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***Lawyers and Economic Analysis of Law: New Learning and Poisonous Apples (Three Scenarios of EAL)***

I. - I swear: what follows won't be yet another attempt to tell the story of a bright intellectual enterprise. There is already plenty of efforts aiming to offer either an apologetic scrutiny of the developments of EAL (worth to be mentioned, amongst the most recent, are the contributions authored by Francesco Parisi and, just now released in the Internet, by Eli M. Setzberger, who does not dare to speak of dominant methodology for legal research) or a passionate critique (in which case the plateau where to choose would be possibly greater). Rather, I will try to briefly describe three states of mind about EAL; implying that I will move as an insider, less interested in its general acceptance than in trying to understand what to with it in the future.

II.- The **first scenario's** background might be represented by Lake Michigan's shores. Actually, Chicago was not the only cradle. There were, dispersed somewhere else, other founding fathers: among them, needless to say, Pietro Trimarchi, working in absolute isolation in a system still dominated a highly dogmatic approach. But the lunatic fringe operating in Chicago was probably the strongest drive and became the icon of the climb.

In the first scenario, the EAL carries out an exploratory activity, in a scientific environment – Milton Friedman was positive on that – which rejects the need to use any technicalities in economics. There was, quite often, a mathematical appendix, but it was just an appendix.

It was the time of the search for grand theories, of powerful syntheses, of shining intuitions, of considerations which appear nonsensical until they turn out to be unusually penetrating. That was the time of, *inter alia*:

- Coasian reciprocity, views of the cathedral and discovery of the many regimes governing incompatible uses of neighboring properties, until the last piece of the mosaic was found (weak protection of the author of emissions) (Supreme Court of Arizona, *Del Webb v. Spur Industries*);
- Burton and good faith *in executivis* as opposing actions aimed at regaining the opportunities lost as a consequence of the contract;
- penalty clause, Shylock's revenge and the crumbling of the "monument to juridical civilization";
- the valorization of Learned Hand's formula as a technique to clarify and specify the volatile concept of fault;
- Ackerman, the expansion of the temporal framework and the split-second absent-mindedness which bewildered André Tunc; and so on.

I'm choosing almost randomly in the wild bunch; indeed, the list might be way longer: such topics are still the crucial points of our basic courses of EAL.

As the exploration was accomplished, *i.e.* when the economic approach touched the extreme boundaries of the legal system, the thrust faded away. And that happened when Chicago had already occupied – actually, it still permeates – a large part of American universities (Europe has never experienced the first scenario). The complexifiers were about to come over and take the lead, it is true: but could this mean a dramatic revision of the seminal, fundamental approach? The obvious answer is no. The geographic exploration did not end up with the discovery of the sources of the Nile; to the contrary, the thirst for knowledge increased, although without the epic of "*Doctor Livingstone, I suppose*".

III.- The **second scenario** is characterized by the physiognomy of Steven Shavell and an implicit motto: *from law & economics to EAL*.

It's the era of the economists, who bring along sophisticated analytical tools and hardly conceal a degree of intolerance towards "unstructured" rationales. Accordingly, a Ph.D. in economics is perceived as a cultural precondition.

I do not have any prejudice against sophistication, the refinement of analytical tools, the proliferation of Propositions, Proofs, Corollaries, QED, and analogue niceties. A more mathematical apparatus is simply difficult to handle, but at the same time can prove extraordinarily useful and worthwhile, if well grounded.

However, we should be careful: in its actual implementation, such an approach might cut the link with the legal component. This ultimately paves the way towards a process of divergence, which would be clearly incompatible with the original interdisciplinary inspiration of the EAL. The worst-case outcome is a completely auto-referential endeavor, which identifies key research questions and hot topics in a totally autochthonous way, instead of drawing inspiration from legal practice.

Do we really need a model based on assumptions that do not reflect the main features of reality? Models are useful for the Luhmanian reduction of complexity, but they are pointless if such reduction amounts to a distortion, accompanied by the promise that, once the exercise has been accomplished, we will relax too strict assumptions and take the long way back to crude facts. Just to offer an example –beware, not a fanciful one!-- an antitrust model assuming that all cartels will be regularly discovered comes close to almost denying the need for the apparatus set out by Article 81 EC, and the like: but, then, why should a lawyer bother with the economic technicalities concerning the monitoring and detection of restrictive agreements?

IV.- Again, and back to the Learned Hand's formula. It has an extraordinarily suggestive power. However, the law and economics scholar of the second scenario – the present reality on both sides of the Atlantic – has to face a qualitative leap. Who carries out such sophisticated computations? Courts? Operators? Actually, these computations are challenging even when they belong to everyday life, as is the case, say, in financial markets. Imagine how difficult could it be when a full-fledged market does not exist – as in our case –, so that there are no actual prices, but only implicit prices.

These criticisms are obvious, but obviously heavy. The typical counter-argument – see, for instance, Shavell – is the use of the "*as if*" formula. Courts and operators are not able to carry out sophisticated computations, they do not even try, but feel and act *as if* they were able to perform such computations. However, the *as if* approach would outpace fideism if we did not observe what courts and operators actually do. Since they are entrusted with such a complex task, we should focus on their behavior; and this focus seems to be lacking.

Let me put it in another, more elaborate, way. If the links with the law and the ways it actually works are lost, it might very well happen, and here we come to a true paradox, that a different strand of economic analysis dispels the achievements of the grand theory, simply because the new learning offers a better insight of the reality of the legal system. Just an example, which I am borrowing from Robert Rhee.

The positive economic theory of tort law, according to which courts maximize social wealth by deterring conduct that imposes net costs on society, rests on the assumption that, contrary to Polinsky's initial hint on the different perception of the likely outcome of litigation, the dispute resolution process is irrelevant to the structure of tort law. The standard argument goes like this. If disputes are tried, courts apportion liability on the basis of the Hand

Formula; if disputes settle, litigants apportion the cost of accidents on the basis of the expected value of the judicial outcome. Since settlements achieve proportional deterrence, there is no pricing advantage between the two dispute resolution markets, except transactional cost saving.

Assume that a defendant injures a plaintiff, inflicting a loss of 100. The Hand Formula would determine whether the defendant's act was negligent, but the outcome of a trial is always subject to uncertainty. In a frictionless, "Coasian" scenario, the parties could agree that liability is uncertain and discount the probability of the defendant being considered liable at 50%. As a consequence, they could then rationally settle at the expected value of 50, so that the total involved value—defendant's payout and plaintiff's net compensation—would be 100. As an alternative, the parties might go to trial, which would result alternatively in liability or no liability, an all-or-nothing judgment of 100 or 0. The expected value of trial would be 50, except that each side incurs trial costs of, say, 20 each. The defendant's expected payout would then be 70, and the plaintiff's net compensation 30. Though the total transaction value is still 100, trial, compared to settlement, increases the defendant's prospective costs while reducing the plaintiff's expected payoff. The value transfer is deemed to be less "efficient", because of transaction costs. However, these costs do not affect deterrence, since the standard of care is assumed to be the same. The tort system forces the defendant to compensate the plaintiff's injury regardless of whether the chosen option is trial or settlement. Accordingly, so goes the mainstream tale, the dispute resolution process is irrelevant to the question of tort efficiency, and the question of process efficiency boils down to a mere accounting of the transaction cost surplus.

But, as Rhees emphasizes, settlement pervades the tort system, so that the efficiency-oriented feature of the system only holds if the standard bargaining model works properly. Private decisions whether to settle or not depend on a stochastic prediction of the courts' decision, which in turn depends on a probabilistic assessment of the accident. If costs and benefits are matched in the aggregate, appropriate deterrence is achieved. This means that the postulate of the irrelevance of the dispute resolution processes is crucially geared on the simplifying, yet fundamental, assumption of risk neutrality on both sides: an assumption which contrasts reality, since it is commonly perceived that most natural persons are risk averse.

Now, a step forward. Since the world is uncertain, risk is a traded commodity; and, by the way, risk is the standard condition of a meritorious lawsuit. Absent some variance of outcome—the would-be plaintiff assumes to have a 80% probability to win, but the defendant strongly believes that she has a 60% chance of prevailing—, no lawsuit would ever arise. It is uncertainty that prompts litigation. There is already a problem with this view: the incentives supported by the Hand formula get blurred, the paradigm against which to evaluate the cautions (that should be deployed since they cost less than the expected damages) is no longer neat. But there is something more. Risk should be neutralized. By deciding to settle, each party undertakes a hedging strategy aimed at eliminating risk. In view of the possibility that the court finds liability and awards 100, the plaintiff agrees to pay the defendant 50; as a consideration, if there is no liability, the defendant agrees that, if no liability is found, she will nonetheless pay the plaintiff 50. "Each party bets *against* one's most favourable outcome": practically issuing, according to Rhees, a put option (or underwriting an insurance policy) to protect the other against the contingency of a negative outcome. This hedging strategy maximizes expected value while eliminating risk.

Asset pricing principles of financial economics explain that uncertain cash flows are always subject to a risk adjusted discount, which determines the transaction price. Now, the discount on the expected value of the *res litigiosa* contradicts the efficiency claim, which assumes that deterrence is achieved through probabilistic allocation of cost. Irrespective of transaction cost

differences, private settlement offers better pricing to defendants than the public forum. The *caveat* is striking: when the economics of settlement is considered, efficiency, the way we think of it, collapses on its own premises. Thus, the structure of fault-based systems presents an arbitrage opportunity, in which the plaintiff's choice of accepting a discount substantially funds the defendant's cost of resolution. From this viewpoint, the tort system appears hardly efficient, at least based on how efficiency has been defined by economic models. If the appropriate level of deterrence is judicially set under the Hand Formula, but the operational standard of care is determined by settlements, the defendant will be systematically under-deterred.

Forget these implications and focus on the cornerstone of the analysis. The new theory is no less abstract than the mainstream approach. But it tells a story that jurists would find more plausible: after all, they have been taught that *sidera sua habent lites*.

V.- Back to my main point. We face the risk of a normative EAL (and so far, so good); but such normative endeavor would come without a *previous* and a *subsequent* positive EAL (not in the Chicagoan sense of an immanent efficiency-based aptitude). To put it more simply, this would fall short of understanding how and why the law is as it is and would merely focus on what the law should look like. Even more bluntly, *the way it is as the way it ought to be*.

This detachment can become a nightmare. Take, for example, the often celebrated theory of efficient breach. In its most suggestive version, building on Oliver Wendell Holmes' perception that contract is a promise to perform or pay damages, it holds that a seller, who has contracted to sell a commodity to a buyer, should breach the contract in order to resell the commodity to a third party who comes along later and offers a higher price, *if*, after compensating the counterparty, she will still make a profit. This outcome, transferring the commodity directly to the individual that values it most, is an allocatively efficient or Pareto-efficient solution.

The theory would have hardly convinced a German lawyer, who is routinely taught that the standard remedy for breach is specific performance; and would have been resisted also by both French and Italian scholars, since, as Rudden and Juillard timely pointed out, in both legal systems the upper limit of foreseeable damages does not apply when the breach was intentional (*scienter*), so that the trade-off faced by the untrustworthy promisor collapses because of unexpected losses suffered by the buyer. We all tried to overcome these hurdles arguing, for instance, that the German specific performance is only proclaimed to be the standard remedy, whereas it is actually overwhelmed by resort to damages; and, for the French/Italian side, that awareness of the harm caused to the promisee falls short of "*scienter*" (or alternatively, in Pietro Trimarchi's view, that foreseeability must exist at least at the moment the promisor decides to breach).

Be it as it may, we might nonetheless discover, much in the same way as the precedent example, that the theory is unworkable on its own grounds.

Actually, as shown by Eisenberg, the theory rests on two factual predicates which are far from straightforward. On the one hand, it assumes that expectation damages really leave the promisee indifferent between performance and breach: however, contract law theorists know that expectation damages do not bring about any such effect, since, besides being based on objective rather than subjective values, this measure fails to include lawyers' fees and other costs of dispute-settlement and litigation, which would not have been incurred if the promisor had performed. On the other hand, the theory assumes that the promisor knows the value that the promisee places on the commodity, whereas the seller will seldom possess such

knowledge. And even if the buyer had disclosed that information, the seller would normally have no way of knowing what profits the buyer expected to make at the time of the seller's perform-or-breach decision, because meanwhile markets may have shifted, or the buyer may have increased his potential profits through an investment in beneficial reliance which will be wasted if the seller breaches. In addition to that, the encouragement of breach does not necessarily promote efficiency. Even in a world fraught with transaction costs, commodities will normally flow to higher-valued uses. If the second buyer, in Eisenberg's terms the overbidder, values the commodity more than the buyer, and knows who the buyer is, she will purchase from the buyer either an assignment of the contract or the commodity itself. If the third party does not know who the buyer is, a rational seller will either negotiate with the buyer to be released from the contract (so that she can sell to the overbidder), or will sell the overbidder's identity to the buyer or the buyer's identity to the overbidder.

But the most intriguing feature is that, were this theory widely followed, it might lead to inefficiency. It would increase the need to resort to litigation, which is very expensive, as opposed to achieving performance of contracts through the internalization of the moral norm of promise-keeping, which is (apparently) very inexpensive; and, more importantly, would inefficiently reshape the parties' contract. It is a fundamental premise of contract law that autonomous and well-informed actors are the best judges of their own utility, so that enforcing bargained-for contracts is efficient, in the absence of pathologic situations such as fraud, duress, unconscionability, or the like. If the buyers were to expect that the seller is not bound by its commitment, or has got an extremely favourable exit option, they might give up and walk away, insist on an explicit contractual provision stating that the seller has a present intent to perform and that any profit on breach and resale will go to buyer, or demand a payment, in the form of a lower price, for the seller's right to resell. Buyers will react this way because, as Ian Ayres and Gregory Klass conclude, normally one key feature of a bargain promise is to convince the promisee that the promisor has an intent to perform.

This approach, based on economic arguments, challenges the classic theory. One more time, its appeal lies in drawing framework that jurists would find more sympathetic to their background. After all, they are normally bred under the polar star of *pacta sunt servanda*.

VI.- At the end of the day –*in cauda venenum!*–, what might be wrong with the second scenario is that, instead of viewing Law & Economics as the integration of two equally important disciplines, it would lead to an economic analysis of law in which the latter is just the passive object of the former. An object among many others, such as, say, Education, Public Health, or Environment. Just a bit more intriguing, maybe, since meanwhile even economists, with La Porta and Shleifer as forerunners, have discovered that *legal rules do matter!*

Such a fascinating discovery lies at the bottom of the **third scenario**, which is still to come, but is already well defined, at least as to the goal to be pursued: positing economic analysis as a legal source, relevant to the making of the law and to its actual enforcement.

This goal cannot be accomplished *against* (or *despite*) the jurists. As perceptively stressed by Bruno Deffains, “l'étude des comportements qui fait abstraction du cadre juridique existant risque de ne pas avoir de valeur dans le monde réel. Si les économistes écoutent ce que les juristes leur dissent, ils seront capables de développer des modèles plus proches de la réalité”. Summing up. If we need a Ph.D. in economics, we need a Ph.D. in law, too. Even more importantly, we need interdisciplinary education and humility.

This is why we should firmly defend and reassert the value of the positive analysis, even though legal technicalities often appear inaccessible and Kafkaesque. The EAL contributed to

shed light on many of these black holes, and can still do a lot more to clarify and rationalize legal concepts.

At any rate, in the transition to the third scenario, let's try to ignore the sirens calling for an EAL (just) for economists!