

## THE DICHOTOMY BETWEEN PROPERTY RULES AND LIABILITY RULES: EXPERIENCES FROM GERMAN LAW

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### Abstract

Calabresi and Melamed delivered a powerful theory to explain under what conditions it is economically efficient to transfer a property right by voluntary and alternatively by involuntary transactions. In the first instance, the property right should be protected by a property rule or an injunction as well as by criminal law sanctions in order to prevent involuntary transactions altogether. In the second instance, it should be protected only by a liability rule that provides compensation for involuntary transactions. Their theory is normative in the sense that they defend involuntary transactions under one

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set of conditions and voluntary transactions under another. However, their analysis is also analytical insofar as it predicts an evolutionary pressure on legal norms to encourage voluntary or involuntary transactions if the conditions, which they identified, are met. This article describes two diametrically opposed legal changes in Germany. In nuisance law, the development was from voluntary to involuntary transactions, while in privacy law it was from involuntary to voluntary transactions. We try to make it clear that these developments were triggered by the underlying causes that Calabresi and Melamed identified in their seminal paper on property rules vs. liability rules.

## **1 Introduction**

The award of the academic degree of Honorary Doctor by the Erasmus School of Law to Guido Calabresi provides us with a most welcome opportunity to contribute to this special issue of the *Erasmus Law Review* and to reflect on the fundamental importance of his work on law and economics for a modern understanding of the structure of private law. This essay discusses developments in the relationship between private entitlements and emissions in German nuisance law and developments in German civil law on the protection of privacy. It also illustrates the gradual development from a property to a liability rule for the protection of private entitlements in nuisance law and the opposite tendency, from liability rules to property rules, in the law applicable to the protection of private life and reputation. These developments in opposite directions can be neither analysed nor understood without the analytical framework provided by Calabresi's insights.

## **2 Property rules vs. liability rules: a fundamental distinction**

In their seminal paper, Calabresi and Melamed presented an integrated concept for the protection of entitlements by rules pertaining to property, liability, and inalienability.<sup>1</sup> This article became of fundamental relevance for the understanding of voluntary transactions, as opposed to torts or involuntary transactions. Voluntary transactions depend on entitlements that are protected by a transferable absolute right. Every infringement or trespass of that right is sanctioned by an injunction and by criminal law sanctions. Consequently, a third party can use a resource protected by such a right only

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<sup>1</sup> G. Calabresi and A.D. Melamed, 'Property Rules, Liability Rules and Inalienability: One View of the Cathedral' (1972) 84 *Harvard Law Review* 1085.

through an agreement with the owner. In contrast to such a property rule that aims to ensure that only voluntary transactions arise, liability rules grant damage compensation in cases of transactions without consent. According to Calabresi and Melamed, transactions by consent – namely, voluntary transactions – are to be preferred, because the price for the transfer of a right then reflects the subjective valuation of those who give up their rights. However, as transaction costs are high and hold-up positions of owners of rights become important, the entitlement should only be protected by a liability rule. In this case, a third party, typically a court, fixes the amount of compensation for an involuntary transaction.

Providing protection by way of a property rule is fully in line with the jurisprudential approach that focuses on autonomy as the guiding principle of civil law. This approach regards the protection of absolute rights, such as property, as a natural extension of individual autonomy.

The property rule, however, also implies that worthwhile activities may be precluded because voluntary transactions are prohibitively costly. To facilitate such activities, the legal order may provide for the limitation or nullification of an entitlement if the taker is willing to pay a value determined by a third party, such as a state organ. The law, for example, may allow an actor to use someone else's property by way of a servitude, the price of which is determined by the court.

From an economic cost-benefit point of view, this line of argument is straightforward and quite convincing. It points to the criteria under which the initial set of entitlements over resources leads to an efficient allocation of costs. Under the conditions of the Coase theorem, society could limit itself to the property rule.<sup>2</sup> This would have two advantages. Resource allocation would be efficient, which is an important element of a welfarist concept of law, and the protection of entitlements would be fully in accordance with the autonomist view of the law. Under high transaction costs, however, a discrepancy arises between the economic welfarist and the autonomist concept of law. A pure liability rule violates the autonomist approach because it justifies the infringement of property without the consent of the owner. In a recent article, Calabresi has pointed to the fact that involuntary transactions take place in many legal orders even in areas that seem to be natural high ground of autonomous and doctrinal thinking. Not even the human body can be protected by a property rule and excluded from an involuntary transaction. 'Thus, people can be conscripted into the military against their will and be made to put their bodies to the service of the common good.'<sup>3</sup> One might add that if an incompetent sergeant sends the

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<sup>2</sup> R. Coase, 'The Problem of Social Cost' (1960) 3 *Journal of Law and Economics* 414.

<sup>3</sup> G. Calabresi, 'An Introduction to Legal Thought: Four Approaches to Law and to the Allocation of Body Parts' (2003) 55 *Stanford Law Review* 2113.

conscript on an unnecessary but deadly mission, neither a property rule nor a liability rule protects the body of the conscript; consequently, nobody has a damage claim either.

Obviously the distinction between property rules, liability rules, and inalienability rules is implicit in the legal order, in which the property rule corresponds to the protection of an entitlement by an injunction based on *actio negatoria*. Liability rules are the domain of tort law. Inalienability rules can be found in statutory laws that forbid transactions such as the sale of human organs.

In this essay we will elaborate on the relevance of Calabresi's categories of legal rules to the development of law under the evolutionary pressure of social and economic change. At first glance, the categories of rules distinguished by Calabresi and Melamed pose no problems for lawyers. These rules are part of the legal order and belong either to the law of property or to the law of torts. On closer inspection, however, there appears to be a gap between the authors' concept and the traditional legal understanding of the function of tort law.

In legal terms, tort law grants a remedy of restoration or damage compensation if an injurer violates a property right that is protected by law against violation by anyone: namely, if the injurer acts illegally. The legal remedy is triggered by an illegal act for which the tortfeasor is responsible under the *culpa* doctrine. This legal manner of reasoning again reflects the autonomist concept of civil law, entailing that where damage was caused against the categorical intent of *neminem laedere*, this leads to the imposition of a sanction.

Calabresi and Melamed do not hold this traditional view. They focus on activities that necessarily imply damages but that are socially desirable. Consequently, the law has to guarantee that such socially desirable activities can take place and that external effects are internalised. Under low transaction costs, a property rule would solve both problems and would lead to an agreement on efficient levels of care and activity. Under the same condition, any rule would lead to the same result. However, the property rule has the advantage over other rules of being in accordance with the autonomy principle. Moreover, there is no need for a third party to fix levels of compensation.

Under high transactions costs, the property rule would result in blocking all dangerous activities, especially by the accumulated veto powers of potential victims. Harmful but socially valuable activities might not occur. In this case, society can decide not to ban a harmful activity: for instance, by not prohibiting motor vehicle traffic but by providing damage compensation for victims. A liability rule therefore implies the acceptance of a dangerous but socially desirable activity, which, however, leads to damage compensation. As Calabresi/Melamed put it:

Liability rules involve an additional stage of state intervention: not only are entitlements protected, but their transfer or destruction is allowed on the basis of a value determined by some organ of the state rather than by the parties themselves.<sup>4</sup>

From this juxtaposition it becomes clear that the view of Calabresi and Melamed on the function of tort law is consequentialist, welfarist, and cost-benefit-oriented but is still embedded in contractual thinking.<sup>5</sup> As such, their view stands in sharp contrast to the traditional legal understanding, which is based on the concept of autonomy. Private property in this view is an emanation of private autonomy and, as such, is regarded as a natural right that is protected for its own sake. Both the property and the liability rule are oriented towards the concept of a natural right that is non-empirical and therefore not subject to a balancing of interests in a utilitarian or wealth-maximising way. This view corresponds to the concept of autonomy, which was fully developed in the 18<sup>th</sup> century period of enlightenment with the writings of Locke and Kant, for whom the basic concepts of law are inherently non-empirical and non-consequentialist. These ideas were taken up in the 20<sup>th</sup> century and developed further, mainly by Hayek and some proponents of the ordoliberal school, such as Mestmäcker.<sup>6</sup> They concentrate not only on the irrelevance but on the impossibility of welfarist analysis and evaluation of consequences, their main argument being that an organ of the state lacks and cannot acquire the information needed to make such assessments. Welfarist considerations that limit private autonomy are therefore strictly rejected. Mestmäcker in this context underlines the position held by Manfred Streit, according to which ‘efficiency beyond the individual logic of choice becomes an irrelevant concept’.<sup>7</sup>

We do not intend to elaborate further on this debate between welfarists and autonomists. Instead we will trace the relevance of the Calabresi and Melamed approach for an understanding of the adaptation of law under evolutionary pressure in two selected fields of German property law and tort law. Calabresi and Melamed favour a property rule in cases

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<sup>4</sup> Calabresi and Melamed, above n. 1 at 1092.

<sup>5</sup> In a recent article Calabresi describes this view as follows: ‘Rather, tort law viewed in this way is characterized by a set of rules which determine when entitlements, when ownerships, can be shifted not as a result of direct agreement of the parties, nor as a result of direct decisions by the State, but as a result of the willingness of parties to take part in activities which will be charged a price determined by the State, a price which will, as a result, both limit the number and type of transfers that occur, and yet permit such transfers.’ G. Calabresi, ‘Toward a Unified Theory of Torts’ (2007) 1 *Journal of Tort Law* 1 at 2.

<sup>6</sup> E.J. Mestmäcker, *A Legal Theory without Law, Posner versus Hayek on Economic Analysis of Law* (Tübingen: Mohr Siebeck Verlag 2007).

<sup>7</sup> *Id.* at 34 and M. Streit, ‘Cognition, Competition and Catallaxy: In Memory of Hayek’ (1993) 4 *Constitutional Political Economy* 223.

involving low transactions costs. This reconciles the autonomist and the welfarist position, as all social outcomes are the result of consensual transactions, and they are efficient. They reject the autonomist view in favour of a welfarist solution in cases involving high transaction costs.<sup>8</sup>

We follow the development of the property rule in the 19<sup>th</sup> century under the influence of the Industrial Revolution, where in Germany under the pressure of increasing transaction costs the effect of the original property rule was reduced and the rule was partly replaced by a welfarist liability rule. Furthermore, we follow the development of the *Allgemeines Persönlichkeitsrecht* (right of personality) under the influence of intrusion of privacy by mass media. In this field of low transaction costs, we find a metamorphosis of the liability rule, which encourages involuntary transactions to a rule that induces voluntary transfers.

### **3 From property rule to liability rule in the process of German industrialisation**

The development of nuisance law in Germany during the process of early industrialisation is an example of the gradual transformation of norms from an autonomist protection of property to a welfarist balancing of interests. At the dawn of the Industrial Revolution, nuisance law in the modern sense was undeveloped, and emission and technology standards in particular were lacking.<sup>9</sup> In the absence of environmental law, several classical Roman texts dating back to the second century A.D. gained importance. These texts held emissions to be illegal unless allowed by a servitude.<sup>10</sup> The recipient or victim of the polluting substance could interdict the emission through an *actio negatoria*. In 1826, Spangenberg proposed to develop this norm into a legal system for the comprehensive protection of landed property.<sup>11</sup> In the first half of the 19<sup>th</sup> century, German courts developed the *actio negatoria*

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<sup>8</sup> The extended debate on the Calabresi and Melamed proposition has shown that for the differentiation between liability rules and property rules, factors other than transaction costs of the entitlement holder should be taken into account, especially the cost and reliability of damage assessment: L. Kaplow and S. Shavell, 'Property Rules versus Liability Rules' (1996) 109 *Harvard Law Review* 713.

<sup>9</sup> N. Koch, *Die Entwicklung des deutschen privaten Immissionsschutzrechts seit Beginn der Industrialisierung* (Rechtshistorische Reihe 293) (Berlin: Verlag Peter Lang 2004) at 2.

<sup>10</sup> Dig. 8.5.8.5.

<sup>11</sup> E.P.J. Spangenberg, 'Einige Bemerkungen über das Nachbarschaftsrecht' (1826) 9 *Archiv für die civilistische Praxis* 268, cited in N. Koch, above n. 9 at 23.

into an instrument of civil protection against all emissions.<sup>12</sup> As Zimmermann puts it, the *actio negatoria* was ‘liberally extended in this context’.<sup>13</sup> This approach was in particular applied to the use of rivers and lakes, which in Germany remained almost completely unregulated by public law until the end of the 19<sup>th</sup> century. However, emissions into the air were also interdicted on the basis of the *actio negatoria*.

This legal development can be explained partly by a conservative bias against industrialisation. More importantly, however, 19<sup>th</sup> century civil law was based on the concept of absolute property of the *ius commune*. The law did not regard the industrial use of land as a factor in the balancing of interests. If industrial use was predominant in a particular area, this fact did not constitute a defence against traditional land owners.<sup>14</sup> The principle of *neminem laedere* also led to the view that, irrespective of the nature of the economic activity engaged in, each landowner should be entitled to basically the same level of emissions, and the legal level of emissions was not subject to a balancing of interests between society at large and the interests of a victim.

With the benefit of hindsight, we know that the *neminem laedere* principle is an empty concept in the event that the incompatible use of resources as the option of not inflicting harm on someone else is not available. As Coase has shown in his seminal article on the problem of social costs, in such cases the damage problem is of a reciprocal nature.<sup>15</sup> Either the industrial land owner inflicts harm on the traditional land owner or vice versa. The choice is not between harm and no harm but between the agricultural or industrial use of the land with the consequence of harm to the one or to the other side.

The balancing of interests between the incompatible economic activities of the new industry and the traditional economy was not in accord with the concept of absolute property rights, which was generally accepted in Germany during the phase of early industrialisation. Consequently, the *actio negatoria* often led to a closing down of industrial sites.<sup>16</sup> We can only speculate why the fundamental insight of the reciprocity principle, which points to the necessity of balancing interests, was not used in the practice of property law in this period of legal development in Germany. One probable

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<sup>12</sup> A. Thier, ‘Zwischen action negatoria und Aufopferungsanspruch’ in U. Falk and H. Mohnhaupt (eds.) *Das Bürgerliche Gesetzbuch und seine Richter* (Frankfurt am Main: Vittorio Klostermann 2000) at 415.

<sup>13</sup> R. Zimmermann, ‘The German Civil Code and the Development of Private Law in Germany’ (2006) *Oxford University Comparative Law Forum* 1.

<sup>14</sup> Thier, above n. 12 at 420.

<sup>15</sup> R. Coase, ‘The Problem of Social Cost’ (1960) 3 *Journal of Law and Economics* 1.

<sup>16</sup> See Thier, above n. 12 at 419 with references to several legal cases.

reason is that in pre-industrial periods the incompatible use of land, despite occurring especially in cities, was of a different scope, compared to land use after the beginning of industrialization. The routines and doctrines developed in pre-industrial times survived for a certain time even though they became increasingly dysfunctional. Moreover, it is certain that legal science did not deal with emissions on any significant level before the time of the Industrial Revolution.<sup>17</sup> The justification of ‘thick’ property rights on the basis of the principle of autonomy by scholars like John Locke and Immanuel Kant, however, did support the concept of property prevalent in society and did not contradict the life of a predominantly agrarian society. None of the philosophers of the enlightenment could have imagined that they lived at the dawn of a new era of economics with unprecedented spillover effects between actors. There is a general agreement among legal historians that the traditional concept of absolute property was an impediment to industrial development in Germany in the 19<sup>th</sup> century. Coasean bargains, by which industrialists would buy entitlements from the traditional land owners, could not solve this problem in a general way due to high transaction costs and hold-up positions.

This constellation of German property law in the 19<sup>th</sup> century presents a classical case of the proposition of Calabresi and Melamed, according to which a property rule becomes dysfunctional if transaction costs are high and it should be replaced by a liability rule. The necessity of a fundamentally different approach to the problem was far beyond the imagination of even some of the most prominent legal scholars of the time. As late as 1862, Rudolf von Jhering wrote: ‘The industrial plants should relocate to reclusiveness because the law is not obliged to consider the specific needs of particular kinds of professions and establishments and to enable their existence at the cost of their neighbours.’<sup>18</sup>

Jhering’s position reflects a strict property rule approach that is prepared to accept the consequence of restricting industrial development to some remote places. However, it was already outdated when it was published. Von Jhering was not blind to the problems that had emerged, but he believed that market solutions were available to solve them. He proposed that the owners of industrial land should either buy servitudes from the owners of agricultural land, which would entitle them to emissions, or that

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<sup>17</sup> Koch, above n. 9 at 22.

<sup>18</sup> ‘Die Fabriken mögen .... sich in die Einsamkeit zurückziehen, (weil) das Recht auf die eigenthümlichen Bedürfnisse besonderer Berufsarten und Einrichtungen keine solche Rücksicht zu nehmen (braucht), dass es auf Kosten der Nachbarn ... deren Existenz zu ermöglichen hätte’, R. von Jhering, ‘Zur Lehre von den Beschränkungen des Grundeigentümers im Interesse der Nachbarn’ (1862) in R. von Jhering, *Jahrbücher für die Dogmatik des heutigen römischen und deutschen Privatrechts*, 6, S. 81-130; cited by Thier, above n. 12 at 424.



they should buy all the land on which the effects of the emissions were to be expected as a consequence of their industrial activity.<sup>19</sup> This proposal was overly optimistic.

The fundamental change came when the property rule was partly substituted for or replaced by the liability rule. The change was implemented through fresh legislation and a new approach by the courts. In 1869, a law was adopted that precluded injunctions against all industrial plants approved by state authority.<sup>20</sup> It replaced the *actio negatoria* by a pure claim for damage compensation. This law was enacted under the pressure of the National Liberal Party, which in particular represented the interests of industry.<sup>21</sup> In addition, courts gradually replaced injunctions by damage compensation. According to Regina Ogorek<sup>22</sup>, this process started well before the 1870s; this point is disputed but can be left open here.<sup>23</sup> In any case, it is certain that after the unification of Germany in 1871 the Imperial Court (*Reichsgericht*) took decisive steps to replace in part the property rule by a liability rule in a large number of relevant cases. Thus, during the course of industrialisation the liability rule gradually reduced the scope of injunctions available to traditional landowners but gave them damage claims instead. Between 1882 and 1932, the Imperial Court took important decisions. In the process, the court dismantled the whole concept of the absolute protection of property. An Imperial Court decision in 1882 stated that an industrial plant without harmful emissions is impossible, but held that it should be privileged if its continued operation is necessary for the general well-being.<sup>24</sup> With this decision, the concept of equal competences resulting from property of land was relinquished and replaced by a welfarist concept, according to which these competences could be different for distinct pieces of land depending upon their use and their contribution to general welfare. This is an important

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<sup>19</sup> Von Jhering, above n. 18 at 127 ‘Dann mögen sie entweder die Vorrichtungen treffen, um die nachtheiligen Wirkungen zu beseitigen, oder sie mögen von den benachbarten Grundeigenthümern die erforderlichen Sevituden aquiriren und dieselben für die Nachtheile, die sie ihnen zufügen, entschädigen oder endlich in dem Umkreise ihres Einwirkungsgebiets das Land aufkaufen.’

<sup>20</sup> §26 der Gewerbeordnung für den Norddeutschen Bund vom 21.6.1869, Bundesgesetzblatt für den Norddeutschen Bund (1869) at 245.

<sup>21</sup> Thier, above n. 12 at 425.

<sup>22</sup> R. Ogorek, ‘Actio negatoria und industrielle Beeinträchtigung des Grundeigentums’ in H. Coing and W. Wilhelm (eds.) *Wissenschaft und Kodifikation des Privatrechts im 19. Jahrhundert* (Frankfurt am Main: Verlag Vittorio Klostermann 1979) 40-78.

<sup>23</sup> Thier, above n. 12 at 419.

<sup>24</sup> Reichsgericht, I. Zivilsenat vom 29.3.1882, RGZ 6, 217, 220.

example of a move from a property rule to a liability rule after the property rule had become inefficient.<sup>25</sup>

#### 4 Towards strong protection of privacy under German civil law

A person's right to privacy encompasses the following entitlements to protection against intrusion of his/her sphere of private life and intimacy: not to be subject to slanderous publications; not to be subject to distortion of his personal image and reputation in public; and not to have his/her name, personal features, and appearance appropriated.

The German Civil Code of 1900 did not contain a right of privacy that covered the full scope of a person's interest in defending his/her private life and reputation against intrusions by others. Instead, the protection of private life and reputation was generally shifted to criminal law offences relating to slander and defamation. Tort law instead focuses on property rights, which include private property and the rights to life, health, and bodily integrity, as well as on other comparable entitlements,<sup>26</sup> including the protection of an individual's name.<sup>27</sup> These entitlements are protected by property rules (injunctions, *actio negatoria*) and also by liability rules granting damage compensation. Only specific infringements of personality interests are covered by tort law: namely, the endangering of a person's credit by assertion or publication of knowingly untrue statements.<sup>28</sup> Furthermore, tort law contains a general rule of damage compensation in case of wilful infliction of damage in violation of *bonos mores*. In addition, a particular entitlement concerning copyright with regard to one's own image was introduced in 1907 by a copyright law concerning works of art and of photography.<sup>29</sup>

Apart from these restricted rules and the rules of criminal law, the Civil Code protected a person's reputation and privacy neither by a property rule nor by a liability rule. The legislators of the German Civil Code rejected all approaches by legal scholars to include a comprehensive right of privacy

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<sup>25</sup> It is worth mentioning that recently a new approach to the protection of the environment has been developed. Western countries and especially the European Union use a system of tradable pollution rights. These rights are individual and transferable entitlements to emit a fixed quantity of certain noxious substances into the environment. Public and criminal law sanction any pollution beyond the limits of the certificate. The violation is not an infringement of individual rights of others. The violation cannot be prohibited by an injunction of a victim. Therefore tradable pollution rights do not lead to environmental protection by a property rule.

<sup>26</sup> § 823 Abs. 1 BGB.

<sup>27</sup> § 12 BGB.

<sup>28</sup> § 824 BGB.

<sup>29</sup> § 22 Kunsturhebergesetz.

in the Civil Code. They also refused to incorporate into the Code relevant legal doctrines of the preceding law, the German *ius commune* (Pandektenrecht), which was derived from ancient Roman Law. In the law of the 19<sup>th</sup> century, a right of privacy was still part of tort law in the form of the *actio iniuriam aestimatoria*. The main characteristic of this action was *contumelia*: insults with regard to the personality of another person. This action was directed at bodily injuries as well as at injuries caused by libel and slander. The sanction consisted in penalty payments, the amount of which had to be set at the discretion of the judge. The *actio iniuriam aestimatoria* was a privately prosecuted criminal action and was finally abolished in the 19<sup>th</sup> century in the course of the strict separation of civil law from criminal law.

The legislators of the Civil Code refused to establish a comprehensive right of privacy for different reasons. One of these was the anticipated difficulty of clearly and properly defining the scope of such a right, and the reluctance of the legislator to leave it to the courts to structure and limit it. Another equally important reason was the reluctance to grant damage compensation by money payments for immaterial damages. To quote a statement from the early legislative process:

According to the common view it is not regarded as honourable to trade an insult for money; and he who seeks monetary compensation for damage done to his honour has not much of it to lose.<sup>30</sup>

Accordingly, the Civil Code restricted damage compensation to payments for pain and suffering in cases of bodily harm and deprivation of personal freedom.<sup>31</sup>

Subsequently, German courts adhered strictly to the rules of the Civil Code. It was only after World War II that they embarked on a new approach to overcome the restrictions of the Civil Code regarding the protection of privacy. A property right of privacy was established and integrated in tort law by the Federal Court of Justice (Bundesgerichtshof) and was continuously developed, beginning with judgments in 1956 and 1958.<sup>32</sup> This development can be explained as a reaction to ongoing social

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<sup>30</sup> ‘Nach der allgemeinen Volksansicht ist es nicht ehrenvoll, sich Beleidigungen durch Geld abkaufen zu lassen, und derjenige habe wenig Ehre zu verlieren, der die Verletzung derselben durch eine Klage auf Geld zu reparieren suche’, Kommissionsbericht, in B. Mugdan, Die gesamten Materialien zum Bürgerlichen Gesetzbuch für das Deutsche Reich, Band II; 1899, S. 1297.

<sup>31</sup> § 847 BGB a.F.

<sup>32</sup> BGHZ 13, 334 – Judgment from May 25, 1954 (unauthorised publication of an attorney’s writ); BGHZ 20, 345 – Paul Dahlke – Judgment from May 8, 1956 (unauthorised use of photos of the actor Paul Dahlke for sales promotion); BGHZ

change, including the decline of traditional barriers based on social norms protecting privacy, as a response to new technologies of information and communication permitting deep intrusions into privacy, and last but not least as a reaction to the increasing relevance of the mass media.

The right of privacy differs from traditional property rights in that it is less predetermined than private property rights on land or tangible goods. Instead, its structure resembles that of a blanket clause whose content and scope have to be formed in a process of balancing interests between privacy and reputation on the one hand and the right to the freedom of communication and the press on the other. The property right to privacy does not aim to exclude all interferences with one's personal sphere. The problem arises from the interpretation of the unique *Spannungsverhältnis* (interrelation of tensions) that characterises the modern human being. In particular, this holds true for the interrelation between the individual, public opinion, and the role of the mass media as mediators. Anyone who enters the public sphere and seeks publicity for his/her activities must in turn accept a closer inspection of his/her personal affairs. Accordingly, the scope of privacy rights typically has to be defined on a case-by-case basis and will differ depending on the circumstances of the case.

As Calabresi and Melamed have shown, property rights may be protected either by a property rule or by a liability rule, whereby from an economic point of view the property rule generally deserves priority because it only allows transactions with the consent of both parties involved – the seller and the buyer. Transactions, then, are based on valuations of the parties, not on value assessments of third parties such as courts or mediators. This consideration is particularly relevant to the integration of subjective valuations in the transaction, which in turn is especially relevant where the transfer of entitlements related to the right to privacy is concerned. The values attributed to such entitlements depend on subjective valuations of private life and reputation by the holder of the entitlement. Markets exist for particular elements of the right to privacy. The widespread use of the public image and reputation of celebrities, including stars from TV, movies, music, and sports, for sales promotion, and the license fees actually paid to these celebrities, are proof of a flourishing market, including market prices, for transactions of personal features and images. However, a market-based valuation for elements of privacy entitlements often does not coincide with the owner's subjective valuation of those entitlements. Take the example of a movie actor or a musical performer who regularly sells licences with regard to his/her image and which entitle the buyer to use these images to promote the sales of various products. However, one day the public figure might be depicted in a commercial for denture additives or for the promotion

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26,340 – Herrenreiter – Judgment from Feb. 2, 1958 (unauthorised use of the photo of a businessman on a horse to promote sales of an aphrodisiac).

of goods to enhance sexual performance. Even if market prices for licences of the latter types of exposure exist, an individual's subjective valuation of being exposed in such a specific context and the personal value attributed to this exposure will not necessarily be reflected by the market price.

It is obvious that in many instances market prices do not reflect the subjective valuations of many or even most holders of the entitlement. Such valuations cannot be assessed by third parties. Take the example of a girl whose nude pictures are published in a newspaper. Whether she is willing to consent to have her photo published and whether she attributes a high or a low monetary value to this act of publicity depends on how she personally estimates and values the consequences for her reputation among her relatives, friends, and colleagues. It also depends upon her personal views about what constitutes proper behaviour. This valuation varies dramatically from victim to victim. Courts are not well placed to assess such subjective valuations, and as a result they fix an appropriate amount of damage compensation.

Such constellations correspond to the conditions under which only a property rule will lead to efficient solutions, provided that transactions costs are low. A property rule ensures that transactions of segments of the right to privacy take place only at prices that fully internalise subjective valuations. Furthermore, the structural preconditions of a property rule are met because transaction costs are low. Typically, there are only two parties involved in the transaction: the holder of the entitlement and the person who wants to use it, the latter being a single party or firm, such as a promotion agency or a newspaper corporation. Calabresi and Melamed have demonstrated that efficient transactions are to be expected only under a property rule. However, based on 'new bargaining theory', doubt has been cast on the authors' fundamental claim. New bargaining theory focuses on the substantial likelihood of bargaining failure due to informational asymmetry – in particular if each party to a bargain knows his/her own subjective valuations but not those of the other parties. This asymmetry implies strategic behaviour and hold-up positions that impede efficient transactions.<sup>33</sup> It has been argued that, as a consequence, the proposition that property rules are socially preferable to liability rules when transactions costs are low appears to be either no longer valid or severely weakened. Hence, Kaplow and Shavell develop an ambiguity proposition: The property rule and the liability rule cannot be ranked in terms of welfare when transactions costs are low and information is imperfect. Imperfect

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<sup>33</sup> See Kaplow and Shavell, above n. 8. For more references to the recent bargaining theory literature, see K. Hylton, 'Property Rules and Liability Rules, Once Again' Boston University School of Law Working Paper Series, Land and Economics No. 05-17 available at <<http://www.bu.edu/law/faculty/papers>> or <<http://ssrn.com> abstract\_id=818944 >(Boston University 2005).

information can indeed raise transaction costs to a level at which consensual transactions are not possible even if both parties were to profit from it; hence, the property rule is not workable. Under this condition, only the liability rule remains as a remedy; however, it is inherently imperfect because it does not protect subjective valuations. This leads to the conclusion that even in the event of imperfect information the property rule generally should be given priority as far as possible. As Keith Hylton puts it: ‘Where the inefficiencies resulting from bargaining failure are relatively mild or infrequent, society should put more weight on the subjective valuation protecting function of property rules.’<sup>34</sup> This is of particular relevance in the context of infringements of privacy rights. In such cases, a general shift to the liability rule would pose a severe impediment to legal sanctions because – as has been mentioned – subjective valuations are essential for privacy rights and are, for most individuals, not reflected by market prices.

Although property rules appear to fit the requirements for efficient transactions of entitlements to private life and reputation, they fail to prevent effectively unauthorised intrusions into those entitlements in many or even in most cases. Notwithstanding the formal availability of the *actio negatoria* also in cases of infringements of privacy rights, it is in fact of little use. Injunctions are of help only against impending infringements that are anticipated by the victim. Typically, however, intrusions into private life and reputation come without warning and cannot be eliminated by means of correction, revocation, or an apology by the offender.

This situation leads to a legal dilemma. On the one hand, the socially optimal rule would be *actio negatoria*, which fully protects subjective values. On the other hand, the only practical possibility to protect the right is a payment of money after the right has been violated. The solution to this dilemma – as will be shown – is to modify the liability rule in such a way that it becomes a perfect substitute for the property rule and thus provides an effective deterrent against involuntary transactions.

Protection of the right to privacy by liability rules was indeed the predominant approach of German courts and legal doctrine until very recently. Infringements of these rights were regarded as torts, resulting in claims for damage compensation. This approach, however, met with many difficulties.

The first was a rule in the Civil Code that restricted monetary compensation in the case of pecuniary losses, the only exception being immaterial losses from pain and suffering resulting from bodily harm or deprivation of personal freedom. This positive law restriction was overruled by the Federal Court in 1958 in the ‘Herrenreiter’ case.<sup>35</sup> The court argued

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<sup>34</sup> Hylton, above n. 33 at 41.

<sup>35</sup> BGHZ 26,340 – Herrenreiter – Judgment from Feb. 2, 1958.

that the protection of privacy rights would remain ineffective without sanctions in the form of monetary payment and therefore it granted damage compensation.

The other problem in applying the liability rule proved to be the assessment of damages caused to the ‘owner’ and the calculation of the appropriate amount of monetary compensation. In the first case decided by the Federal Court concerning the unauthorised use of photos of the actor Paul Dahlke for sales promotion, the Court granted damage compensation according to a hypothetical licence fee.<sup>36</sup> This was a great step forward but with the typical shortcomings of a liability rule: subjective valuations above the market price were disregarded.

However, soon afterwards the Court abandoned this approach in the ‘Herrenreiter’ case. Here, the court found that the plaintiff had not suffered pecuniary loss, based on the argument that he would not have agreed to be exposed in such a humiliating and ridiculous situation, given his social status as an esteemed business man and member of society. Instead, the loss suffered by the plaintiff was regarded as an immaterial loss, and damage compensation was granted as satisfaction for the distress suffered as a result of the assault, in analogy to damage compensation for pain and suffering in the event of bodily assault. This approach dissociated damage compensation from the market price but still did not protect all subjective valuations.

A change in the judicial approach has emerged in recent years, which has eventually led to a change of paradigm in the direction of a property rule. The first step in this direction was a judgment of the Federal Court focusing on the preventive function of damage compensation. The leading case concerned an action for compensation of immaterial losses brought by Princess Caroline of Monaco against the Burda Publishing Company.<sup>37</sup> The claim was based on a fictitious interview with the princess, which was published in a yellow press journal together with a photo of the princess with a partner. These photos were declared to be snapshots from the family album, but were actually taken by paparazzi from a long distance. The publisher was held liable of tort and was first charged with a payment of 30,000 DM by the lower courts.<sup>38</sup>

The Federal Court overturned this judgment with regard to the amount of damage compensation and ordered the lower court, the Hamburg Court of Appeals, to reconsider the case and to fix damage compensation high enough to provide an effective barrier against unauthorised commercialisation of the plaintiff’s right of privacy and reputation. Finally,

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<sup>36</sup> BGHZ 20, 345 – Paul Dahlke – Judgment from May 8, 1956.

<sup>37</sup> BGHZ 128, 1 – Judgment from Nov. 11, 1994 – Caroline von Monaco.

<sup>38</sup> OLG Hamburg judgment from Dec. 16, 1993 (3 U 60/93) not published.

damage compensation was set at 180,000 DM, an amount that up until that time was unprecedented in cases of infringement of personality rights.

This development signals a change of paradigm. The focus is being shifted from satisfaction for immaterial losses to sanctions for violating the autonomy of the holder of the entitlement and to make the involuntary transaction unprofitable. In the *Caroline of Monaco* case, it became apparent that the protection of personality rights aims at restoring the property rule. The journal had first asked the princess for an exclusive interview. When the princess refused, the management of the journal decided to invent one and to publish it. The text of this false interview was as such neither slanderous nor did it contain untrue statements. But it was held by the court that the publication constituted an intrusion of privacy because it violated the autonomy of the princess to decide for herself whether to agree to an interview, and if so, at what price. Again it must be pointed out that only a property rule protects the subjective valuation of the entitlement holder, which is at the core of the personality right in question in the *Caroline of Monaco* case. Although the monetary compensation in this case was set far above the compensation granted in previous cases and thus the transaction was made less profitable, it is not guaranteed that the transaction would either have been voluntary or would not have taken place.

The same structure applies to other less prominent cases of infringements of personality rights, where elements of private life or reputation are made available to the public without the consent of the owner. Such elements are generally transferable and may be purchased depending on the price. Many entitlements to private life and even of intimacy are sold especially to mass media, as one can witness in certain afternoon television series where often embarrassing details of private life and sometimes even sexual habits are presented by individuals having no sense of shame. If consent is too difficult or too costly to obtain, the media often make unauthorised use of personal information, bypassing the entitlement holder and undertaking the risk of being held liable, possibly much later, for payments that until recently were quite moderate. Thus, any incentives for the unauthorised use of elements of private life and reputation should be removed in order to ensure that only consensual transactions take place.

This is a strong argument for the use of the liability rule as a substitute for the property rule. The problem, however, remains that courts cannot determine subjective valuations. They cannot reconstruct the hypothetical decision of the plaintiff as to whether and at what price to sell elements of private life or reputation, because it is not possible for a third party to assess subjective valuations. Therefore compensation granted on a liability rule cannot guarantee that involuntary transactions are prevented and that only voluntary transactions take place. As a result, compensations that are based on a liability rule lead to inefficiency. This holds true even if information about transaction prices of somewhat comparable cases is



available. Such information is not representative of the subjective valuations of other parties in other cases. Again take the case of Princess Caroline of Monaco, who was awarded a payment of 180,000 DM as compensation for an unauthorised and fictitious interview.<sup>39</sup> Compared to a payment of 250,000 DM paid by a journal for an interview with a formerly prominent prison inmate convicted of large-scale fraud, the compensation payment to the princess appears to be low. It seems plausible that the princess would not have accepted a lower fee for a voluntary interview. For the rest, we can only speculate on her subjective valuations.

Because of these inherent shortcomings, a liability rule that provides compensation for the violated holder of the entitlement will not effectively deter involuntary transactions and thus substitute for the property rule. Instead, the subjective valuations of the offender can be assessed reliably by focusing on the profit he expected from drawing on the personality of the entitlement holder. The offender would not pay a fee that exceeds his expected profit. Consequently, a transaction would not take place if the owner demanded a higher fee according to his subjective valuations. This would lead to a solution in conformity with the property rule. If the owner accepted a fee lower than the expected profit of the offender, a consensual transaction would occur. This result again would be in conformity with the property rule and would guarantee efficiency. The motive for the offender to violate the personality right of the holder is to benefit from using the right at a price that does not reflect the subjective valuations of the holder. This development is contrary to the property rule and leads to an inefficient solution. If the holder of the entitlement is given a claim to recover the profit from the offender, the incentive to circumvent the consent of the holder is removed. Consequently, to base the payment to the holder on a disgorgement of profits would be a perfect substitute for the property rule.

## 5 Conclusion

In a seminal paper, Calabresi and Melamed illustrated that the law can protect a private entitlement either by a property rule (injunction) or by a liability rule. The property rule guarantees that the transfer of a right is voluntary. A property rule protection guarantees first that the transaction does not violate individual autonomy and is therefore compatible with the philosophical ideal of the Enlightenment. It further guarantees that the transaction increases the utility of the parties concerned and generates a win-win situation. However, if an entitlement is protected only by a liability rule that leads to damage compensation, this gives incentives to third parties to

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<sup>39</sup> BGHZ 128, 1, 5 above n. 37.

take the entitlement away from the owner whenever its value for the third party is higher than the expected damage compensation. A liability rule therefore triggers involuntary transactions that violate the principle of autonomy. Nevertheless, Calabresi and Melamed argue that such involuntary transactions are recommendable whenever transactions costs are high and the market for the transfer of rights does not work smoothly enough. In such cases, the legal system should resort to a weaker protection of entitlements by liability rules despite the increase in involuntary transactions.

In this article, we present two examples of legal development in German Civil Law. We demonstrate that the approach of Calabresi and Melamed is not only a normative principle but that it explains the evolutionary pressure to change legal norms in two important fields of the law. Our first example is from nuisance law. In the beginning of the 19<sup>th</sup> century – before the Industrial Revolution – the rights of pollutees were protected by property rules of land owners against the polluter. Only when it became clear that private transactions between the polluter and the pollutee were often impossible and that the injunction of landowners caused huge economic losses for society did legislation and jurisdiction gradually replace the property rule with a liability rule. This resulted in an entitlement to pollute against compensation and removed an important barrier against the development of modern industry.

The second example is from privacy law. This is a field in which private transfers of rights are easily possible and transaction costs are low. Originally, however, privacy was only weakly protected, which with the development of modern mass media led to ever increasing numbers of involuntary transactions. We show that this triggered a wave of claims and caused a series of far-reaching court decisions that aim at making involuntary transactions unprofitable. The Calabresi and Melamed approach is therefore an analytical starting point to explain two important legal developments in Germany. These developments in two different fields of the law went in opposite directions because market transaction costs for the transfer of an entitlement were different.