to physical or technological dimension, as many analysts have assumed, this model ignores the property boundary and institutional comparison. Consequently, no liability rule and strict liability rule are seen as symmetric; the utilities of the injurer have been taken into account in intentional torts; negative duty and affirmative duty cannot be distinguished; a more capable person has to bear higher standard of care; the reason so many torts arise is due to deficiency of tort enforcement.

¹ See Neil K. Komesar, *Imperfect Alternatives: Choosing Institutions in Law, Economics, and Public Policy* (1994).

² See William M. Landes and Richard A. Posner, *The Economic Structure of Tort Law* 59 (1987).

From efficiency point of view, reciprocity, indeed, is the essence of damage. However, this only means that, contrary to Pigovian view of externality, imposing liability on the injurer is not necessarily leading to efficiency.³ For example, a well-defined property right system would facilitate transactions to reduce external effects and achieve efficiency. The model of equation (1), as Brown said, is a production model.⁴ A centralized administrator might want to achieve a certain outcome and then ex ante prescribe some specific standard to be complied with. The characteristic of tort law, however, is that a unique not a statistical damage has already occurred and the attribution of responsibility has to be done. An ex ante prescribed standard is not a good benchmark against which whether the injurer is liable or not should be judged. This paper would argue that a transaction cost-adjusted property right theory would provide a more coherent and more simplified explanation of tort law.

II.

In the above typical model, the effect of no liability rule is that the injurer would take zero level of care because under no circumstances he has to pay any damages while symmetrically the effect of strict liability rule (without contributory negligence) is that the victim would take zero level of care because under all circumstances he would receive full compensation paid by the injurer. The implication is that from efficiency point of view, whether no liability rule or strict liability rule should be the legal regime is an empirical question. However, their system-wide effects are very different. Under rule of law, a liability rule should be universally and equally applied. Therefore, no liability rule means that property right does not exist at all while strict

³ See Ronald H. Coase, The Problems of Social Cost, in *The Firm, the Market, and the Law* 95-156 (1988).

⁴ John Prather Brown, Toward an Economic Theory of Liability, 2 *J. Legal Stud.* 323-49 (1973).

liability rule means that only partial restrictions are imposed on property right. The implication of no liability rule is not just a tragedy of commons—it's a Hobbesian world of wars.⁵ Resources would not just be exhausted too quickly but would also be spent on attacking and defending. On the contrary, a strict liability rule would restrict the usage of property but it still allow that property can be used to the extent there is no harm caused by this usage.⁶

Actually, no liability rule has never been an option for legal doctrine of tort law because no liability rule means no law at all. Indeed, under tort law, the injurer is either liable or not liable for his act, so we can compare the effects of the injurer being held liable and being held not liable. However, we cannot say the injurer being held not liable is derived from no liability rule and the injurer being held liable is derived from strict liability rule. Liable or not is legal result not legal doctrine. The former is the application of the latter. The application of strict liability rule will make the injurer liable for his act but so does the application of negligence rule. The comparison of effects of the injurer being held liable and not being held liable cannot be the basis for choosing no liability rule or strict liability rule although it would do for strict liability rule and negligence rule.

Furthermore, from property right perspective, a rule of strict liability even with contributory negligence would not be the same as a negligence rule. A system-wide strict liability rule means some property rights would be infringed. For example, if no amount of noise could be tolerated then the property rights of use or enjoyment of land would be much discounted. Therefore, there exists no such thing of pure strict liability rule. An exemption of liability from victim's contributory negligence or other

⁵ See Steven Cheung, Common Property Rights, in *The New Palgrave: A Dictionary of Economics* 504-6 (1987).

⁶ Here, of course, causation should be carefully defined. If a passive activity is not distinguished from an active activity, the strict liability rule and no liability rule would blur.

factors could not be cut off from analysis of strict liability rule. That is why in a codified tort law negligence rule is the principle of tort law while strict liability rule only covers some well-defined activities and with some limitations such as contributory negligence or damages cap.

III.

In a private property system, it is a logical conclusion that an injurer who intentionally inflicts harms to other persons' property has to be punished because he bypasses the market transactions. Of course there are some circumstances under which an intentional injurer should not be responsible for the harm. However, this is nothing to do with the injurer's utilities such as modeled by Landes and Posner:⁷

$$L(x,y) = p(x,y)(D - G) + A(x) + B(y) \text{ -----(2)}$$

Contrast to equation (1), in this model, they take into account the injurer's gains G derived from taking the intentional act. y means the resources the injurer spends to cause the harm. Therefore, to increase y would increase p . This is also different from equation (1).

Landes and Posner say G should be larger than zero otherwise the injurer would not spend resources y to inflict harm. In this model, however, the conditions of minimizing social costs depend on whether the injurer's gains is higher or lower than the victims' damage. When the victim's damage D is larger than G , for minimizing social loss L , L would be zero and therefore p , x , and y should be zero. This means that the injurer should not intentionally do harm. When the victim's damage D is lower than G , for minimizing social loss L , L would be negative and therefore the injurer should take more than zero y to increase p . The implication of this model is that the injurer can claim that he should not be responsible for his intentional act if he

⁷ Landes and Posner, *supra* note 2, at 153.

can prove that he derives more gains from the intentional act than the victim's damage. In practice, this is not true. In theory, this is unsound.

Landes and Posner do not directly measure the injurer's gains and the victim's damage as the structure of this model dictates. They resort to transaction costs proxy -- high transaction costs means high injurer's gains while low transaction costs means low injurer's gains. The whole model collapses! There is no correlation between injurer's gains and transaction costs. This model can explain nothing.

In a private property system, under the circumstances of low transaction costs, a person just cannot take away another person's property even he claims he gains more than victim's loss. Even in the case of necessity, the injurer is still responsible for victim's damage although he would not be imposed punitive damages as intentional tort would be.

Self-defense is the last reason why Landes and Posner introduce injurer's gains into the model. Self-defense, by definition, means that the injurer intentionally inflicts harm on offender to prevent offender's illegal act, such as taking away other persons' property when there exists no high transaction costs. In the law, it is not necessary that the self-defender does this for his own interest. Protecting other persons' property from being invaded is still within the scope of self-defense. The justification of self-defense should be seen from external point of view—the enforcement costs of property right. The alternative means to prevent the right-invading, not self-defender's gains, is the key to balancing test in self-defense. For example, although the value of life is higher than property, to kill the person who breaks in to steal is still self-defense if the person ignores the warning!

IV.

In tort law, financial interest is not usually protected. In the equation (2), the

injurer, a new entrant, spends resources (y) to compete with the incumbent firm and causes the latter's loss of profits (D). Usually, the new entrant's gains (G) is not larger than (D). However, this does not mean that the new entrant should not enter the market to compete with the victim as Landes and Posner's model would imply. In the equation, the consumers' gains derived from the competition are not taken into account in the equation. This is so because under the normal assumption of competitive market the new entrant cannot exercise price discrimination to extract consumers' surplus to enlarge its gains. Therefore, although $(D - G) \geq 0$, the new entrant should not be liable for the incumbent firm's loss.

The Article 184I of Taiwan's Civil Code provides different protections for rights and interests. According to this provision, rights holders can claim compensation for the harm caused by a negligent injurer while beneficiaries of interests can only claim compensation from an intentional injurer with a socially immoral act. Judging from above discussion, this makes sense. The comparison of injurer's gains and victim's loss has never been the issue. Freedom of contract is the core of a private property system. If financial interests are protected as rights, this would mean freedom of contract does not exist any more. In the analytical framework of negligence rule versus strict liability rule discussed above in section II, nondiscrimination in protection of financial interests would be an application of strict liability rule. This example also confirms that the strict liability rule could not be universally applied and therefore cannot be the principle of liability law.

V.

That a person would not be responsible for the damage which was caused by other persons but he can prevent with little effort is a puzzle for many observers. According to the equation (1), if a small increase of $B(y)$ would lead to a large

decrease of $p(x,y)$ D and B does not take that level of care, B would be held liable for the damage. This is not the law of real world. This is so because affirmative duty and negative duty are not distinguished in the equation. In a private property system, tort and contract should not be messed up. As in the case of necessity, transaction costs, not the gains of the “victim”, is the key for determining liability. The law just cannot force every person to be a good Samaritan. However, if a person wants to be a good Samaritan, the law provides a quasi-contract framework to regulate the relationship. Even in this framework, the law does not give good Samaritans rights to demand reward. The good Samaritans can only ask reimbursement of necessary fee. The law does not want to give too much incentive for intervening behavior even though some cases might be socially beneficial. When system-wide effects are taken into account, the law is sound.

VI.

Reasonable man standard is the legal doctrine to determine whether an injurer is negligent or not and therefore liable for the damage. The doctrine says that an injurer with less physical or technological capability to prevent the harm shall be judged by the same standard as ordinary persons. In applying the equation (1), a less capable man would be judged by a lower standard while a more capable man by a higher standard because his efforts are less effective to prevent damage. However, physical or technological capability has never been an independent factor for determining negligence. It is the conflict of activities that is the root of concern. Therefore the trade-off between values of conflicting activities is the standard by which a person's negligence should be determined. Contrary to the implication of equation (1), a more capable person (or firm) should enjoy larger scope of legal activity because he would cause less value loss of conflicting activities when taking same activity as a less

capable person does. Due to the lack of information about each injurer's capability to prevent harm, as suggested by Landes and Posner,⁸ is not a good explanation for this doctrine because the difference between classes of injurer is clear to courts although the difference among the same class of injurer is not. The legal doctrine is concerned with former problem not latter one.

For example, a normal driver might be held negligent at speed 60km/hr while a drunk driver would be held negligent at much lower speed. This is so because once a drunk driver reduces a same amount of speed as normal driver he would prevent more harm than normal driver would. Therefore when courts say drunk driver should be judged with the same standard, this means that the values of driving for normal person and drunk driver are the same. And at same speed, a drunk driver would cause more harm than normal driver would so drunk driver's socially optimal speed would be lower than normal driver.

Shavell shares the same fallacy with Landes and Posner. He argues that young men should be responsible for more snow shoveling than old men should because the former are more capable than the latter to do this.⁹ In what context he says this? In the war, young men are much needed to defend the nation so old men are left to shovel snow. In normal time, old men are richer than young men so they have bigger houses and then longer sidewalk on which snow falls. They are therefore responsible for shoveling more snow to clear the sidewalk. The only situation we can imagine that young men are responsible for more snow shoveling is both young men and old men are employed by a firm to do the work. However, the firm has to pay more to young men otherwise they would not enter the firm from the beginning. In some sense, a nation is a superfirm. The law, indeed, might require people to offer service. But this

⁸ Landes and Posner, *supra* note 2, at 123-31.

⁹ Steven Shavell, *Economic Analysis of Accident Law* 73-7 (1987).

is the function of public law not private law such as tort law and it is highly regulated in procedure and in substance under the rule of law or constitutionalism.

VII.

Why negligent acts are not wholly eliminated if a social optimal negligence standard has been set? The deficiencies of legal process, such as judgment proof and not all damages being claimed, are usually the answers given by economic analysts. However, these cannot be whole story, probably just a minor part of it. In a private property right system, negligent acts are part and parcel of the system because courts would never check into each injurer's physical or technological capabilities of preventing the harms. An equal application of law – like cases should be treated alike – would allow people to pursue each own purpose and pay the price. This means the negligence rule is a kind of liability rule while intentional tort is a kind of property rule as proposed by Calabresi and Melamed.¹⁰

The difference between intentional torts and negligence is whether the injurer really foresaw the damage. An injurer foresaw the damage is intentional tort whereas a negligent injurer did not foresee the damage although it might be foreseeable. If the damage is not foreseeable there is no negligence. Foreseeing the damage means that the injurer knows the transaction is going to happen although it is a coercive one. Once a concrete transaction pops out in the injurer's mind, a voluntary transaction becomes possible. In contrast, if the injurer does not sense that a transaction is going to happen, he could not initiate any voluntary transaction. Lack of this information means a high transaction costs, by definition. Therefore a liability rule contrast to property rule shall apply.

¹⁰ Guido Calabresi and A. Douglas Melamed, Property Rules, Liability Rules and Inalienability: One view of Cathedral, 85 Harv. L.Rev. 1089 (1972).

In essence, a negligence standard should be seen as a norm developed simultaneously in society, not as a deterrence manipulated by the courts. How can an ex post compensation deliver an ex ante incentive to the people? In the extreme circumstance which courts determine whether the injurer should be liable wholly based on a case by case approach, there exists no ex ante incentive to the people. Contrast to ex ante regulations mostly promulgated by administrative institutions which would set up *some specific standards* (such as in technological or physical dimensions) backed up by administrative fines or other punishments, the courts' tort decisions don't deliver such rigid criteria to the people. A blind trust on the courts would not solve the problem, either. More probably, the courts which cannot deliver ex ante incentive to the people would not earn their trust.

VIII.

In the Williamson's four levels of social analysis, private law is part of level 2: institutional environment.¹¹ Under private law, governance is next level which would be implemented by market players. The function of courts is to keep private law clear and to be applied equally among population. However, as Komesar says: "Richard Posner's standard treatise on law and economics is filled with instances in which the substitution of common law courts for *real* markets is viewed as efficiency enhancing because these courts are allegedly superior to the imperfect markets at replicating *ideal* market outcome."¹² (*Italicized* is original.) Good Economics could be bad law, as Buchanan once said.¹³ It is invisible hand, not courts, which would guide market players to allocate their resources efficiently.

¹¹ Oliver E. Williamson, The New Institutional Economics: Taking Stock, Looking Ahead, 38 J. Economic Literature 595-613 (2000).

¹² Neil K. Komesar, Law's Limits: The Rule of Law and the Supply and Demand of Rights 140 (2001).

¹³ James M. Buchanan, Good Economics – Bad Law, The Collected Work of James M. Buchanan (18): Federalism, Liberty and the Law 327-337 (2001).