ECONOMICS
and the
JUDGES

The Case for Simple Rules and Boring Courts

NEW ZEALAND BUSINESS ROUNDTABLE
JUNE 1996

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This lecture was delivered at a dinner at the Auckland Centra Hotel on 14 December 1995

First published in 1996 by
New Zealand Business Roundtable,
PO Box 10–147, The Terrace,
Wellington, New Zealand

isbn 1–877148–07–5

Design and production by *Ruth Munro, Daphne Brasell Associates Ltd, Wellington*

Printed by *Astra DPS, Wellington*

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Richard A Epstein is the James Parker Hall Distinguished Service Professor of Law at the University of Chicago, where he has taught since 1972. Previously, he taught law at the University of Southern California from 1968 to 1972.

He has been a member of the American Academy of Arts and Sciences since 1985 and a Senior Fellow of the Center for Clinical Medical Ethics at the University of Chicago Medical School. He served as editor of the Journal of Legal Studies from 1981 to 1991, and since 1991 has been an editor of the Journal of Law and Economics.

His books include *Bargaining With the State* (Princeton, 1993); *Forbidden Grounds: The Case Against Employment Discrimination Laws* (Harvard, 1992); *Cases and Materials on Torts* (Little, Brown, 5th ed, 1990); *Takings: Private Property and the Power of Eminent Domain* (Harvard, 1985); and *Modern Products Liability Law* (Greenwood Press, 1980).

Professor Epstein has written numerous articles on a wide range of legal and interdisciplinary subjects and taught courses in contracts, criminal law, health law and policy, legal history, property, real estate development and finance, jurisprudence and taxation, torts, and workers' compensation.

His latest book, *Simple Rules for a Complex World* (Harvard, 1995), grew out of a series of lectures and seminars given in New Zealand and Australia in 1990.

Introduction by
David Williams QC

PROFESSOR EPSTEIN, MRS EPSTEIN, your honours, ladies and gentlemen.

A couple of years ago, the Dean of the Yale Law School published a book called *The Lost Lawyer: Failing Ideals of the Legal Profession*—a legal profession which, incidentally, he said was in very poor shape. Speaking of the law and economics movement in the years since 1965, he wrote:

> No other approach to the study of law has had a comparable effect on the way that academic lawyers in the United States write and teach. Law and economics is today a permanent institutionalised feature of American legal education. Specialised journals are devoted to it, and its presence is pervasive in the older law reviews as well. Faculty positions at many law schools are explicitly reserved for its adherents and it is now represented by a professional organisation of its own, the American Association of Law and Economics. Even these external markers do not fully measure the movement's influence which is nearly unrivalled in some fields such as corporations and commercial law and is dominant in others such as torts, contracts and property.

The Dean of the Yale Law School might have added that the law and economics movement has been significantly boosted by the appointment of some of its most notable members to influential positions on the United States federal judiciary. One thinks immediately of former pro-fessor, now judge, Richard Posner, whose 1972 work *Economic Analysis of Law* is a central text for the law and economics movement. One thinks as well of his former colleague on the University of Chicago Law Faculty, Judge Frank Easterbrook. Both of these professors are now judges on the Seventh Circuit of the Federal Court of Appeal.

In this country, the interest in law and economics has been slow to materialise, although it has been given a boost in recent times by the formation in 1994 of the Law and Economics Association of New Zealand and by the organisation of several Law Society seminars on economics and the law. Is there anything that is useful for the New Zealand judiciary in the acquisition of some understanding of the basic principles of law and economics? One of the few New Zealand judges who has some real interest in the subject so far is Sir Ivor Richardson, who is the founding patron of the Law and Economics Association and is soon to be the President of the Court of Appeal. In a 1995 speech to the Waikato Law School (see Rt Hon Sir Ivor Richardson, 'The Harkness Henry Lecture: Public Interest Litigation' (1995) 3 Waikato Law Review 1, 9) he said:

> The acceptable resolution of disputes involves reaching a satisfactory substantive answer in a fair and cost efficient way. Both the substantive decision and the process by which it is arrived at must balance community values (moral, social and political), fairness considerations and resource constraints. In economic cost terms, the object is to minimise the sum of three types of costs. In other areas of public policy the costs are conventionally referred to as administration costs, compliance costs and economic or deadweight costs. In the justice system the administration costs are the net costs to government after deducting court fees and other receipts. The compliance costs are the costs borne by those involved in the litigation. The economic costs are the risks and the costs of erroneous and inefficient decision making.

Sir Ivor went on to say that the substantive decision also carries costs and benefits. The point is that in both the decision-making process itself and in the ultimate decision on the public policy rule, the court should take account of all of the costs involved.

If we are to have someone who can speak to us authoritatively on the subject of law and economics, and in particular on economics and the judges, we could not possibly hope for a more highly qualified speaker than Professor Richard Epstein, the James Parker Hall Distinguished

Service Professor of Law at the University of Chicago. He is a graduate of Yale, Oxford and Columbia universities and the author of a number of well-known books which consider in a theoretical as well as a practical way the interaction of law and economics. Professor Epstein has taught at the University of Chicago since 1972.

As was stated in a recent New York Times book review of his latest work *Simple Rules for a Complex World*, "Richard Epstein has a record of proposing radical and extreme alterations in key areas of the law—alterations that perhaps initially could be dismissed as so far from the centre of legal thinking as to be of only theoretical interest, but that turn out to have much more political life in them than one could have thought possible." The reviewer gave one example among many from Professor Epstein's book *Takings: Private Property and the Power of Eminent Domain*. This was a book, published in 1985, in which he took the radical position than any governmental restriction on the rights of private property should be properly compensated. The reviewer pointed out that Richard Epstein's views on what was proper compensation went far beyond what judges at that time had traditionally allowed, and yet today we are told that legislation which incorporates much of what Professor Epstein was proposing is making its way through the US Congress. Anyone who is familiar with his writings or who has heard him speak will surely agree that his intellectual range is impressive and his ideas enormously stimulating.

As you have heard, this is not Richard Epstein's first visit to New Zealand. Indeed, in the preface to his most recent book, *Simple Rules for a Complex World,* he records that he was approached by the New Zealand Business Roundtable and an Australian company to make a speaking tour of New Zealand and Australia and that the talks he gave on that visit were the origins of that book. It is obvious that Professor Epstein finds the atmosphere of this part of the world congenial and intellectually stimulating, and, in December, doubtless a welcome relief from the sub-zero temperatures of Chicago.

It is my great pleasure on behalf of the New Zealand Business Roundtable and all present tonight to warmly welcome him back, and to invite him to address you on the subject of economics and the judges.

ECONOMICS AND THE JUDGES
THE CASE FOR SIMPLE RULES AND BORING COURTS

THIS PAPER INVESTIGATES the use of economic theory by common law judges. I shall begin that inquiry by propounding a gentle paradox. Great progress has undeniably been made over the last two generations, both in the science of economics and, more specifically, in the law and economics movement. Today we can analyse, in a more sophisticated fashion than formerly, a range of economic processes that are relevant to legal issues. We know something of the impact that legal rules have on social behavior and how economic theory can assist in choosing the efficient legal rule. Given these academic advances, we might have imagined that this new knowledge would slowly diffuse itself throughout the legal profession and the courts. We could hope therefore to see the development of a judicial body of knowledge reflecting many of these academic advances. Yet the opposite is largely true. A little learning—or even a great deal of learning—can sometimes be a dangerous thing. The legal profession today seems not unlike an overstretched juggler who tries to keep too many balls in the air at once. In attempting to do too much he gets himself into a terrible tangle, and the balls come clattering down and fall at his feet.

The perils of discretion

In some instances the source of our uneasiness lies in the direct way that legal rules are said to incorporate economic considerations. Too often we are told, for instance, that the courts should consider a wide range of costs, and then seek to minimise their sum across disparate domains, or costs, and then seek to minimise their sum across disparate domains, or to undertake similar technical feats. To that challenge we react with confusion, wondering how on earth to take all these variables into account, how to acquire all the relevant information, and how to put the data together in a coherent manner so as to come out with the correct answer. In many cases modesty is the superior virtue. The effort needed to apply so precisely an articulated theory is so fraught with difficulty that judges are well advised to abandon it. In its stead, they should follow some simple commonsense rule, or rule of thumb, in order to avoid these complicated economic calculations. The equal division of damages under the older admiralty rules may well be superior to the constant struggles to develop more refined approaches to the apportionment question.

My contention is that greater judicial sophistication has not brought forth higher quality judgments, but rather the reverse. Nineteenth century judges, who thought in much less sophisticated economic terms than their counterparts today, often delivered judgments that better reflected sound economic principles. No one would deny that we have greater economic wisdom today and more sophisticated tools of analysis. But where should we go from here, now that the economic genie is well and truly out of the bottle? Our challenge is to domesticate that new knowledge within the judicial setting.

What then accounts for the disjunction between economic knowledge and judicial performance? One obvious constraint is that judges are not economists. We do not expect to see in judges' opinions precise economic demonstrations of the kind found in a standard textbook. Judges do not derive a demand curve or a long-run supply curve. That does not in itself concern me. The legal profession is better off taking economics more as a set of heuristic principles for understanding fundamental social relationships than as a set of formal equations or precise quantitative knowledge.

A second constraint is that judges themselves are limited by institutional barriers. Frequently they must interpret statutes and regulations. Unfortunately, a sound rendition of a bad statute should yield a bad result.

Judicial construction should not be able to cure the flaws in bad legislation; consequently one cannot criticise judges for faithful construction. Conversely, a good statute, correctly construed, should lead to a congenial result because now an accurate translation should preserve the basic statutory principles. The task of judges is not to make the law but to apply it in a sensible fashion; they have delegated authority only. When the statute they are applying contains economic wisdom, that wisdom should be reflected in their judgments. When the statute does not contain wisdom it is not the role of judges to attempt to improve the law under the guise of construction. Thus we cannot look simply at judicial output and automatically criticise judges for decisions with bad consequences. We need to look deeper, and decide whether it is judges who have mangled a fine statute or whether it is the statute itself that is doing the damage.

But we cannot push this point too far for, within the set of statutory constraints, judges retain considerable capacity to use the economic tools at their command for good or for ill. There are three aspects to this judicial discretion. First, even today a large number of judicial decisions are at common law, whose first principles are rightly understood as falling in the province of judge-made law. Thus judges retain a degree of freedom—without any legislative guidance—to make decisions, for good or for ill, regarding which of our earlier doctrines should be preserved and which should be changed. In these circumstances no judge can 'pass the buck'. Each judge must rationally defend his or her decision with reference to the principles appropriate to the decided cases. If those principles include our favourite duo, justice and efficiency, then the sound judge needs rationally to address both.

Secondly, a large number of statutes themselves contain a reasonable degree of openness and fluidity. For instance, the Sherman Antitrust Act—one of the leading statutes in the United States—opens by prohib-iting in general terms contracts and combinations that operate in restraint of trade. It is largely left to judges to determine how its grand principles will apply to concrete situations. Legislation that gives judges that degree of running room should be read in a different light from more tightly specified statutes. A statute such as the Sherman Antitrust Act should not be thought of as a series of chains binding judges to certain inevitable outcomes, but rather as an authorisation for judges to tread in areas they might not otherwise have thought appropriate to enter. When judges are given this degree of discretion, we are entitled to expect them to do the right thing, and to be critical of them if they fail. Using that statute to attack vertical and conglomerate mergers should be condemned as an over-aggressive judicial invalidation of transactions that hold out no real economic danger.

The third area where there is scope for judicial discretion concerns a unique American institution—our written constitution. The judicial application and interpretation of constitutional law, designed as a check upon statutory authority, brings us back to territory very similar to the common law adjudications handled by judges. For example, under the American constitution, the protection of private property necessarily invokes the common law conceptions of 'what sticks are contained within the bundle'. So do freedom of speech, freedom of religion, the impairment of contract, and a wide range of other doctrines. The framers of our constitution clearly understood the continuity between common law rights, the statutory systems designed to implement and preserve those rights, and the constitutional safeguards designed to ensure the legislature did not misbehave. In this context, economic reasoning by judges will again be appropriate to explain why these institutions are worthy of constitutional protection in the first place. When modern judges therefore strip private property of its content, and treat ownership as embracing little more than bare possession, they both do violence to the original constitutional structure and weaken perhaps the most fundamental institution for social improvement.

The virtues of restraint

There is clear scope, then, for judges to exercise their discretion either well or badly. Here I want to draw a broad contrast between the nineteenth and twentieth century judges. The nineteenth century could not, in fairness, be called an age of economic illiteracy. Adam Smith was an eighteenth century figure, David Ricardo a figure of the early nineteenth century. As we move through that century we encounter the works of other great economists. Nonetheless, as late as 1875 the state of economic knowledge was still strictly limited; many important developments lay in the future. The whole analysis of marginal cost was developed by Alfred Marshall only in the 1880s. Also in the future lay all the most insightful measures of social welfare, such as Pareto optimality—developed around the turn of the century—or its English version, the Kaldor-Hicks standard, dating from the late 1930s. Moreover, serious analysis of topics such as information costs and transactions costs—to many of us the heart and soul of modern economics—dates only from the late 1950s and early 1960s.

This state of affairs meant nineteenth century judges, when dealing with transactional issues, necessarily proceeded without a knowledge of modern theories of law and economics. Indeed, the decisions of these judges do not appear to have been based on any of the calculations one typically hears mentioned today; they were not maximising or minimising anything, at least not explicitly. They were trying, in a rather simple fashion, to come up with an appropriate resolution to the cases in front of them. Yet for all these limitations, their modest approach generally served them well.

A number of reasons account for their success. First, most nineteenth century judges were aware of their own limitations: of what they knew, and what they did not know. By contrast, modern law and economics can encourage the dangerous feeling in judges that, with the grand theoretical principles now elaborated, they can know a great deal about specific transactions. In other words, knowledge of economics is treated as a licence for intervention. If judges think they understand all the details of transactions, they are very tempted to believe themselves justified in imposing a command and control system, with them in the role of commanders and controllers. But the nineteenth century judge, who was aware of how much he did not know, tended to think: "I should be sceptical about intervening, and fairly cautious about what I am prepared to do." In many cases this translated into judges thinking: "I don't know what is right and wrong under these circumstances. Perhaps the best thing is to let people decide for themselves what they want to agree to." One important consequence of this sceptical attitude was a firm belief in the doctrine of freedom to contract—even by judges who had never heard of the proposition that voluntary exchanges between two or more parties will shift resources to a higher-valued use.

A second feature of the wisdom of nineteenth century judges was a realistic assessment of human nature, of how people interact. An easy mistake for a modern judge to make is to assume that the tools he or she possesses are capable of being put to good ends, and that it is possible to tell which of the parties in a given case are the 'good guys' and which are the 'bad guys'. On those assumptions, it follows that the judge should tilt the scales of justice in favour of the more 'deserving' individuals. The nineteenth century judges were more cautious about attempting such feats than their twentieth century counterparts. They realised that one should have a fair measure of scepticism about the motives of everyone who comes to court, and that judges should not pick sides on the basis of the status or roles of the various parties. This recognition of self-interest reinforced their scepticism and put them on their guard against being hoodwinked by either party.

The third element of wisdom frequently found in nineteenth century jurisprudence started with the presumption that litigation is a drastic step to take. Litigation is a form of aggression. It may be aggression that is licensed, sanctioned and organised by the state, but an individual should still have a powerful reason for invoking state powers against other individuals. Law suits should not be lightly or transiently pursued, but should require a breach of major proportions by the other party. Disputes below that level should generally be settled outside the courts.

Finally, and following on from the previous point, nineteenth century judges had a clear sense of their own limitations in selecting the legal sanctions to impose on individuals. Given their limited knowledge of both parties and circumstances, they recognised a simple and uncomplicated remedial structure. No elaborate decrees of specific performance of service arrangements, and no structural injunctions to reform prisons, hospitals and schools.

These four elements generated a strong tendency amongst nineteenth century judges to defer to their inherent limitations, and to be cautious about how much they attempted to do. I will give several examples of that attitude, and in each case I will also look at how that attitude changed in the twentieth century.

The insurance cases

The English developed a law of marine insurance, and its content was shaped by the nineteenth century judicial presumption of distrust. The party to an insurance contract about which the courts were most sceptical was not the rich and powerful insurance company, but the insured party. It is not difficult to see why. The insured was in possession of the property, and had the lion's share of the information about the nature of the risks that were being run. Only the insured party could claim that a ship was safe and sound when it was not seaworthy. After offering a favourable premium, the insurance company would then discover that the ship was a worthless tub that had sunk in the ocean, leaving the company with a large bill. The insurer did not possess similar weapons to brandish against the insured. Based on this simple but powerful insight about the opportunities and motives of the parties, the early legal doctrines placed strong obligations of disclosure upon the insured. Contracts were construed in the light of their ordinary meaning. The nineteenth century judges entertained no assumption that writers of insurance contracts had superior bargaining power, or were wicked and greedy capitalists. They rightly refused, therefore, to shift covertly the balance of advantage in favour of the insured.

Twentieth century judges, in contrast, have often taken a different view of an insurance contract. It is a view which leads to incredible complications which can, in turn, create grave international repercussions from local disputes, as in the asbestos cases. No longer do American judges regard both parties to an insurance contract with the scepticism of former times. Despite the fact that insurance companies operate in a competitive market, the courts tend to impute to those companies a high degree of market power. This view arises, in part, merely because the insurance companies enter into standard form contracts with insureds. The courts imagine that standardisation carries with it an element of coercive force that no contract should contain. So they take upon themselves the unwise task of neutralising that power. They wield counterbalancing power by construing the provisions in an insurance contract in the fashion least favourable to the interests of the insurer. If a contract is unclear, the scales are always tilted in favour of one party—the insured. Now that this rule has been left in place for so long, hardly any insurance contract will ever be clear.

The asbestos coverage dispute in the United States provides a good example of the process at work. Back in the early 1940s, people became aware that accidents and injuries came in two broad categories. One type was the standard traumatic injury where an old lady would fall off a bus and strike her head on the sidewalk, and an insurance company would answer for that particular loss. That situation posed few problems. The second category of accident was much more problematical. It concerned people who were exposed to dangerous or injurious conditions for a long period—perhaps for decades. Suppose the party responsible for those conditions had purchased liability cover over different periods from different insurance companies with different contracts. Which of these various companies should honour the policy in question? There is no obvious answer to this question. In 1943, the insurance industry in the United States did the only honourable thing—it punted. It said: "We've managed to live with a very informal response to this particular problem for about 20 or 30 years. We can't agree amongst ourselves as to how it should be definitively solved. We will all go our separate ways."

That was the situation before the asbestos litigation arose in all its unanticipated fury. After the asbestos litigation, instead of needing to worry about one law suit every couple of years, there were now several hundred thousand cumulative trauma cases whose cover was provided under standard insurance contracts crying out for interpretation. These contracts were undeniably ambiguous.

Then a case called *Keene v. INA* (1981) 667 F. 2d 1035 laid down an astonishing rule. On the assumption that sophisticated economics tells us that one party to an insurance contract is the dependent party and the other party is independent, *Keene* adopted the rule that ambiguous contracts should be construed so as to maximise the degree of coverage to the weaker party. This was done by allowing the insured, after the race had effectively been run, to pick any insurance contract in effect during the entire period of exposure as the source of cover for the particular case. Clearly this approach is tantamount to rigging the race: it allows the insured party to place its bets on a particular horse after the race is over. It can always collect handsomely after the event. Yet the sheer oddity of the *Keene* judgment has been lost on many sophisticated judges who still assert that the object of an insurance policy is to maximise the coverage to the insured, rather than to promote the mutual benefit of the parties, as seen by them, at the time the contract is made.

The consequences of allowing the insured to pick a preferred insurance policy can be bizarre. Imagine an insurer who had written an insurance policy for one week's cover. The policy may have been written for $100 million, and attracted a premium commensurate with the period of coverage—say $5,000. If the new rule is applied, everybody exposed to asbestos during that one week (by which I mean everyone with asbestos in the lungs during that week) who subsequently becomes ill will be covered by that one policy. This is no mere theoretical case: there were many instances in the United States where policies that had involved trivial premiums for insurers ended up generating huge liabilities, simply from this ability to select at will the operative insurance policy. The havoc created in American markets by this approach to insurance contracts ended up being exported to the London markets. One result has been the near bankruptcy of Lloyd's.

By 1993 or 1994, some American judges had realised that the *Keene* rule was unworkable. They had gone back to the older view which recognised that neither insureds nor insurers are angels, and that it is necessary to look sceptically at the motivations of both sides. But these days judges seem unable to let themselves do anything simple. They seem driven to use their economic sophistication to find other complicated rules. I prepared some expert testimony in a recent New Jersey case, *Owens-Illinois v. United Insurance Co.* (1994) 650 A. 2d 974, that turned on the correct interpretation of excess insurance policies in an asbestos coverage dispute. Predictably enough, the New Jersey Supreme Court would not accept the simple solution of pro-rating the coverage amongst policies based upon the duration of their respective periods of coverage. They wanted to find an elaborate economic formula which would allow them to calculate the amount that should be assigned to each period. They ended up creating a sophisticated model with so many constraints that it failed to yield any solution at all, even though it generated an enormous flurry of economic testimony. It was a classic illustration of a court having a high degree of economic literacy, being aware of all the imperfections associated with ordinary commercial transactions, having good intentions—and making a complete hash of the entire project. That sophistication is not what we want from a court. The older approach, in which people recognised the limitations of their economic knowledge but could follow a rule of pro-ration when necessary, was simple and just. It was also economically efficient. If our knowledge of the case is very limited, a simple pro-ration rule will at least eliminate the various forms of strategic behaviour—the gaming of the system—in which litigants will be tempted to indulge to exploit the fluidity that judges have introduced into the system.

The lesson to take from insurance contracts is that if we do not know what we are doing, we should simply make straightforward assumptions about human behaviour. We should not play favourites. If we followed the lead of the older judges we would, paradoxically, come up with the most economical of solutions. Our new and elaborate theories do not imply that the results achieved a century ago were unsound. It simply means that we have more sophisticated explanations as to why the simpler results of last century actually make sense.

Tort and cost-benefit analysis

The problems that have bedeviled contract law often carry over to other common law areas. Modern tort cases, for example, bring us to another economic tool that is too often misused by the courts—cost-benefit analysis. Cost-benefit analysis can be extremely useful for explaining the world in abstract terms and, closer to home, in organising our daily lives. Modern economic theory allows us to analyse costs and benefits in a much more sophisticated fashion than formerly. We understand, for instance, that relative prices depend on marginal benefits and marginal costs. We understand the maximisation process that takes place. But the fact that cost-benefit analysis may be important for rational decisions does not mean that judges themselves should be employing it to decide concrete cases. To explain why, I will look at some nineteenth century examples and their twentieth century parallels.

One of my favourite nineteenth century judges is Baron Bramwell. He was a flinty old fellow, and probably the most consistent and powerful libertarian intellect who served on the English courts last century. His attitude to cost-benefit analysis was most instructive and is well illustrated with the following case—one which modern economic theory has considered in great detail.

In *Powell v. Fall* (1980) 5 QBD 597, a traction engine ran along a highway and emitted sparks that set fire to the haystack of a farmer who owned the land nearby. Should the operators be held responsible for the damage that occurred? Lord Justice Bramwell (as he had become) broke this case down into the analysis of two scenarios. In the first scenario, it is assumed the activity was sufficiently profitable to enable the operators to compensate the farmer for the loss of his hay. Under those circumstan- ces the operators should pay the farmer. The operators will be internalising all the benefits from running the engine; they should pay all the costs as well. In other words, a cost-benefit analysis will tell us that if it is rational for one party to undertake such an activity, then that party should pay.

Lord Justice Bramwell then considered the scenario in which the engine damaged the hay, but its operators could not afford to purchase the insurance necessary to cover the loss. Under this scenario, we should still make the operators pay because they will then think very seriously about their actions. Having been forced to bear the cost of the damaged hay, they will recognise that it is no longer worthwhile to run the engine. So cost-benefit analysis again yields the result that the operators should pay.

Having established that principle, no judge actually needs to do a cost-benefit analysis in court. It is of no moment to a judge whether the cost-benefit analysis says that an engine should run because the operators can afford to pay, or whether it says that the engine should not run because the operators cannot afford to pay. All that judges need to do is enforce the rule that the company pays for the damage. If it is rational to continue running the engine, the operators will pay up and continue, while if it is irrational the activity will stop. The legal rule sets up the necessary boundary conditions. The cost-benefit analysis is taken out of the public sphere and placed in the private sphere where individuals can understand which costs they will be held accountable for, and can make rational calculations on that basis. Thus the legal rule—the boundary condition—induces a private cost-benefit analysis, but it does not turn judges into charter members of a planning commission with a licence to decide which activities will be undertaken for which benefits, and why.

The modern view on this issue is in many ways the complete opposite. It received its most vivid formulation when Judge Learned Hand used cost-benefit analysis as a test for negligence, and it was taken up and championed by Richard Posner—then a colleague of mine at the

University of Chicago and now a most distinguished judge on the Seventh Circuit who has impeccable economic credentials. In the case I described, Posner believed that the operators should be held responsible only in the second scenario, where it was not cost-justified for the engine to run. Superficially, this rule appears highly sophisticated. It incorporates an explicit economic judgment based on the social welfare of certain activities. But the rule turns out to be a mistake. If, as Bramwell had it, the company will be held responsible whatever happens, there is no need to calculate where the line should be drawn. But once we deter-mine that the company is not responsible for cost-justified activities, but is responsible for activities that are not cost-justified, courts will need to decide where to draw that line. Having set themselves this task, they typically discover that they lack the necessary information to discharge it in an intelligent fashion.

How, for instance, do courts decide the marginal cost of additional measures to prevent losses? What factors should they vary? Should they examine the speed of vehicles, the type of engine, the nature of the spark, the crews that are used, the cutting of the grass along the verges and so forth? Courts become de facto central planners using, *ex post*, formulae appropriate for private decision making but inappropriate for dealing with the public sphere. One of the major insights of modern economics is that costs are to a large degree subjective. They are opportunity costs: they represent the loss of opportunities that we would otherwise have had. Their subjective nature makes it extremely difficult to identify and measure these costs in a public forum. In these circumstances, the entire cost-benefit process involves a judicial second-guessing of how industries should be structured and operated—speculations that Posner, for example, is all too eager to make. But even gifted judges lack the competence or the skill to do this successfully. Once again the nineteenth century judges were, paradoxically, more modern. Their scepticism was more consistent with modern analysis of subjective value. By contrast, the efforts of today's judges to quantify costs is inconsistent with the best modern theory.

Custom and the 'open and obvious' rule

The problem of costs and benefits arises not only in the stranger cases where one party is burning another's crops, but also in what might be termed consensual cases. The rise of modern technology towards the end of the nineteenth century led to the emergence of two classes of tort which had been very rare prior to 1850—medical malpractice and industrial accidents. The recent growth of these two subjects can be illustrated by the fact that Oliver Wendell Holmes's classic book *The Common Law,* published in 1881, referred to neither in its extensive discussion of liability.

Both medical malpractice and industrial accidents involve voluntary associations, whether between a worker and an employer or between a patient and a physician. Characteristically, nineteenth century thinking on this subject relied upon two rules, neither of which depended in any explicit sense on the sophisticated cost-benefit analyses often essential for sound business and strategic planning. One rule was that if judges were uncertain as to their knowledge, they should always follow the custom of the trade or profession they were attempting to regulate. If, for example, a physician is in compliance with the custom of his profession, a judge should not hold him liable for his decisions, even if the judge disagrees with the professional wisdom of the practice. If, however, a physician is not in compliance with an admitted custom, then a judge has strong grounds for imposing liability.

The second rule—important not only in medical malpractice but also in the industrial accident cases—was what might be termed the 'open and obvious' rule. If a worker was aware of the working conditions in his employer's premises, and if he decided to take the job while being aware of the risks involved (or if the risks would have been apparent to an ordinarily intelligent person in his position), then he could not turn around and sue the employer in the event of accident—unless there was some particular contractual provision giving him a right of action.

Thus we had two broad rules of thumb for judges: the custom of the industry should be respected, and obvious hazards should not lead to recovery for personal injuries unless there was an explicit undertaking to that effect. In the twentieth century the judges have gone sadly astray. Both rules have been largely rejected in favour of the same cost-benefit analysis that we examined and found wanting in stranger cases. Let us take them in order.

Custom

In many modern settings, we have been told that while a given custom within the industry will be informative, it is nonetheless not dispositive. Judges will have the last word, and their views will be binding. The judge most famous for this approach is the same Learned Hand who gave the cost-benefit definition of negligence its modern prominence. According to Hand, an entire profession could 'lag' behind the appropriate standard, so in the end judges have to decide what the applicable standard should be.

How realistic is such an approach? In assessing the appropriateness of custom, we cannot just examine the small minority of cases that go to litigation. We need also to think about custom in those instances where people do not go to litigation, but organise their lives to deal with repeated interactions. Since the same rules of thumb are used repeatedly, the participants have very powerful incentives to get them right. Over time, of course, most customs can change—as technology, opportunities, preferences and tastes change. For example, in the United States the amount of information a patient is given by a physician has increased as a matter of customary medical practice. This is also true, to a lesser extent, in England and elsewhere in the Commonwealth. No judge, viewing the situation from the outside, has sufficient information as to why people are doing things in a certain way. If a judge imposes his or her own cost-benefit analysis, the risk of error, and the costs of decision, will both increase.

And sure enough in Learned Hand's famous admiralty case (*T J Hooper* (1932) 60 F. 2d 737), Hand himself misread the record. The issue in that particular case was whether radios were a custom on sea-going tugs. Hand thought that, as late as 1930, they were not customarily used in the shipping trade. Yet at that time it was an act of madness to go out on to the water without a radio, since boats were by then able to receive reliable weather broadcasts from shore stations. The trial transcripts clearly show that captains generally took radios on board for just this reason. Hand was not ahead of the industry; he was merely surmising what had been standard practice in 1930—practice which the industry had adopted, without fanfare or judicial prodding, some years before.

When a sharp conflict arises between an industry custom and the conclusions from a judicial cost-benefit analysis, we can suspect two possible reasons for the discrepancy. First, as outsiders we may be failing to understand the custom within the industry. There may be something wrong with the way the evidence was presented to us, or some other bias may have been secretly at work. Alternatively, we may be doing the cost-benefit analysis wrongly. We may, for instance, be missing an impor-tant element in the equation which is not apparent to an outsider. In either case, the older, more conservative approach to this issue is correct, and the disadvantages of the newer view all too apparent. In the United States, a huge proportion of the expansion in product liability this century has stemmed from the unwillingness of the courts to treat customary industry practices as being dispositive on the safety of products—even when the conditions and risks are well known to the consumers of the products. When customary standards are put aside by a court, cost-benefit analysis clearly becomes the alternative of choice. And the only way to undertake a cost-benefit analysis is to have experts designing machines purely in the abstract, hypothesising their costs and their benefits, thereby effectively retrofitting a command and control economy. Once again, sophisticated cost-benefit analysis becomes a mechanism for second-guessing market operations. Yet surely those who have the most to lose from error are more likely to have acquired correct information than a judge and jury who are sitting in a disinterested fashion years after the event. The court is not likely to collect the right information to do the job properly, and even with a high level of diligence will probably sadly misfire. It is far better to leave in place a custom that is 95 percent reliable than to indulge in the illusion that improvement is possible through pursuing the holy grail of a perfect rule.

Yet one may contend that courts that rely on professional custom run the risk of advancing the interests of a trade or profession at the expense of consumers or bystanders. That challenge forces us to address the fundamental question of what counts as a self-serving custom. Consider first a situation with repeat transactions between two individuals, or two classes of individuals, where the individuals will switch roles between transactions. For example, first I may be a buyer and you a seller; in the next transaction you become the buyer and I the seller. In these circumstances a self-serving custom is improbable because neither of us knows our future positions. To optimise our own utility, each of us has to optimise the good of the whole system. Thus, if I am for the time being a seller, a rule that favors sellers but causes greater damage to buyers will harm me in the long run, because I will be a buyer 50 percent of the time. That is the easy case to analyse.

Alternatively, in some sophisticated transactions between repeat players everyone is permanently either a buyer or a seller with no switching of roles. In this case, custom is likely to work less well. Yet even in this instance, the repetitive nature of the transactions gives the parties incentives to gravitate to efficient terms. The parties can always adjust other terms, such as price, once the efficient liability rule is established.

Custom, however, can fail in two ways: one evident and the other more subtle. The evident case of failure is where two parties follow a custom that hurts strangers. Suppose an industry practice sets a standard level of care for an owner to entrust a driver with a team of horses. Both parties follow that agreed level of care, and a third party is run over. Any custom between the owner and driver of a team of horses should not bind a third party. Even if liability turns on negligence generally, in this context at least negligence should not depend on custom. A simpler rule is to protect the stranger by Baron Bramwell's preferred strict liability standard, where custom is irrelevant.

The more difficult issues arise when the background set of circumstances, under which the custom has been created, changes radically—say by technological change. For example, a new market might suddenly be created by a new-found ability to catch fish cheaply. The custom of the trade may have been perfectly suitable for sustaining future yields when the means of collection were very inefficient, but these practices will no longer work when the catch multiplies five-fold or ten-fold. The exhaustion of a common pool resource may have to be met by legislative control over the catch.

In other areas technological change poses different challenges to customary rules. In medicine, for example, it is obviously foolish to follow an old custom in the face of a major breakthrough. I think, however, that the medical profession is sufficiently attuned to that problem. Indeed it even has a custom about customs, one that says that customs change—that better customs replace old ones.

That raises the question of how much information must be accumulated before abandoning an old treatment in favour of a new treatment. So long as there is a substantive division of opinion inside the profession as to which of two courses of conduct is the best, the physician should be free to follow either course. Otherwise the person who takes up the new custom runs the risk of being told that the older custom was correct, and that his departure was rash and foolish. Similarly, the person who stays behind can always be told that the world has moved ahead, and that he is retrograde. In these periods of transition and fluidity, the courts should stay their hand until matters are sorted out within the profession.

As an exercise, I have tried to find documented cases of inefficient industry-wide customs in stable environments. I can identify almost none. The most famous instance where such inefficiency was asserted was a medical malpractice case in the United States—*Helling v. Carey* (1974) 519 P. 2d 981. The medical custom required the physician to check patients over 35 for glaucoma, but not younger patients. The plaintiff was a woman under 35 with glaucoma, presumably asymptomatic, who had not been checked. The court held this custom inefficient under its own cost-benefit analysis. Within months, many ophthalmologists had pointed out the numerous errors in the court's analysis. For example, the court did not take into account the high rate of false positives and thus overstated the benefits of testing.

In medical cases, the American courts have retreated from massive intervention to the narrower customary base. Product liability, however, has not so contracted. One key difference between American and English product liability law is the ability in America of a good plaintiff's lawyer to bring in an expert to say: "My alternative design is cost effective and technically superior to the existing technology." Thus a jury can award liability on the basis of an untested and unused alternative design, with an enormous unwarranted expansion in liability.

In sum, the limits of customary standards are found in the two cases mentioned above: stranger cases and cases of rapid external changes. In making this observation I do not mean to claim that customs are always perfect. My point is simply that any device constructed to detect inefficient customs is likely to have a greater error rate than the customs themselves. Clearly any such method is more costly than my rule. There is no point in getting lower reliability at higher cost.

Open and Obvious Conditions

The analysis of custom carries over to the many judicial departures from the other nineteenth century rule of thumb—the open and obvious rule. The logic of this rule is as follows. An employer first puts an offer to a worker. It specifies the conditions of the job. It effectively says: "If you decide to work here, these are the risks you will take. We will pay you to take them by a deal that satisfies both of us." This situation is sharply distinguishable from one where a hidden defect or trap results in injury to the employee. The latter case contains a fundamental misrepresentation of an important term of the contract, from which liability may follow. Thus the rule of no liability under open and obvious conditions does not give employers *carte blanche* to do as they like. Concealing relevant information about traps or latent defects can become a potent source of liability. The rule gives us a very simple litmus test: it is usually not difficult to decide which conditions are obvious and which are not. If a defect is patent and if it is passively accepted by the worker, then the worker cannot recover. If a defect is latent and hidden, then the worker can sue. This rule of thumb effectively allows the courts to partition responsibility between two parties.

The rule also leaves open the potential for the two parties to get round the open and obvious rule by contracting out. This option is not merely of theoretical interest. In England, workers' compensation systems of that type were common in the mines, the mills and the railroads. Thus if the open and obvious rule turns out to be inefficient in a given circum-stance, contracts can be written to expand the scope of liability or to reduce the level of damages. This would provide a superior set of incen-tives to those generated at common law.

Again, the modern view is different. It does not regard it sufficient that the law encourages the passage of information within an employer-employee relationship, but too often postulates that employment relation-ships are borne of domination and oppression. On that assumption, even if workers know about a certain condition attaching to a job offer, they are helpless to turn down the job. The employee awareness of a risk when combined with a willingness to take the job no longer amounts to a 'real' willingness to work. What is observed is supposedly not a freely chosen market transaction. Having come to that position, how does a court then proceed? One option is to declare that an employer is always liable when a worker is injured. Few judges have embraced this position, because clearly workers can do so many foolish or self-destructive acts for which employer liability would be bizarre. So once again judges fall back on cost-benefit analysis and substitute some type of collective judgment for the individual judgments of the parties. This approach was resisted by nineteenth century judges. Yet this century it has been a dominant feature of modern liability law, at least in the United States. If, for example, a machine tool has an unguarded blade and a worker gets her hand caught in the machine, today she may be able to sue the manufacturer. This is an even worse outcome than holding the employer liable. Logically, responsibility for fixing the machine, if something needs to be corrected, should rest with the employer not the manufacturer. The manufacturer may have made the machine many years ago, whereas the employer possesses the equipment today and may be able to alter it in the light of current circumstances and risks.

When cost-benefit analysis displaces the open and obvious rule, it generates exactly the same consequences as subverting the customary rule. It converts the court from an institution that tries to understand and enforce private contracts to one that re-creates contracts, after the fact, when events have run their course. There is a peculiar symmetry between these industrial accident cases and the cumulative trauma insurance cases we examined earlier. The basic intuition about what has gone sour with modern approaches is the same in both cases. If two parties make a contract, the courts must enforce it. If not, the integrity of the entire system is weakened: nobody will make promises and part with money without a credible judicial commitment to ensure the future receipt of a promised quid pro quo—be it cash or protection from liability.

The fallacies of activism

The modern view assumes that a court, after the fact, can decide whether the bargain made by other people was rational. The court assesses rationality in terms that *it* understands, but which the parties themselves may not have entertained. If the court approves of the parties' actions, it can ratify them. If the court does not, it feels free effectively to override them. Much of the activism of American judges has, I suspect, sprung from their own confidence on economic issues. They have been exposed to the problems of imperfect information and 'inequality of bargaining power'. They know that positive transaction and administrative costs may block some transactions. But it is one thing to grasp these propositions in the abstract, it is quite another to apply them correctly in concrete situations. Mastering the abstract theory does not give a judge or an academic licence to second-guess the preferences of other people, for what economics truly teaches is that people generally have a better knowledge of their own preferences than do others. The role of the courts is to understand what the parties meant, what they said and how they construed it—not to superimpose their own judgment as to the wisdom of their behaviour.

I am not denying that there is any room whatsoever for judicial intervention. Nor am I insisting that we should adopt a legal regime of absolutely pure contract with no constraints, where any agreement between two parties is automatically upheld by the courts. Many of the nineteenth century judges possessed a better instinct on such matters than the twentieth century judges. In any contract between two parties, the key elements for a court to consider are the gains from trade between the parties and the consequences that contract has for third parties. If a contract between two individuals has positive effects on third parties, that is all the greater reason for enforcing it. Most contracts—for selling goods, hiring labour and so on—are of this type. These contracts have positive externalities because they enhance the wealth of the two parties to the transaction, and wealthier and more commercially sophisticated people provide greater opportunities for contracting to third parties. Thus, paradoxically perhaps, anything we do to make ourselves better off helps other individuals in the long run by creating the opportunities for further commercial transactions.

Certain contracts, however, do not have this effect—such as the contracts in restraint of trade alluded to above. Two parties may agree to restrict output or to divide markets. In both cases they are attempting to reduce the number of possibilities available to third parties. Standard economic analysis tells us that when we allow these monopoly practices to flourish, welfare losses ensue. The nineteenth century judges struck a good balance in dealing with this problem. Their attitude was simply not to enforce these arrangements. They relied on the ordinary incentives of one party or the other to cheat on the cartel, leading to its disintegration and the scope for a competitive equilibrium to re-emerge.

Today we understand the dynamics of this process, but we fail to appreciate the simplicity of the common law remedy. Instead, we have elaborate antitrust laws and various public tribunals and private rights of action. This creates an enormous incentive for people to sue other parties, for huge sums of money, over ostensible misbehaviour. At least in the United States, the consequence has been to confuse the good with the bad, at enormous public cost. We now allow private rights of action against forms of contract that are in fact not contracts in restraint of trade. The attempt to provide direct legal enforcement of various remedies amounts to a less effective mechanism for countering restraint of trade than was used by the common law judges. As happens so often, the modern approach takes a good instinct one step too far. By attempting to eliminate every single evil, it creates bigger imperfections elsewhere. So in this area, as in others, we have much to learn from the nineteenth century approach of offering cheap and simple legal remedies. Non-enforcement of restraint of trade arrangements may not be perfect. But it is better than establishing an elaborate set of government agencies and tribunals which will usually slow down ordinary commercial transactions and do more harm than good.

The case for simple rules

To summarise: today we know a huge amount about the way a legal system works. We know more than in past eras about the interactions between various parties to contracts. We understand concepts such as information asymmetries, transactions costs and the dynamics associated with bargaining power. But we fail to appreciate how difficult it is to use what we know. Our knowledge tells us how individuals can beat the system if given the chance. It does not tell us how to fine tune the rules by building ever more complicated models. The best way to handle the complexity of analysis is usually to reduce it to a form that yields some simple rules of thumb—simple rules for a complex world. These rules allow us to get results which are 95 percent correct without working through, on a case by case basis, the tortuous analysis of all the factors regarded as relevant under general economic theory. The rules I have recommended can all be justified in terms of the most sophisticated modern economics, but their operational content is manageable within a legal setting.

The first of these rules is that in a contract between two parties where we believe the parties know what they are doing, we should construe that contract in its ordinary meaning. We should not attempt to tilt the balance in one direction or another. We should not have friends or foes. We should not think that employers are good or that insurers are bad, or that landlords are terrible and tenants virtuous, or vice versa. We should ignore the roles associated with the parties and simply treat the contract as though it were created amongst anonymous equals, the 'As' and 'Bs' of countless hypotheticals, even if it were not. This stripped-down approach will bring far superior outcomes than if we are constantly aiming to rig the scales and complicate the analysis.

In tort law the rules should be simple too. If we run into a stranger's house or car, we should pay damages for the harm caused. In other situations where people voluntarily come together—such as premise liability and employer liability—we should hold people responsible when they create hidden traps for other individuals. But we should not hold them responsible when the dangers to which those other individuals are exposed are open and obvious. Moreover, in assessing the standard of liability in a medical malpractice case or a case involving some other unsafe service or product, we should find out the standards of that profession and slavishly follow them. We should do this even if we do not understand the rationale for the standards, on the grounds that the people professionally involved in these activities are likely to have a better grasp of what goes on than we do.

A common mistake made by judges is to reason from the infrequent cases that come before them to the routine cases their rules will govern. In a thousand situations where there is a physician/patient relationship, the case that gets to the court of appeal is the case where something has gone terribly wrong. Thus the peculiar method of selecting cases for appellate litigation generates a sample of cases radically different from those that somebody involved in business would see on daily basis. In that sense, most of the cases that a judge sees are aberrations. Yet it is a great mistake for a judge to assume that the rules a court creates only apply to the aberrational cases. The legal rules will also govern the mundane cases that remain within the system, to be resolved without litigation. The judge needs to fear that laying down an ideal rule for this one case in a thousand may unglue the system that works well for the other 999 cases.

I remember teaching tort law about 25 years ago, and outlining to my class the rules of thumb that I thought should apply in automobile cases. For example, if you go through a red light and hit a car which is proceeding on a green light, you should be liable. If you run into the back of somebody parked at a stop sign, you should be liable. I went through all these rules. One of my students went into the practice of insurance claims adjustment. He later said to me: "Professor Epstein, it's remarkable. I discovered that 99.9 percent of our cases are litigated by your rules, which are not the official rules of tort liability today. And the only cases that are litigated by the judge-made rules are those that go up on appeal." The insight is that we will get a long way with simple rules of thumb for traffic accidents—not a no-fault system as you have in New Zealand, but simply a rule which says that whoever violates the rules of the road will have to pay somebody who does not violate the rules for the damages incurred.

If we understand how this system works in the routine cases, we will avoid excessive mischief in the sophisticated and idiosyncratic cases that end up before a judge. By aiming for subtlety and economic refinement, we risk falling flat on our faces by making the errors that simpler techniques could have avoided. The most sophisticated economic theory leads us back, in fact, to simple and powerful rules. If we understood that, it would probably make judging a more boring profession. But in the end, society, lawyers and even we academics would be better off for having more boring courts.