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Status and Incentive Aspects of Judicial Decisions

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INTRODUCTION

> Go with me to a notary, seal me there
> Your single bond; and, in a merry sport,
> If you repay me not on such a day,
> In such a place, such sum or sums as are
> Expressed in the condition, let the forfeit
> Be nominated for an equal pound
> Of your fair flesh, to be cut off and taken
> In what part of your body pleaseth me.[1]

Should a court enforce this bond upon Antonio's failure to pay? How a court could, consistent with efficiency, refuse to enforce this contract once puzzled Judge Richard Posner.[2] There is an easy economic justification for the refusal, but it can be missed by those taking the usual economic approach to law. Analysts approaching the issue from the perspective of the new law & economics are quick to point out that the outcome chosen by the court will establish a rule which will create incentives that influence the behavior of others.[3] What law & economics scholars often leave unexamined is the obvious fact that the court's decision will also affect the state of being, or status,[4] of the parties to the suit. The purpose of this article is to show that an economic model can offer a comprehensive normative or positive theory of judicial behavior only when it takes status effects into account.

In this article, I intend to explain and illustrate the distinction between status and incentive effects and show some uses for this distinction in the economic analysis of law. Part I describes the distinction between status and incentive efficiency. Part II demonstrates that labeling this distinction can

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1. W. SHAKESPEARE, THE MERCHANT OF VENICE act I, sec. iii. (O. Welles & R. Hill eds. 1939).

2. R. POSNER, ECONOMIC ANALYSIS OF LAW 187 (2d ed. 1977); *see* Michelman, *A Comment on Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 307, 310-11 (1979) (discussing Posner's puzzlement over how a court could refuse to enforce Antonio's bond and still be consistent with efficiency). Judge Posner has found a way to explain a judicial refusal to enforce the agreement. *See* R. POSNER, ECONOMIC ANALYSIS OF LAW 240 (3d ed. 1986) [hereinafter POSNER 3D] (no court would enforce Shylock's contract with Antonio because the probability of default was substantial, no matter how much care Antonio exercised).

3. By the term "new law & economics" I mean the literature applying economic analysis to legal questions since the early 1960s, when Professor Ronald Coase published *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960), and Professor Guido Calabresi published *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499 (1961). Following Professor Herbert Hovenkamp, I have adopted the "&" to refer to the intersection of law and economics and will use "and" to refer to the two "discrete disciplines." *See* Hovenkamp, *The First Great Law & Economics Movement*, 42 STAN. L. REV. 993, 993 n.1 (1990).

4. "Status" in this context means state of being and is not limited to social rank or class. I also do not mean to limit the term to narrower relational considerations in the manner of H. MAINE, FROM STATUS TO CONTRACT (1969). Relational aspects do become important, however, to the concept of status efficiencies. *See infra* Part III.D.1.

help those engaged in the normative economic analysis of law by identifying missing components of the efficiency calculus. In Part III the status-incentive distinction is employed to identify one method of using economics in positive legal research and to suggest types of cases for which the method may be helpful in predicting judicial behavior. Part IV supports this positive approach by presenting four theories of how the common law evolves toward efficiency. Part V demonstrates the power of the distinction between status and incentive effects by using the distinction to examine the theories discussed in Part IV and to draw some conclusions about the areas of law that can be expected to evolve toward efficiency. As a final illustration of the utility of the status perspective, I will show that legal theorists engaged in research on the fifty percent hypothesis have overlooked certain status effects that undermine a critical assumption of their model.

I. STATUS AND INCENTIVE EFFECTS

A. THE BASIC DISTINCTION

Judicial decisions generate two fundamentally different types of effects. Status effects arise from the resolution of the dispute between the parties to the suit. The decision defines their entitlements—rights, immunities, duties, and liabilities—and their subsequent relationship to the extent it depends on those entitlements. Incentive effects are behavioral changes that arise from the change to or reinforcement of the messages sent by the existing law to persons subject to it.

With respect to any person's course of conduct, over time, there are many decision nodes—points at which the actor chooses between two or more actions. The distinction between status and incentive effects of a judicial decision separates the effects on persons at early decision nodes (incentive effects) from the effects on persons at later decision nodes (status effects).[5]

Status effects include the changes in the states of being of the parties, others who are similarly situated, and those who become similarly situated in the future. Thus, if Bassanio had made the same deal with Shylock and had failed to perform, the decision in Antonio's case, to a large degree, would also determine the fate of Bassanio. The case would also decide the fate of Venetian borrowers in the future who, unmindful of the consequences suffered by Antonio, get themselves into the same fix.

Every judicial decision has status effects, even if the court is not declaring a wholesale shift in legal rights. Whether the decision of the court was con-

5. Professor Mark Kelman's distinction between broad and narrow time frames subdivides incentive effects. *See* Kelman, *Interpretive Construction in the Substantive Criminal Law*, 33 STAN. L. REV. 591, 600 (1981). His broad time frame includes early decision nodes; the narrow time frame is restricted to later decision nodes.

sistent with or contrary to what most people would have predicted affects the magnitude, but not the existence, of status effects. The change from prelitigation uncertainty to post-litigation certainty, even if only a confirmation of a ninety percent chance of recovery, is a status effect.

Status effects often lead to incentive effects. The incentive effects of a decision are the changes the decision causes in the behavior of persons who are not yet in the posture of the parties to the case. By changing the rights and responsibilities of persons in the positions of the parties, the court changes the attractiveness of those positions. Incentive effects flow from those rewards and costs presented to persons who might be in the position of the parties in the future. For example, by deciding for Antonio, the court tells people considering whether to default on a promise secured by a pound of their flesh that the price they will pay for defaulting is not high. By doing so, a court could increase the frequency of default—an incentive effect of the decision.

The perception of a legal rule may be more important than the rule itself for determining incentives. A decision may change actors' impressions of the legal rule, which will influence their future behaviors, even if it does not change the rule itself. A case that merely reaffirms a well-established rule or the publication of a previously issued decision may make a rule known to more people and so shape behavior.

The baseline for analysis of both status and incentive effects is the status quo. The effects of each possible decision the court might make are measured against the status quo rather than against each other. The rights and liabilities of the parties, and others, before the decision is announced are compared to their rights and liabilities afterwards. The behavior choices being made before the decision are compared to the behavior choices that will be made after the case is done.

The distinction between status and incentive effects of judicial decisions is analogous to the difference (also subject to ambiguity) between rule and act utilitarianism.[6] In addition to resolving disputes between parties present before the court, the behavior of judges shapes rules for the future. The choice of a rule influences or determines the outcome of the case, and the choice of an outcome affects the rule derived from the case. Because their on-the-job actions may shape citizen behavior as well as determine litigant rights, judges sometimes confront a tension between the utility of their act and the utility of their rule. A judicial decision in a case chooses both a rule and an outcome. The utility of the two need not have the same valence.

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6. *See generally* J. SMART & B. WILLIAMS, UTILITARIANISM FOR AND AGAINST (1973).

B. TWO DIFFERENT COMPONENTS OF EFFICIENCY

Incentive effects directly implicate efficiency. By shifting the prices of some behaviors, judicial decisions increase or decrease those behaviors. It is less obvious but equally important to recognize that status effects also have efficiency implications. The following examples illustrate the status-incentive distinction and demonstrate some of the efficiency aspects of status effects.

1. A Pound of Flesh and Other Penalty Clauses

Shylock's agreement with Antonio called for a pound of Antonio's flesh if Bassanio failed to repay 3000 ducats on time. A court deciding whether to enforce the contract might think that enforcement would send a worthwhile message to lenders and borrowers in the future—the deals they strike will be enforced. People who consider themselves good credit risks but who have no property for collateral would find it easier to borrow money.[7] Upholding the contract would also encourage people to think carefully before entering into contracts in the future. And unrelenting enforcement of savage forfeiture provisions would lead to fewer forfeitures. Finally, as Shakespeare recognized, confidence in contracts benefits commerce:

> Antonio: The Duke cannot deny the course of law:
> For the commodity that strangers have
> With us in Venice, if it be denied,
> Will much impeach the justice of his state;
> Since that the trade and profit of the city
> Consisteth of all Nations.[8]
> . . .
> Shylock: If you deny me, fie upon your law!
> There is no force in the decrees of Venice.[9]

Even if the incentive effects clearly favor enforcement, the court should still consider the status effects on Antonio and Shylock. A decision not to enforce the bond makes Shylock less wealthy, but a decision for enforcement reduces Antonio's assets. Status effects of the decision, however, go beyond these obvious distributional consequences. Assuming Antonio can put his flesh to better use, allocation of the flesh to Antonio is the more efficient choice. Allocation to the party that values the asset more highly[10] saves soci-

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7. For discussions of hostage-taking as an alternative to collateral as a means of securing the promised performance, see Kronman, *Contract Law and the State of Nature,* 1 J.L. ECON. & ORG. 1 (1985); Williamson, *Credible Commitments: Using Hostages to Support Exchange,* 73 AM. ECON. REV. 519 (1983).

8. W. SHAKESPEARE, *supra* note 1, act III, sec. iii.

9. *Id.* act IV, sec. i.

10. "Person that" will be used instead of "person who" whenever the clause following "person" further defines the person. This usage has the advantage of allowing two different words ("that" and "who") to serve two different purposes (introducing defining and nondefining clauses). *See* H.

ety the transaction costs of a subsequent transfer or the forgone gains from trade if, as in Antonio's case, the transfer will not occur.[11] A judge can never determine with certainty which party would value the asset more highly, but she can guess.[12] In this case, Antonio would certainly miss the flesh more than Shylock would enjoy it. Antonio's pain would serve Shylock's vengefulness,[13] but Shylock's retort to Salarino shows that the flesh itself would be of little use to Shylock:

> Salarino: Why, I am sure, if he forfeit, thou wilt not take his flesh: what's that good for?
> Shylock: To bait fish withal: if it will feed nothing else, it will feed my revenge.[14]

2. Debtor's Prison and Other Criminal Laws

It is not necessary to rely on dramatic but unrealistic examples to demonstrate the distinction between status and incentive effects. The ancient courts deciding whether to put a person in jail for failing to pay his debts faced the same tradeoff between incentive and status effects. By jailing the debtor, the court increased the likelihood that others would pay their debts or not incur them but decreased the jailed debtor's ability to pay.

This example suggests that the efficiency tradeoffs involved in the imposition of criminal sanctions resemble those in the enforcement of penalty clauses in private contracts. If a defendant kills someone in the heat of pas-

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FOWLER, A DICTIONARY OF MODERN ENGLISH USAGE 701-02 (E. Gowers 2d rev. ed. 1983). Further, it fits better with the legal sense of "person," which includes corporations (to which "who" seems somewhat inappropriate).

11. Professor Stephen Margolis offers two definitions of efficiency in Margolis, *Two Definitions of Efficiency in Law and Economics*, 16 J. LEGAL STUD. 471 (1987). The first definition, which Margolis claims is "impossible and undesirable to achieve," is that an "efficient legal system imitates the set of entitlements and responsibilities that would prevail in a world without transaction costs." *Id.* at 482. The second definition, which Margolis favors, requires courts to "minimize the losses due to transactions and forgone gains from trade." *Id.* Posner has noted the importance of correct judicial allocation of rights when the parties will have difficulty trading the rights after the case. *See* POSNER 3D, *supra* note 2, at 45.

12. Which party values the asset more highly is a more complex question than it initially appears. It may depend on the initial allocation of the asset. *See* POSNER 3D, *supra* note 2, at 15.

13. Whether the law ought to count one's pleasure in witnessing or knowing the pain of others as a good is an intriguing question to some. *See* Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 173 (1968) (societal loss from crime decreased by value of gains to criminals). I have no trouble answering that question in the negative. *See* Lewin & Trumbull, *The Social Value of Crime?*, 10 INT'L REV. L. & ECON. 271, 278 (1990) (all criminal gains should be excluded from the economic evaluation of law enforcement or social programs that affect criminal activity).

14. W. SHAKESPEARE, *supra* note 1, act III, sec. i; *see also id.* act I, sec. iii ("A pound of man's flesh taken from a man Is not so estimable, profitable neither, As flesh of muttons, beefs, or goats."). Antonio's productivity ought not be taken for granted, however; he did have a knack for sending ships off to be sunk on reefs.

sion and contends that the victim's provocation should be a mitigating factor, the court has to decide if that circumstance should make a difference to the penalty.[15] The rule the court chooses results in longer or shorter incarceration of the defendant before the court, and also determines the future status of similar defendants that have not yet killed their victims. If the court thinks that this defendant is not, or will not be after a short prison sentence, more likely to commit other crimes than the average person, then it would be a waste of the defendant's skills and abilities and the state's resources to lock her up for a longer time. It would, in such a case, be status inefficient to ignore the element of passion.[16]

The incentive efficiencies cut in the other direction. Any reduction of sentence for this defendant would reduce the perceived price for killing. Without entering the debate over the degree of elasticity in the demand for murder, it seems safe to say that reducing the penalty paid for killing someone does not improve disincentives, as long as the certainty of punishment remains the same.

A judge that is worried about the message she sends to persons that might commit crimes in the future, including the current defendant, is thinking about the incentive consequences of the decision. When the judge turns her attention to the effects of prison life on the defendant, she is addressing status concerns. Retribution, too, is in part a status concern, though not an economic one. The judge attempts to effect a state of being that accords with her notion of a just world. Thus, the status-incentive distinction may also be used to classify the goals of criminal law. Incapacitation, rehabilitation (which I understand as a mental form of incapacitation), and retributive justice are all status effects. Deterrence, in contrast, is an incentive effect.

3. The Rule Against Perpetuities

A man dies and in his will leaves his farm to the town. The will requires the town to use the farm as a park and playground, and if the town ceases to use it that way, the farm reverts to his son; moreover, if ever a great-grandchild is born to him, the land shall pass to his great-grandchild. Years later, the city wants to sell the park to a local university and sues, asking the court to declare that the interest of the unborn descendant violates the Rule against Perpetuities.[17] The application of the Rule would shift rights from

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15. *See* Smith v. State, 83 Ala. 26, 28, 3 So. 551, 552 (1887) (homicide reasonably provoked is manslaughter, "not because the law supposes that this passion . . . stripped the act of killing of an intent to commit it, but because it presumes that passion disturbed the sway of reason . . . " (citing Hill v. State 34 Amer. Dec. 396)). *See generally* W. LAFAVE & A. SCOTT, CRIMINAL LAW 653 (2d ed. 1986) (discussion of the rule of provocation).

16. It might be status inefficient to lock her up at all.

17. The Rule against Perpetuities states that "[n]o interest is good unless it must vest, if at all, not later than 21 years after some life in being at creation of the interest." J. GRAY, THE RULE

the great-grandchild, an intended remote beneficiary, to the city, an unintended beneficiary of those rights. On what grounds can the law justify this capricious redistribution of wealth from someone with a claim based on the intended gift of the rightful owner to a person without any just claim at all?

Looking at incentives uncovers no answer to this question; indeed, the incentives look bad. The Rule causes persons to seek legal assistance to accomplish their dynastic designs. Avoidance maneuvers waste resources. Occasionally, the lawyers will inform their clients that their goals cannot be achieved and that other plans must be made. Losses in donor happiness associated with such limits on donative behavior are also an economic loss. Some would-be donors may respond by deciding to consume the assets if they cannot give them away as they wish. This too is an incentive inefficiency. These incentive effects support the argument that the Rule is no good.

Looking at status efficiencies yields better answers.[18] First, when the Rule against Perpetuities shifts the ownership into the hands of a single owner, the Rule makes it easier for others to purchase the land and allows the real estate market to function more efficiently.[19] Thus, the distribution of rights among parties may influence the efficiency of subsequent resource allocation. This status efficiency is not lost on traditional perpetuities scholars; improving "alienability" is the standard justification given for the Rule.[20] Nor has the law & economics movement ignored this sort of efficiency; it has emphasized the importance of creating conveniently tradeable packages of rights.[21] Thus, traditional and law & economics scholars are concerned about the status efficiencies of some legal rules. Second, in some cases the Rule eliminates a possibility of loss to the prior possessor by shifting a few twigs in the bundle of sticks from one person to another. Finally, the Rule sometimes shifts

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AGAINST PERPETUITIES § 201, at 191 (4th ed. 1942). For an example of a similar transfer to a city in which the instrument was written so as not to violate the Rule, see Ink v. Canton, 4 Ohio St. 2d 51, 52, 212 N.E.2d 574, 575 (1965).

18. For a more detailed discussion of the Rule's efficiencies, see generally Stake, *Darwin, Donations, and the Illusion of Dead Hand Control*, 64 TULANE L. REV. 705, 716-23 (1990).

19. An example of a recent legislative attempt to accomplish a similar status improvement is the escheat provision of the Indian Land Consolidation Act of 1983, Pub. L No. 97-459, 96 Stat. 2519 (codified as amended at 25 U.S.C. § 2206 (1988)). This section ameliorated the problem of extreme fractionation of Indian land caused by laws that prevented Indians from alienating their land. Hodel v. Irving, 481 U.S. 704, 707 (1987). It provided that certain small interests in land would escheat to the tribe upon the death of the current owner, without compensation by the tribe. *Id.* at 709. This provision was declared unconstitutional because it constituted a taking of the descendants' property without just compensation in violation of their fifth amendment rights. *Id.* at 718.

20. *See* A. GULLIVER, CASES AND MATERIALS ON THE LAW OF FUTURE INTERESTS 16-21 (1959) (imaginary dialogue between life tenant in possession, two remaindermen, and reversioner illustrates the difficulties with setting a price and dividing the proceeds); L. SIMES & A. SMITH, THE LAW OF FUTURE INTERESTS § 1117 (2d ed. 1956).

21. *See* POSNER 3D, *supra* note 2, at 61.

rights from unborn persons (who cannot possibly enjoy holding the rights) to persons that can take pleasure in ownership. These second and third benefits are also status effects.

The Rule against Perpetuities illustrates two closely related components of status efficiency. The first benefit of the Rule arises because the judicial reallocation of rights makes it easier for the market to allocate the land efficiently.[22] The second and third benefits stem directly from the judicial reallocation of rights from a less appreciative to a more appreciative owner. In both components the ultimate benefit is that the rights end up with the user that values them more. In the latter two cases the judge places the rights with the more appreciative owner and in the former the judge groups the rights in a way that allows the market to do the reallocation.

4. Servitudes After the Neighborhood Changes

Servitude law determines whether courts will enforce promises that are intended to bind subsequent purchasers of land.[23] Suppose that a boy inherits a small farm on the outskirts of a town in southern California. To finance his future college education, he sells a few acres of the land to a produce retailer. To protect his rural life style, he obtains a promise from the retailer that neither she nor any future owner will use the land for anything but agriculture and single family residences. Years later, the town has grown and has zoned the area for high-rise apartments and commercial development. The retailer, seeing an opportunity for much larger profits, wishes to open a store. She offers to buy freedom from the restrictive covenant. The offer is more that the rights are worth to the student. But he has chosen to study economics and he has a taste for strategic bargaining.[24] He thinks that if the retailer is rational she should agree to pay any price that leaves her with a net gain. He negotiates with the hope of capturing for himself nearly all of the gains from the change in the use of the land. Not surprisingly, negotiations fall through.

The retailer asks her lawyer whether she can free the land of the restriction by selling to someone else. The lawyer advises that, in general, servitude law permits promises to bind future owners as tightly as they do the original promisor. However, the lawyer further advises that he might be able to get a judge to declare the restriction outmoded and unenforceable under the doctrine of "changed circumstances."

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22. This assumes that transaction costs are sometimes asymmetrical—transfers are easier one way than the other.

23. C. CLARK, COVENANTS AND OTHER INTERESTS WHICH "RUN WITH THE LAND" 93 (2d ed. 1947).

24. *See* Carter & Irons, *Are Economists Different, and If So, Why?*, 5 J. ECON. PERSPECTIVES 171, 175 (1991) (freshmen economics students bargain more strategically than other freshmen).

The doctrine of changed circumstances, also called "changed neighborhood" and "changed conditions," says that "[i]njunctive relief against the violation of the obligations arising out of a covenant cannot be secured 'if conditions have so changed since the making of the promise as to make it impossible longer to secure in a substantial degree the benefits intended to be secured by the performance of the promise.' "[25] By convincing a court to apply this doctrine, the retailer can free her land of the now-burdensome restriction to agricultural and single family use.[26]

The incentives created by a court's adoption of this doctrine appear little better than the incentives created by the Rule against Perpetuities. Once a court holds that changed circumstances can make a servitude unenforceable, subsequent parties to land transactions are limited in the types of deals they can make. By destabilizing the law of servitudes, the court creates incentives for wasteful avoidance behaviors and deters beneficial trades. Some will turn to alternatives such as defeasible fees, though presumably such forms would suit their needs less well than would a clearly enforceable servitude.[27] Other sellers, worried that the court might also apply the changed circumstances doctrine to the alternatives, might refuse to sell at all, forgoing the gains from trade that they would have obtained if the seller could be sure of enforcement.

The status effects of a court's application of the doctrine include ordinary distributional effects and efficiency consequences. By taking rights from the economics student and shifting them to the produce retailer, the court adds to the wealth of the latter at the expense of the former. It is hard to justify this transfer on the ground of fairness or justice. But consider the efficiency aspects of the change in status. By reallocating the rights of development from the student to the produce retailer, the court places the rights in the hands of the person it perceives to value them more highly, achieving the gains from trade that were prevented by the strategic bargaining of the parties. Some courts attempt to ensure that the doctrine will be applied only

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25. 5 R. POWELL & P. ROHAN, THE LAW OF REAL PROPERTY ¶ 679[2], at 60-131 (1990) (quoting RESTATEMENT OF PROPERTY § 564 (1944)); *see also* Robinson, *Explaining Contingent Rights: The Puzzle of "Obsolete" Covenants*, 91 COLUM. L. REV. 546 (1991) (finding no satisfactory theoretical explanation for the changed conditions doctrine).

26. *See* Marra v. Aetna Constr. Co., 15 Cal. 2d 375, 378-79, 101 P.2d 490, 492-93 (1940) (neighborhood changes, including nonresidential use of a protected lot and erection of a seven-story apartment house, a three-story apartment house, a gown shop, and other commercial facilities, rendered obsolete and unreasonable a restriction on land's use to single family residence, even though the limitation would by its own terms terminate after 40 years). *See generally* Annotation, *Change of Neighborhood As Affecting Restrictive Covenants Precluding Use of Land for Multiple Dwelling*, 53 A.L.R. 3D 492 (1973).

27. *See generally* Epstein, *Notice and Freedom of Contract in the Law of Servitudes*, 55 S. CAL. L. REV. 1353, 1364-65 (1982) [hereinafter Epstein, *Freedom of Contract*] (only enforcement of equitable servitudes can protect the legitimate freedom of contract rights of landowners).

when such gains will accrue by requiring that "the changes must be so radical as practically to destroy the essential objects and purposes of the agreement."[28]

Another status efficiency that may be accomplished by the application of the changed circumstances doctrine parallels the market-making benefit mentioned in connection with the Rule against Perpetuities.[29] By shifting rights from the promisee back to the promisor, the court allocates all rights to one set of hands. Even if the produce retailer values the rights no more highly than does the economics student, benefits can result if there exists a third party, such as an apartment builder, that places on the collected rights a value greater than the sum of the values the student and retailer place on their rights. By applying the doctrine, the court makes it much more likely that the builder will acquire and develop the property.

Benefits from both the improved allocation and the improved packaging of rights are much less likely to obtain in suits for damages than in suits for equitable relief because an award of damages does not prevent development. Thus, the distinction drawn by early courts, that the changed conditions doctrine did not prevent a suit for damages,[30] is defensible, or at least explainable, on status efficiency grounds. In effect, courts making this law-equity distinction find that the person holding the benefit of the servitude still has rights after circumstances change. But such courts protect those rights with a liability rule rather than a property rule in order to permit efficient use of land.

C. TWO PROBLEMS IN ASSESSING STATUS EFFICIENCY

The Rule against Perpetuities and the doctrine of changed circumstances each illustrate two distinct considerations important to status efficiency. First, the judge should place the rights in the hands of the person that values them more highly. Second, the judge should also allocate the rights to facilitate subsequent market transfers.[31]

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28. Rombauer v. Compton Heights Christian Church, 328 Mo. 1, 18, 40 S.W.2d 545, 553 (1931) (despite growth of businesses affecting some lots, the area's residential nature had not been altered enough to allow construction of church on restricted lot). Other courts have said that the change must make the restriction valueless to the holder and onerous to the owner of the restricted land. Thodos v. Shirk, 248 Iowa 172, 186-87, 79 N.W.2d 733, 742 (1956) (change of road from dirt to paved with increased traffic and growth of business concern across the street from the tract did not alter condition of area enough to warrant waiver of "residential only" restriction on lot at issue).

29. *See supra* text accompanying note 19.

30. *See* C. CLARK, *supra* note 23, at 185-86 (criticizing the equity-law distinction on the ground that both types of enforcement encumber titles); 5 R. POWELL & P. ROHAN, THE LAW OF REAL PROPERTY *supra* note 25, ¶ 679[2], at 60-138 (characterizing as "more realistic [the modern] view that the facts justifying a refusal of injunctive relief should also eliminate a recovery of damages at law").

31. These two considerations might conflict or coincide.

For two reasons the first consideration is more problematic than the second. First, interpersonal comparisons of utility are at best a hunch. There is no way for the court to be sure of who values the rights more highly. Nevertheless, this problem ought not be over-emphasized because the court in any case must make a decision. Ignoring interpersonal differences in utility does not make them go away. A judge may be able to tell who values the rights more dearly even though no one can prove she is right.

Second, and more serious, the judge's guess as to which party will enjoy the rights more fully will inevitably be biased by her own values. Judges will project their own values onto the litigants and make their decisions according to how they would feel if they were in the position of the parties. Given that judges as a group do not fairly represent all persons in society,[32] it is likely that they will appreciate some values more than others. In guessing at the rights' subjective values to parties, judges could easily underestimate the worth of rights to persons that have different values. If so, the guesses at the status-efficient result will be biased toward the values of the class from which the judges came.

D. OTHER TERMINOLOGY AND DISTINCTIONS

It might be helpful to see how the distinction between status and incentive effects differs from other distinctions that describe the economic effects of judicial decisions. One could argue that the status-incentive distinction is really the difference between short-run and long-run concerns. But use of that terminology mischaracterizes the distinction. In the changed conditions example, the efficient trades facilitated by a decision for the promisor (producer retailer) are status effects, but those trades can occur immediately or far in the future. Status effects can thus be both short- and long-run concerns. Incentives too can have both short- and long-run importance. The incentives for avoidance behaviors maintained by enforcement of the Rule against Perpetuities last for as long as the decision is not overturned.

Although the word "entitlements" might be a reasonable substitute for the term "status effects," that word also fails to describe the status-incentive distinction perfectly. For example, one of the status effects of a criminal case might be that the court allows the state to execute the defendant, changing his status from living to dead. Describing that decision as giving an "entitlement" to the state seems inapt.

The status-incentive distinction can be seen as a sort of *ex ante-ex post* issue. Incentive effects are those falling upon persons in circumstances that have not yet fully developed. Status effects are those falling on persons who

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32. On the backgrounds of federal judges, see generally S. GOLDMAN & J. JAHNIGE, THE FEDERAL COURTS AS A POLITICAL SYSTEM 64-72 (1971).

have arrived beyond some critical point. Thus, persons in an *ex post* position feel status effects and those in an *ex ante* position may feel incentives.

I have avoided the terms *ex ante* and *ex post*, however, because their use might confuse the issue. Although they are often employed to convey meanings similar to my own,[33] these more general terms are sometimes used in ways that do not reflect the distinction drawn here. To refer to *ex ante* effects and *ex post* effects might conjure up the idea of effects that occur before or after a certain event, rather than immediate changes wrought by the decision. In addition, the terms might give the impression that *ex ante* effects look to the future and *ex post* effects do not. Because both incentive and status effects influence subsequent efficiency, that impression would be incorrect. The terms used here better describe the distinction.

An economist might be more comfortable referring to the status-incentive distinction as the often noted difference between distributional and efficiency concerns. For my purposes, however, those terms will not do. "Efficiency" cannot replace "incentive" because the former, unlike the latter, includes status efficiencies.[34] "Distributional" might substitute for "status," but not without some confusion. Notwithstanding that the distribution of rights can have an impact upon efficiency, writers sometimes use those two terms to refer to mutually exclusive, nonoverlapping effects.[35] Because status effects relate to both efficiency and distribution, the use of distributional instead of status might send the wrong message to readers accustomed to considering distributional and efficiency issues as separate.

Even for readers that remember that transaction costs can turn distributional effects into efficiency concerns,[36] the word distributional might fail to elicit the right image in some types of cases. For example, it is somewhat indirect, though quite correct, in cases upholding the death penalty to say that the court distributes to the state the right to decide whether the convict lives. In cases involving liability for dues assessed by a homeowners' associa-

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33. *See* R. COOTER & T. ULEN, LAW AND ECONOMICS 181 (1988) (using *ex ante* and *ex post* to describe two means of regulation, the former falling on all persons that might cause harm and the latter falling on persons actually causing the harm).

34. Incentive effects also include messages that are important for reasons other than efficiency, though efficiency is the primary focus in this paper.

35. *See* Hovenkamp, *The First Great Law & Economics Movement*, *supra* note 3, at 1009 (1990) (the problem of "distribution" "was generally considered by later economists to be outside the bounds of economic science"); Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L.J. 388, 391-92 (1981) (balancing the distributive effects of changing a rule against the efficiency gains); Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 294 (1979) (defense of law & economics approach, which accepts the existing distributional allocation and seeks only to optimize the efficiency of this allocation).

36. Suppose *A* values some rights at $10, *B* values them at $12, and the cost of a transfer is $3. If a judge allocates the rights to *A*, they will stay there. What is purely a distributional issue in the absence of transaction costs becomes an efficiency concern in the real world.

tion, one of the important efficiency questions is whether the members will be able to use the association to overcome free rider problems that would prevent efficient (both Pareto superior and potentially Pareto preferred) projects. It is perfectly accurate to say that the decision distributes rights to money in the amounts of homeowners' dues. But those words do not readily convey the idea of a relationship involving democratic decisionmaking, an idea which is central to a functioning homeowners' association. A decision that gives money for food to a poor person may make him more energetic on the job. Thus, the concept of status effects is expansive enough to include effects on concerns as disparate as relationships and health, effects that might not be suggested by the word "distributional."[37]

E. EFFICIENCIES DIFFICULT TO CLASSIFY

A number of economic effects do not fit neatly into the category of either incentive or status effects. One important example is the costs associated with a change from a clear rule to an unclear rule. Suppose a court changes from the clear rule that changed circumstances never prevent enforcement of servitudes to a new rule that a change in circumstances can warrant a refusal to enforce. Across the jurisdiction, parties who are burdened by a servitude gain rights at the expense of those holding the benefit of the servitude. And both groups will become uncertain about their rights. The shift in wealth and the uncertainty are both status effects. But the shift from a clear right in the hands of a covenantee to a state of uncertainty also has an incentive effect. The court's decision creates an incentive to sue because it raises the possibility of having the servitude stricken by the court. The rent-seeking behavior that results is an incentive effect.

Another effect that is difficult to classify is that encompassed within Professor Frank Michelman's "demoralization" costs.[38] As Michelman explained in the context of takings law, a judicial decision can make sympathizers of the losing party feel worse.[39] Those feelings are themselves status effects of the decision and they weigh in the efficiency balance. In addition, their demoralization may cause the sympathizers to lose enthusiasm for their work. That lethargy is a secondary economic loss stemming from the losing party's change in status. In many cases the demoralization costs will be balanced, and in those cases they can safely be ignored. But demoralization aspects could be asymmetrical. Implicitly presuming such

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37. "Status" also has the advantage of being shorter than "distributional." The status-incentive distinction may parallel the difference between exchange and production, status efficiencies being like gains from exchange.

38. Michelman, *Property, Utility, and Fairness: Comments on the Ethical Foundations of 'Just Compensation' Law*, 80 HARV. L. REV. 1165 (1967).

39. *Id.* at 1214.

asymmetry, Michelman used demoralization costs, rather than the direct status effects upon Antonio, to explain why a court might not enforce Shylock's bond.[40]

The reader may find it easy to identify other troublesome efficiencies. Criminal lawyers can wonder about how to classify a reduction in vigilante behavior that accompanies a decision to punish a criminal severely. Tax lawyers may puzzle about a reduction in consumer spending when the government increases taxes to reduce the deficit. The inability of the status incentive distinction to sort out all economic effects is not a fatal flaw. I do not suggest that these efficiencies be treated differently. Both need attention. The distinction need not be crystal clear or all-encompassing to be useful.

II. NORMATIVE IMPLICATIONS

Neither status nor incentive effects carry greater normative weight. The examples in Part I show that both types of efficiencies are essential to a comprehensive analysis of how a judge should reach an efficient result in a given case. The changed conditions doctrine appears to be efficient from the status perspective (it frees up land for market allocation) but inefficient from the incentives standpoint (it shunts parties to alternative arrangements that waste resources). Which effect is greater is a matter of speculation. Until that speculation is resolved, the economically desirable decision remains in question.

As has been repeatedly demonstrated by the law & economics literature, traditional legal scholars may miss issues of incentive efficiency, even when they consider economic aspects of an issue. A good example is Professor Richard Epstein's analysis of the Rule against Perpetuities. Although there existed an extensive body of traditional work, Epstein was the first to bring to light some of the inefficient incentives created by the Rule.[41] Conversely, as the Rule against Perpetuities debate also illustrates, law & economics scholars often miss the status efficiencies of decisions. Focusing on the fact that judges make rules, economic analysts sometimes forget that judges also decide cases. When the research aims to provide understanding of the law, the omission is not critical. But when the research aims at telling judges what they should do, the omission of status effects undermines the whole enterprise. Awareness of the distinction between these two types of concerns should help prevent such oversights.

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40. Michelman, *supra* note 2, at 311 (decision to enforce bond would distress people enough to pay Shylock to relent, assuming they could overcome transaction costs).

41. Epstein, Remarks in *Time, Property Rights, and the Common Law (Round Table Discussion)*, 64 WASH. U.L.Q. 793, 842 (1986) [hereinafter Epstein, *Time, Property Rights, and the Common Law*] (discussing, among other issues, the psychological effect of the Rule against Perpetuities on people's approaches to the transfer of property).

Similarly, it is critical that those who use the method proposed below to generate hypotheses for positive understanding of judicial decisionmaking remember this limitation. A finding that cases conform to the predictions of a hypothesis based on status effects, however rewarding as a positive matter, does not mean that the test is justifiable in any normative sense, even an economic one. Status efficiencies do a better job of explaining the Rule against Perpetuities than anything else, but they only start to answer whether to adopt or continue the Rule. The Rule may, as Epstein argues, generate inefficient incentives that more than offset its status efficiencies.[42] Thus, a complete economic examination of any legal issue might well show that judging in accordance with a status-based principle is ultimately inefficient. Neither incentive nor status efficiencies, either of which might be ignored without harm in a positive analysis, should be forgotten when the analysis is normative. And it ought to go without saying[43] that a comprehensive analysis including liberty and justice might also undermine an economic hypothesis as a normative standard.

III. STATUS EFFECTS IN LEGAL RESEARCH

A. ATTENTION TO INCENTIVES IN THE NEW LAW & ECONOMICS SCHOLARSHIP

Traditional economic analysis of law often looks closely at status effects. Antitrust scholarship, for example, focuses on the effects a judicial decision will have on the economic structure of the market.[44] Tax scholarship has long included attention to tax incidence.[45] Such analysis depends upon incentives and behavioral responses to them, but the key concern is with status effects. Recently, as the new law & economics writers have focused their lens on common law subjects involving issues less obviously in need of economic analysis, incentive effects have displaced status effects as the main concern. As Professor Epstein has said, "[t]he law and economics approach lays great stress on the incentives for cost-minimizing behavior that legal rules are said to create."[46] Judge Posner confirms the centrality of incentives by introduc-

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42. Epstein, *Past and Future: The Temporal Dimension in the Law of Property*, 64 WASH. U.L.Q. 667, 712 (1986) [hereinafter Epstein, *Past and Future*] (ease with which the Rule against Perpetuities can be evaded makes the Rule insignificant and inconsequential). Epstein points out that the percentage of wealth caught by the Rule is a very small fraction of the total wealth transmitted at death. *Id.* The fewer and smaller the transfers caught, of course, the less important are the status effects.

43. But it never would in a law review.

44. *See, e.g.*, 1984 Merger Guidelines, 49 Fed. Reg. 26,823, 26,831 (1984) (Department of Justice uses change in market concentration to determine whether to challenge horizontal mergers).

45. *See generally* W. KELLER, TAX INCIDENCE: A GENERAL EQUILIBRIUM APPROACH (1980).

46. Epstein, *The Social Consequences of Common Law Rules*, 95 HARV. L. REV. 1717, 1740 (1982).

ing the incentive approach early in his classic text:

> "To the economist, the accident is a closed chapter. The costs that it inflicted are sunk. . . . The decision in the case . . . should interest the economist because it will establish or confirm a rule for the guidance of people engaged in dangerous activities . . . thus altering prices that confront people."[47]

The new law & economics sees judicial decisions as making rules and sees rules (and remedies) as prices on behaviors. As Professor Thomas Ulen has stated:

> [T]he basic premise of law and economics is that legal rules create implicit prices on behavior and that the responses of individuals (and organizations) to those prices can be analyzed in exactly the same way that responses to explicit prices can be analyzed.[48]

This comparative static analysis often asks how persons subject to the law will behave if a rule incorporating one result is adopted and compares that to the behaviors likely if another rule is adopted. Professor Lewis Kornhauser has argued that this elaboration of an economic theory of individual behavior in response to legal rules is the major contribution and innovation of the new law & economics.[49] Thus the new economic analysis of law often highlights the incentives that the decision will create for any person acting in the future, whether or not they are connected to the case.

The attention legal scholars give to incentive effects goes too far when the economic effects on the parties themselves, the status effects, are forgotten. Epstein's attack on the efficiency of the Rule against Perpetuities, for example, pays more attention to the incentives created by the Rule than the status effects of the Rule's application.[50] An overriding concern with the incentive effects of decisions might also explain Posner's puzzlement at the law's failure to enforce Shylock's exaction of a pound of flesh.[51] It is entirely possible that the status inefficiencies of such a decision—the flesh likely being worth

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47. POSNER 3D, *supra* note 2, at 22.

48. Ulen, *Cognitive Imperfections and the Economic Analysis of Law*, 12 HAMLINE L. REV. 385, 388 (1989) (analysis of the systematic errors individuals make in their efforts to maximize efficiency under a law & economics approach); *see also* Kelman, *Misunderstanding Social Life: A Critique of the Core Premises of "Law and Economics"*, 33 J. LEGAL EDUC. 274, 274-77 (1983) (discussion of the four affirmative positions that form the core of legal economics, one of which is the idea that legal commands can be treated as prices on behaviors).

49. Kornhauser, *The New Economic Analysis of Law: Legal Rules As Incentives*, in LAW AND ECONOMICS 28, 49 (1988).

50. Epstein, *Past and Future*, *supra* note 42, at 710-13; *see also* Epstein, *Time, Property Rights, and the Common Law*, *supra* note 41, at 842 ("[The Rule against Perpetuities] tends to queer all sorts of transactions, slow people up, get them apprehensive and nervous for no particular social gain."). To be fair, it should be noted that Epstein did not claim to have undertaken a complete economic analysis of the Rule.

51. *See supra* note 2.

less to Shylock than Antonio—would outweigh the incentive inefficiencies that arise from the marginal destabilization of contracts caused by the refusal to enforce that one agreement and a few like it in the future.

Of course, not all new law & economics scholarship approaches problems from the incentive standpoint. A good early example of the status approach can be found in Professor James Krier's review of the first edition of Posner's treatise on law & economics.[52] Krier suggested that economic analysis could be used to explain when courts use the touch and concern doctrine to terminate servitudes.[53] His theory was that courts refuse to bind successors to covenants when the successors would be unlikely to do so in a costless transaction. Although he did not distinguish the status effects from the incentive effects now central to law & economics analysis, his example clearly suggests a positive analysis focusing on the status aspects of the decisions to be explained.[54]

The new law & economics has recognized from its beginning the centrality of status effects in theoretical discussions of what judges ought to do. Professor Ronald Coase himself urged courts to take the consequences of their actions into account and to allocate disputed property rights in such a way as to reduce transaction costs even when the parties might subsequently exchange the rights in a market transaction.[55] More recently, Professor Stephen Margolis focused entirely on status effects in his discussion of which efficiency approach a court ought to take in a hypothetical property dispute.[56] His discussion, however, was abstracted from the rules of law. He talked only of how to decide the case, not of which rule should be adopted.[57] In sum, despite a few appearances by the status approach in the new law & economics literature, much of the scholarship has not followed Krier's example nor has it lived up to Coase's prescription in analyzing particular rules of law.

Economically-oriented scholars might occasionally forget status effects because changes in status frequently have no effect on efficiency. For example, whether the driver of one car compensates the other for damages incurred in the accident does not weigh heavily in the efficiency balance. Moreover, such distributional consequences are sometimes seen as being outside of the spe-

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52. Krier, Book Review, 122 U. PA. L. REV. 1664 (1974) (reviewing R. POSNER, ECONOMIC ANALYSIS OF LAW (1972)); *see also* Merrill, *Trespass, Nuisance, and the Costs of Determining Property Rights*, 14 J. LEGAL STUD. 13, 42-43 (1985) (describing covenant law as governed by "a judgmental entitlement-determination rule").

53. Krier, *supra* note 52, at 1679-80.

54. Krier acknowledges that his hypothesis follows one of the approaches taken by Posner in analyzing other legal issues. *Id.*

55. Coase, *supra* note 3, at 19.

56. Margolis, *supra* note 11, at 476-77.

57. *Id.*

cial expertise of economists.[58]

The purpose of this article is not, however, to ask why scholars applying economics to law miss some of the efficiency effects of judicial decisions, to prove how often they do so, or even to present representative examples of research done in law & economics. Nor is the article's goal to establish any essential distinction between the old and new applications of economics to the law.[59] Rather my hope is to alert researchers applying economics to law to a distinction that may prove helpful in both reviewing normative economic analysis that relies upon the laws-as-prices approach and developing additional hypotheses for positive analysis and prediction of judicial behavior.

B. THE FREQUENT EXCLUSION OF UNCLEAR LAW FROM POSITIVE EFFICIENCY ANALYSIS

When its goal is explanation, the new economic analysis of law typically focuses upon existing or proposed rules,[60] often referring to opinions, hornbooks, and treatises as authoritative statements of legal rules. Areas in which there are no clear rules have generated comparatively little positive analysis by law & economics scholars, other than the important analyses of the costs of uncertainty and the costs of clear rules.[61] It is not clear whether this is a cause or consequence of the frequent attention to incentives, but it is closely related. It is difficult to analyze the incentives created by a law if no one can condense the law into a rule. As Professor Duncan Kennedy put it, "If the lawyer says, 'this is a case of first impression,' or 'there is no law,' the economist cannot proceed."[62] Plainly, as Kennedy recognizes, an efficiency approach hoping to explain results of cases and predict judicial decisions in areas of the law lacking meaningful, consistent rules will not go far by taking the usual look at incentives. One cannot easily explore the price effects of a law without knowing what the law is.

It is obvious that hornbook rules do not summarize, predict, or explain all judicial events; some areas of the law remain shrouded, yielding to no attempt to explain the results of the cases. Most legal scholars would admit to

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58. *See* Hovenkamp, *supra* note 3, at 1009.

59. Professor A. McGuire asserts that the distinction between old and new law & economics is an artificial and unhelpful concept because the application of micro-economic theory underpins both. *See* McGuire, Book Review, 10 INT'L REV. L. & ECON. 211, 212 (1990) (reviewing LAW AND ECONOMICS (1988)). This article suggests that the application of the transaction cost paradigm is not the only difference between the two law & economics approaches.

60. *See* Ulen, *supra* note 48, at 385 ("The central concern of law and economics is to understand the efficiency properties of legal rules").

61. *See* Epstein, *Freedom of Contract*, *supra* note 27, at 1361-64 (citing effects of uncertainty as a reason to abolish the touch and concern element).

62. Kennedy, *supra* note 35, at 430 n.103.

knowing a few areas in which the outcomes of cases are hard to predict with reasonable certainty even when the facts are clear. Some observers go further, contending that black letter rules explain very little of the law.

There are a number of ways in which the law can be unclear. First, the court's opinion may fail to tell what the important factors are or how they interrelate. Takings law immediately after *Penn Central Transportation Co. v. City of New York*,[63] for example, was quite unclear. Although the Court identified several factors relevant to determining whether a taking had occurred,[64] it did not say how the factors fit together.

Second, the individual judges may have, in similar cases, used substantially different words in describing the applicable rule. If one court states that a given set of facts calls for justice and another decides the opposite way on the ground that the same set of facts calls for efficiency, the law, if it can be called law, for that set of facts is unclear. The judges are not even using the same language. This type of uncertainty about the applicable standard is more likely on issues that are relatively new.

Finally, judges may use the same language and clearly articulate the structure of the doctrine within which the rule fits, but the words may themselves lack an agreed meaning. The touch and concern element of servitude doctrine is an example of a well-articulated, but nearly meaningless rule.[65] The "best interests of the child" standard in family law is similarly lacking in agreed content.[66]

Unclear rules do not include those that depend on facts that are hard to find. Hence, Judge Learned Hand's formula for negligence,[67] though indeterminate because of difficulties in determining the facts,[68] is not an unclear rule. Nor does unclear law include legal issues that have not yet been decided by any court; on those there is no law at all.

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63. 438 U.S. 104 (1978) (no taking occurred when a city designated a building as a "landmark," thereby limiting the owner's right to alter the property).

64. *Id.* at 124-28.

65. *See* Stake, *Toward an Economic Understanding of Touch and Concern*, 1988 DUKE L.J. 925, 928. Some scholars may prefer to call this a standard instead of a rule.

66. *See* H. KRAUSE, FAMILY LAW IN A NUTSHELL 248-49 (2d ed. 1986).

67. United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947) (enunciating the standard for negligence as when the burden of prevention is less than the injury multiplied by the probability, that is, when $B < PL$).

68. *See* Moisan v. Loftus, 178 F.2d 148, 149 (2d Cir. 1949) (L. Hand, J.) (" '[O]f these factors [in his negligence formula] care is the only one ever susceptible of quantitative estimate, and often that is not. The injuries are always a variable within limits, which do not admit of even approximate ascertainment; and, although probability might theoretically be estimated, if any statistics were available, they never are; and, besides, probability varies with the severity of the injuries. It follows that all such attempts are illusory.").

C. A POSITIVE APPLICATION OF ECONOMICS TO CASES INVOLVING UNCLEAR LAW

This article suggests a way for the law & economics scholar to help the expert lawyer, and any others who care about what the law is, when the law is unclear. Both incentive and status analyses may help to explain the law, but unclear law might not yield to the incentive approach because there is no rule to provide the incentives needed for the analysis. Positive analysis focusing on status effects may clarify conflicting cases that have eluded synthesis in the hornbooks and treatises. Analysis of status effects, both distributional effects and status efficiencies, may give meaning to vague doctrine.[69]

By asserting that scholars might be able to use economics more often to explain case results I do not claim that economics is the only or even the best hope of finding a theme for rationalizing a set of seemingly patternless cases. There are many sources of explanations; any discipline offering insights into human behavior can be tapped as a source of hypotheses to explain judicial behavior. Economics is only one among them. It need not explain most or all judicial decisions to make a contribution to a practical understanding.[70] When cases cannot be explained by other criteria, synthesis and understanding might be furthered by looking at the status consequences of the decisions in the cases. Prediction, too, might benefit from attention to status effects, though it is possible that a status-oriented understanding will not aid much in predicting cases if the status efficiencies vary greatly with small variations in the facts.[71]

This claim that judges might decide cases in unclear areas of law in ways that reduce status inefficiencies implies that they sometimes sacrifice distributional fairness and incentive efficiencies to do so. As evidence that this is not preposterous, recall the discussion of the changed circumstances doctrine. The distributional unfairness of taking assets away from owners is obvious

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69. Identification of status inefficiencies may be especially helpful if neither poor individuals nor wealthy businesses win consistently.

70. *But cf.* R. POSNER, THE PROBLEMS OF JURISPRUDENCE 371 (1990). Posner finds unsatisfactory any positive theory that leaves unexplained many of the phenomena it sets out to explain and does not provide any suggestions for how to explain the rest. I suggest that economics can be used as a tool in pursuit of a more limited goal, the traditional goal of figuring out what judges are up to in particular types of cases.

71. As an example, consider the question of whether a promise to insure land touches and concerns the land. It has been held to touch and concern, but courts usually hold that it does not. Decisions both ways can be explained by a status-oriented theory. *See* Stake, *supra* note 65, at 965. But the explanation relies on a distinction between insurance premiums that might vary greatly depending on the use of the land and insurance premiums less likely to be so variable. The importance of that distinction would have been difficult to anticipate before the courts split on the issue. Therefore, even a lawyer with a good understanding of the efficient-allocation hypothesis, *see infra* note 85, might not have been able to predict the outcome of the case holding the covenant to touch and concern.

and the incentives created by the doctrine are mostly wasteful. Those rationales will not explain judicial acceptance of the rule. Status efficiency does a better job. The courts eliminate the restrictions in order to rearrange the rights of the various parties into more efficient packages. The following section suggests another unclear rule that might be understood using status effects.

1. Examples of Positive Hypotheses Based Upon Status Effects

The seemingly unpredictable cases involving suits between homeowners' associations and their members might be harmonized and predicted with a simple hypothesis derived from status concerns. Courts hearing such cases often require that the actions of the association be reasonable, not arbitrary or capricious, and in good faith.[72] This reasonableness standard has no clear meaning. This is not just a matter of difficulty in determining the facts. Unlike the cost-benefit reasonableness standard applied in some types of cases,[73] this reasonableness test has no commonly accepted content. It is not even clear under this reasonableness test what sorts of facts are important and how they are to be weighed.

One could formulate a more clear and determinate rule from some of the economic factors that might enter into a judge's determination of whether the association acted reasonably. A judicial concern for status effects could cause a judge to worry about a governance structure that allowed the majority to enrich itself at the expense of the minority. Just as the just compensation clause[74] expresses a concern that the majority might use its control of governmental power to take property from the minority, the judges might be expressing a concern for minority rights in imposing the reasonableness requirement. This status concern suggests the hypothesis that courts will not allow associations to change the association rules or the common physical facilities if such a change will result in a reduction of the net market value of

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72. *See, e.g.*, Rhue v. Cheyenne Homes, 168 Colo. 6, 9, 449 P.2d 361, 363 (1969) (covenant requiring approval of plans by an architectural committee); Hidden Harbour Estates v. Norman, 309 So. 2d 180, 180-81 (Fla. Dist. Ct. App. 1975) (condominium association can adopt reasonable rules limiting use of alcoholic beverages in common areas); Justice Court Mut. Hous. Coop. v. Sandow, 50 Misc. 2d 541, 545, 270 N.Y.S.2d 829, 833 (N.Y. Sup. Ct. 1966) (striking down a cooperative regulation restricting the playing of musical instruments to one and one-half hours per day as arbitrary and unreasonable).

73. *See* Mullane v. Central Hanover Bank & Trust, 339 U.S. 306 (1950) (applying a cost-benefit analysis for determining reasonableness in due process context); United States v. Carroll Towing Co., 159 F.2d 169, 173 (2d Cir. 1947) (enunciating the standard for negligence as when the burden of prevention is less than the injury multiplied by the probability); La Salle Nat'l Bank v. City of Chicago, 5 Ill. 2d 344, 351, 125 N.E.2d 609, 613 (1955) (balancing the benefits of the zoning as applied to the parcel in question against the costs of the regulation to the landowner to determine reasonableness in substantive due process challenges to zoning rules).

74. U.S. CONST. amend. V.

the property held by a minority member.[75]

If accurate, this summary gives lawyers and their clients a better idea of what courts will do with a given set of facts than does the current reasonableness standard. This is not to suggest that the fair market value approach should displace the reasonableness standard in the discourse of judges; that is a separate, normative question.[76] And research would need to be done to determine whether this positive construct has any useful empirical content. The point here is that it might.

The use of arithmetic or economic constructs, like that in the homeowners' association example, to provide frameworks for research in unclear areas of the law is not new to legal research. Professor John Leubsdorf's analysis of preliminary injunction decisions provides a fine example from traditional scholarship.[77] After noting that there was variation in the enunciated standards and confusion in their application, he proposed a decisionmaking model sounding in economics.[78] Without claiming to present a true economic analysis, Leubsdorf argued that for each party the judge should multiply the likelihood of success on the merits by the magnitude of the irreparable injury from an adverse decision on the preliminary injunction.[79] The party with the higher product should win the preliminary injunction decision. On a descriptive note, Leubsdorf concluded that the then-existing standard did a good job of capturing the essential components of his model.[80] This is just one of many examples of how traditional legal scholarship considers economic status effects.[81]

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75. *Compare* Lincolnshire Civic Ass'n v. Beach, 46 A.D.2d 596, 364 N.Y.S.2d 248 (1975) (upholding assessment of $330 from all members for reconstruction of swimming pool) *with* Theiss v. Island House Ass'n, 311 So. 2d 142 (Fla. App. 1975) (invalidating attempt to privatize use and responsibility for upkeep of laundry machines to minority owners located nearest to machines) *and* Grimes v. Moreland, 41 Ohio Misc. 69, 322 N.E.2d 699 (1974) (attempt to privatize ownership of common areas).

76. *See* Stake, *supra* note 65, at 972-73.

77. Leubsdorf, *The Standard for Preliminary Injunctions*, 91 HARV. L. REV. 525 (1978). The use of Leubsdorf's article as an example does not mean that I challenge or criticize any of Leubsdorf's conclusions or analysis.

78. *Id.* at 541-44; *see also* POSNER 3D, *supra* note 2, at 522 (adopting Leubsdorf's model).

79. Leubsdorf, *supra* note 77, at 565.

80. *Id.* Leubsdorf did not discuss the inefficiencies created by the indeterminacy of the preliminary injunction rules or attempt to determine whether the benefits of a more determinate, predictable law would outweigh the costs of adhering or conforming to his model. Leubsdorf's standard, although conceptually clear, will likely leave the law quite indeterminate because it is difficult to assess the magnitude of harms when the injuries are, as are many irreparable injuries, not monetizable. Nor did Leubsdorf discuss what incentives his standard would create for those contemplating litigation. Although these effects appear insubstantial, a complete normative economic analysis requires their mention.

81. *See, e.g.*, C. CLARK, *supra* note 23, at 185-86; L. SIMES, PUBLIC POLICY AND THE DEAD HAND 57-58 (1955); Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 476-77 (1987).

2. Comparing Status-Oriented Approaches

There are two notable differences between this proposal for developing positive hypotheses and Leubsdorf's preliminary injunction methodology. Although the two share the status perspective, the traditional application of economics to law is more normative and more "realistic" than the hunt for status efficiencies recommended here.

Traditional legal analysis commonly includes a heavy normative component.[82] Scholars develop a theory of what ought to be and proceed to determine what cases and rules are inconsistent with their theory. Deviations from the theoretical norm are evidence of bad judging or bad law rather than an incorrect theory. By contrast, the approach advocated here uses economics to derive hypotheses, such as that for homeowners' association cases, for use in explanation and prediction, rather than to derive norms for use in critique.

Traditional uses of simple economics to draw a thread through unclear case law were "realistic" in the sense that they were phrased using economic constructs elementary enough that it was plausible to believe that the judges indeed thought in those terms.[83] The words and phrases of judicial opinions often supported the theories directly. Indeed, the theories were sometimes formulated by judges themselves, as was Judge Learned Hand's negligence formula.[84] The homeowners' association example also makes use of a construct simple enough to present a realistic representation of the thoughts of judges. However, the use of economics in the development of positive hypotheses need not be so constrained. The more sophisticated tools of the new law & economics can also be applied to generate models of judicial behavior.

An example of such an application is the efficient-allocation model of the touch and concern element of servitudes.[85] Suppose a woman buys a home in a condominium complex. Her vendor, the original owner of the condominium, had promised the builder to pay assessments made by the homeowners' association in the future. After she buys, the association votes a large assessment for improvements to common areas, and the woman refuses to pay. The association asks a court to enforce the vendor's promise to pay against the new owner.[86] The decision of whether a promise to pay home-

82. Much new economic analysis of law is normative too. Perhaps the law attracts scholars with a normative bent.

83. *See* United States v. Carroll Towing Co., 159 F.2d 169 (2d Cir. 1947); Leubsdorf, *supra* note 77.

84. *See supra* note 67 and accompanying text.

85. *See generally* Stake, *supra* note 65, at 930 (courts find that a covenant touches and concerns land when the benefit or the burden at issue is more efficiently allocated to the successor than to the original party to the covenant.).

86. For examples of this type of dispute, see Boyle v. Lake Forest Property Owners Ass'n, 538 F. Supp. 765, 769-70 (S.D. Ala. 1982) (covenants binding grantees to pay for maintenance of public

owners' association assessments runs with the land changes more than the relative wealth of the parties. The decision will affect the future ability of the association to maintain and improve common areas in ways desired by the association. If the promise is unenforceable, free rider problems may prevent the neighbors from implementing shared preferences in the future.[87] Transaction costs may block Pareto superior moves. Thus, the change in the status of the parties affects the efficiency of resource allocation. The hypothesis of the efficient-allocation model of touch and concern decisions is that judges impose the burdens of covenants on successors to the original promisor when doing so would prevent an inefficient situation.[88] This efficiency-derived model explains rather well the results of cases turning on the touch and concern factor, and it accounts for the willingness of courts to impose the burden of association dues on homeowners despite the traditional rule that promises to pay money do not touch and concern the land.

In contrast to Leubsdorf's model, the efficient-allocation model of the touch and concern element is "unrealistic." It makes use of economic concepts of strategic behavior such as holdouts, moral hazards, bilateral monopoly, and rent seeking, some of which are not part of the education and training of the judges whose decisions the model explains. And there is little evidence from the opinions that the judges consciously considered the touch and concern test in the way described by this status-efficiency model. The model makes use of assumptions about judges' rational (and rationale) processes that may be false or unrealistic. Not only does the touch and concern model include unrealistic factors, it excludes realistic factors, such as fairness.

This failure to be realistic is not a deficiency. The value of a positive theory lies in its ability to squeeze the richness out of reality and leave a comprehensible skeleton, to pare away facts but leave the important contours. The richer and more complex the theory, the less it is a theory and the more it is a description of reality.[89] Models should be tested by reference to the purposes for which they were constructed.[90] It would be silly to criticize the colorful, official map of the London Underground on the ground that it fails to give utility repair persons an accurate picture of where they will find subway tunnels when they dig. It would be equally silly to criticize the map used by utility repair persons for its failure to predict which Underground trains will

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areas near the subdivision run with the land and are enforced as written), and also the many cases cited in Stake, *supra* note 65 at 963 n.146.

87. *See* Stake, *supra* note 65, at 936 n.57.

88. Stake, *supra* note 65, at 930.

89. *See* POSNER 3D, *supra* note 2, at 16.

90. This does not mean that the purposes for which the model is constructed are beyond critique. Nor do I mean to suggest that unintended political, social, economic, or other effects flowing from the choice and use of a model should be ignored.

arrive at which stations. Like maps, models of law have limited purposes. The question to be answered about any positive theory of law constructed for prediction is whether it predicts the actions of judges better than other available models, not whether it ignores some points or includes unrealistic assumptions.[91] The model may be built with constructs absent from both the opinions and the minds of the judges deciding the cases. Conversely, the model may omit concepts expressly stated in the opinions. Neither of those facts necessarily undermines a model designed to explain or predict.

In legal scholarship, however, prediction of future judicial events is a particularly problematic test of the viability of a theory. Legal scholars sometimes influence the direction of the law, and most hope their work will cited by the courts. The effect of the observers on the observed confounds efforts to test a model by reference to later cases. It is easily possible for even those (few?) scholars that have only a positive agenda to influence the course of future decisions by publication of their work. It therefore may be more appropriate to judge a positive theory by reference to its ability to explain previous cases than by reference to its ability to predict subsequent ones.

D. CASES FOR WHICH STATUS EFFICIENCIES MIGHT PROVE A USEFUL TOOL

In many cases, there are no status efficiencies worth noting; and judges cannot base decisions on status efficiencies that do not exist. The next task is to identify which types of cases will have status efficiencies and which will not.

1. Property Rules and Liability Rules

Suits in which a party asks for an injunction frequently implicate status efficiencies. When a plaintiff asks for specific performance of a running covenant, for example, the parties will usually remain in contact, maybe close contact, with each other following the conclusion of the case. The ways in which they deal with each other when they leave the courthouse will affect their wealth and, consequently, societal wealth. The degree to which the parties will remain in a continuing relationship is a gross measure of the degree of potential for inefficient behavior between them.

Because injunctive relief signals some post-trial relationship, requests for such relief raise status efficiency concerns. It is somewhat paradoxical to suggest that cases in which the plaintiff seeks equitable relief can be explained by economic concerns, such as allocative efficiency, rather than fairness or

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91. *See generally* M. FRIEDMAN, *The Methodology of Positive Economics*, in ESSAYS IN POSITIVE ECONOMICS 3-43 (1935); POSNER 3D, *supra* note 2, at 233.

justice. But the paradoxical nature of the proposition signals its potential; it would be an important revelation if it were to prove correct.

In a similarly counterintuitive way, most suits for money damages will have only minor status efficiency consequences, if they have any at all. As Posner has suggested,[92] a tort suit against a driver from another state will have no status efficiency ramifications. The suit will allocate rights, but the alternative outcomes between the parties (as opposed to the alternative legal rules presented to the judge) will not alter the wealth of society. Therefore, the decision's efficiency will depend on the messages it sends, not on how it changes the rights and duties of the two parties.[93] If the plaintiff seeks protection of rights with a liability rule rather than a property rule, the status efficiency aspects will usually be insignificant and therefore insufficient to form a basis for explaining or predicting the outcome of the case.

In some areas, however, a status efficiency hypothesis might predict the results of damages suits. If the plaintiff could have maintained a suit for an injunction, the court might treat the suit for damages as if it had been so prosecuted. Again, servitude law provides an example. Because many servitudes can be enforced with either remedy, the judge in a damages action for breach of a running covenant might easily imagine the same case in the posture of a suit for injunctive relief. The judge might then decide the damages case the same way that she would decide an injunction case, on the basis of the considerations that would typically present themselves in such cases—even though the governing considerations happen to be absent from the atypical instance in front of her. Thus, it is theoretically possible to develop a status-based understanding of some types of damages decisions even though the results did not implicate status efficiencies.

The degree to which the parties (and connected nonparties) will have to relate after the judicial resolution of the dispute should correlate positively with the potential for the resolution's having status efficiencies. This suggests that, as a general matter, property disputes will have a large potential for raising status efficiency concerns. Two neighbors disputing the validity of a covenant will continue to live near each other, maybe for a long time. Land use disputes are particularly likely to result in future status inefficiencies. Many negligence cases, on the other hand, do not by their nature involve parties that have a continuing relationship, and thus fewer status efficiencies will appear. The two parties to a suit arising out of a car accident that oc-

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92. *See supra* text accompanying note 47.

93. Because the resolution of the dispute will affect the wealth of the parties it can affect the subsequent allocation of societal resources if the parties differ in consumption preferences. *See* Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 15 (1982). *But see* R. COASE, THE FIRM, THE MARKET, AND THE LAW 170-74 (1988). That resources would be allocated in two different ways depending on the court's decision does not imply, however, that one of the possible outcomes is inefficient.

curred while one party was on vacation may never see each other again. Indeed, the negligent act or the suit or both may put an end to whatever continuing relationship existed previously. Contract law stands somewhere in the middle; cases involving fungible commodities will have fewer status efficiency ramifications than cases involving unique goods and services.

Of course all three of these broad classes will include types of cases with greater or lesser status efficiencies. Cases in which recording acts are applied to disputes over fee simple ownership of land, for example, rarely give rise to status inefficiencies because disputing parties will have little to do with each other after the case. The decision on ownership will end their interaction. Nevertheless, the status efficiency hypothesis should have the greatest application in property law, followed by contract and finally tort law. Hence it is no coincidence that the examples given above involve property rights and injunctions.

2. The Degree to Which the Decisionmaker Is Constrained by the Law

In some cases there may be significant status efficiencies but no way for the decisionmaker to consider them because some clearly applicable rule of law mandates a contrary decision. A court faced with status inefficiencies created by a testator's creation of a contingent interest that might vest too late to be valid can do little to strike the interest if the legislature has adopted the wait-and-see approach to the Rule against Perpetuities.[94] Of course, in some cases the controlling statutes and cases may require a decision consistent with status efficiency. The law may have been formed, consciously or not, to achieve just that. But in many other cases the court may have no honest way to avoid a decision that works against status efficiency. The rule may have been written to achieve justice, fairness, autonomy, incentive efficiency, or some other value. When the rule is clear and the judge lacks the power to change it, she will likely decide the case in accord with the law, and contrary status efficiencies will be unable to exert an influence.

3. The Degree to Which Incentives Are Important

In some situations, the incentive efficiencies will favor a different result than the status efficiencies. But bad incentives will not result in unwanted behaviors if no one learns of the decision. If the opinion is not reported, the judge has more freedom to give weight to the status considerations than in a reported case. The level of review is also important to the court's incentive sensitivity. Courts of appeals announcing decisions in opinions that will be

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94. Under the common law rule, the court strikes the interest if the interest might vest too late. Under the wait-and-see variation, the court must wait until it is impossible for the interest to vest in time before striking the interest. L. SIMES & A. SMITH, *supra* note 20, § 1230.

widely read will affect behavior more than trial judges whose opinions, if written at all, will not become known generally to the bar and public. So we might expect trial judges to be more sensitive to status efficiencies than appellate judges. This effect might counterbalance the fact that trial judges are less free than their appellate brethren to announce changes in the law.

At the least public end of the scale, juries should be the least concerned about incentive effects and, hence, in the best position to achieve desirable status efficiencies. On the other hand, juries might be more influenced by the justice and fairness dimensions of status effects than by the potential status efficiencies. If so, their greater freedom to consider status effects would not result in more status-efficient decisions.

4. Interpersonal Utility as a Predictive Factor

There is a way to extend the economic approach to cases in which there are no incentive effects and no status efficiencies. By factoring interpersonal utility into the model, the theory can be applied to cases in which the only status effects relate to wealth.[95] Hypothesizing 1) that judges or juries are willing to make interpersonal comparisons of utility and wish to maximize utility, and 2) that they believe people have the same declining marginal utility of wealth (or, equivalently, that people are similarly risk averse), one would predict a bias for the poor and against the rich.

Some might reject this use of interpersonal utilities on the ground that it is impossible to prove that one person's utility is higher than another's. But that is irrelevant to the model's predictive value, just as the extent to which standard economics is based on unrealistic assumptions is irrelevant to its value in prediction. Equally important, it is not clear that the model's assumption regarding utility is not true. The assumption is not that one party gets more utility from the asset than the other, but that the court *believes* that one party will get more utility than the other. A standard against which to measure the utility of something to two persons is not essential to a model of judicial behavior incorporating interpersonal utility. Such a model requires empirical data on the beliefs of the decisionmakers, not data on the actual utility functions of the parties.

A model maker might approach beliefs about interpersonal utility in two ways. She might include a factor in the model to account for judges' or juries' perceived marginal utility curve, fine-tuning the model by adjusting the slope of the curve to make the model fit the case results. Another approach is to study common perceptions about the utility of money and incor-

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95. *See* Hovenkamp, *supra* note 3, at 1054 (arguing that common law judges calculated economic consequences for the parties and similarly situated persons in a way resembling interpersonal comparison of utility).

porate those findings into the model. Careful analysis might reveal, for example, that different economic classes of people hold different beliefs about the slope of the curve. That might explain different responses of judges and juries to similar sets of facts. Thus, without making any interpersonal comparisons of utility, the positive scholar may include assumptions about perceived interpersonal utility as an independent variable in a scientific model of judge or jury behavior.[96]

Whether the builder of a model would wish to include such a factor is another question. Including a marginal utility factor in the hypothesis could enhance predictive power if those who perceive a redistributive cast to common law decisions are correct in their perception.[97] On the other hand, one good reason for not including perceived interpersonal utility in a positive economic analysis is that it makes the model too pliable. Little is known about how judges or juries perceive utilities. If their perception becomes a factor in the model, this factor may become a catchall to explain every decision not otherwise easily explained. Without good data on perceived interpersonal utility of income, that malleable factor makes it nearly impossible to disprove the model. A model that cannot be disproved can have but little scientific content and fails to further our knowledge beyond the unclear rules it purports to explain.[98] Until data is available on what judges think about the utility of income at increasing levels of wealth, it is better to avoid that factor in economically derived models of judicial decisionmaking.

IV. THEORIES OF EFFICIENCY OF THE COMMON LAW

I have suggested that searching for status efficiencies might uncover a structure or pattern within judicial decisions. But, aside from providing a few pertinent examples, I have not presented any reasons for expecting status or incentive efficiencies to work themselves into the fabric of the law. This section offers theoretical support for the claim that status efficiencies deserve attention by describing four theories of how the common law becomes efficient. Two of these theories cast judges as the directive agents in the development of efficient law. The other two see the selection and litigation of

96. On whether a science of economics can include interpersonal comparisons of utility, see Hovenkamp, *supra* note 3, at 1039-40 (pointing out weaknesses in the argument of economic positivists, who postulate that economics can be considered a science only if it can separate fact from value).

97. *See* Ellickson, *A Critique of Economic and Sociological Theories of Social Control,* 16 J. LEGAL STUD. 67, 99 n.114 (1987) (arguing that Posner's hypothesis on the evolution of common law in a wealth-maximizing direction is unpersuasive in light of the overtly-redistributive cast of many recent common law decisions).

98. *See* Rowley, *Public Choice and the Economic Analysis of Law,* in LAW AND ECONOMICS 127 (1989) (discussing the views of Karl Popper, as presented in K.R. POPPER, THE LOGIC OF SCIENTIFIC DISCOVERY (1959)); R. POSNER, THE PROBLEMS OF JURISPRUDENCE 365 (1990).

cases by parties as the engine of efficiency.[99]

A. JUDGES APPLY THEIR LEARNED VALUES, WHICH INCLUDE EFFICIENCY

The most straightforward theory is that judges have learned the principles and desirability of efficiency either through formal training or informal inculcation of societal values.[100] The formal training could include any study of economics. The informal learning occurs through the adoption of maxims and aphorisms. "Don't throw good money after bad" tells us to ignore sunk costs. "Don't bet the house on it" reminds us of the diminishing marginal return of income. "Waste not, want not" warns us not to behave inefficiently. The theory need not assume that all people in our society learn those lessons. It requires only that many judges have learned them. Judges then attempt to implement those values for the benefit of society, deciding for efficiency in the cases they hear. Judges reach efficient results because they value efficiency.

One of the questions raised by this judicial values theory is why, if efficiency is the judges' central or even an important concern, they so often frame their opinions in other terms. This question leads to the conjecture that the judges unconsciously reach efficient results. Nevertheless, if it were true that economics forms the fundamental structure of the common law primarily because judges have assimilated efficiency values, then it is likely that judicial opinions would contain more economic overtones than they actually do.[101]

B. JUDGES NATURALLY SEEK EFFICIENCY

There is another theory, not yet explored in the literature, explaining how judges promote efficiency in the law. In making their decisions, they might simply do what comes naturally, which includes avoiding inefficiency. The starting point for such a theory is that learning not to waste one's resources improves fitness for survival. Persons failing to conserve resources would

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99. These theories have been developed in the pages of the *Journal of Legal Studies*. *See* Cooter & Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?*, (J. LEGAL STUD. 139, 156 (1980); Goodman, *An Economic Theory of the Evolution of the Common Law*, 7 J. LEGAL STUD. 393 (1978); Landes & Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235 (1979); Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL. STUD. 65 (1977); Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977); Terrebone, *A Strictly Evolutionary Model of Common Law*, 10 J. LEGAL STUD. 397 (1981); *see also* LAW, BIOLOGY, AND CULTURE: THE EVOLUTION OF LAW (M. Gruter & P. Bohanna eds. 1983). For the historical roots of the idea and discussion of other forms of "evolutionary" development, see Hovenkamp, *Evolutionary Models in Jurisprudence*, 64 TEX. L. REV. 645 (1985).

100. *See* POSNER 3D, *supra* note 2, at 232.

101. *But cf.* R. POSNER, THE PROBLEMS OF JURISPRUDENCE, *supra* note 98, at 372-73 (doubting whether we should expect the deep economic structure of legal decisions to be expressed by judges in economic terms).

tend over time to have their genes eliminated from the gene pool. Not all of this efficiency-seeking proclivity need be genetic; judges can also learn experientially. A common law judge might learn about the potential tragedy of a commons by participating in, or reading about, the extinction of whales through hunting. Judges in Texas might learn about the wastefulness of rent seeking from local oil-drilling lore. Thus judges might act in the interests of efficiency because the human body and brain have evolved and learned to seek efficiency.

As with the learned values theory, this fitness theory requires only that those who become judges carry this trait, an assumption shown reasonable by their ability to accumulate essential credentials. The theory assumes that judges can sense what is efficient and what is not without applying any general propositions or maxims which they might have absorbed through formal training or acculturation. In this respect, the theory is different from the learned values theory. Whereas the first theory relies on a deductive application of efficiency principles learned through generalizations communicated by others, the fitness theory posits that the judge has or her genes have developed a sense of efficiency by generalizing from experience. Because of this difference, evidence that judges rarely write in terms even hinting of efficiency is not problematic for the theory. Judges may have insight beyond that displayed in their written opinions.[102]

Because potential inefficiencies of a case are external to the ethical judge, this theory needs some mechanism for bridging the gap between seeking efficient results for oneself and seeking such results for others. Empathy makes the connection. It is reasonable to assume that it is a survival advantage to project oneself occasionally into the shoes of another and appreciate the danger or wastefulness of her situation. An ability to learn vicariously, by hearing stories told by others about their experiences, enhances the ability to avoid wasteful actions. Empathy coupled to the taste for avoiding waste would cause judges to reach efficient results, even though they have no personal stake in the outcome.

C. THE LAW EVOLVES BY LITIGANT SELECTION

Two other theories of how the law incorporates efficiency apply the idea of natural selection directly to the process of dispute resolution rather than to those who decide the law. Both of these theories rest on the observation that most judges do not choose the cases they decide or the arguments and evidence they hear. In the common law process, the parties bring the cases to

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102. *But see* Cooter & Kornhauser, *supra* note 99, at 139-40 (arguing that although the law can improve over time due to judicial insight, such insight is generally represented only in judges' written opinions, which do not reflect a calculation of economic costs and benefits other than in a very narrow class of cases).

the courts. Several authors have developed the idea that parties to disputes behave differently when facing efficient rules and inefficient rules. Under one theory, parties are less likely to litigate when the existing rule is efficient; this is the theory of differential case selection.[103] Another theory hypothesizes that those parties whose case is supported by an efficient rule devote more resources to litigation than do parties urging an inefficient rule.[104] Professors Robert Cooter and Lewis Kornhauser have shown that under certain conditions differential litigation can move the law in an efficient direction.[105]

Under the theory of differential case selection, inefficient legal rules are litigated more often than efficient rules. Inefficient rules tend to generate litigation because they are wasteful, and there is a potential gain from changing the rule to a more efficient alternative. Assuming that judicial decisions are not skewed toward inefficiency and that the rules can change, efficient rules will prevail over time.[106]

The rule on easements by necessity provides a plausible example of how this theory might work. Assume Seller sells to Buyer a pasture that Buyer can reach only via Seller's land. After Seller dies, Heir takes over Seller's lot and decides not to let Buyer use the road. Suppose also that Buyer's use of the road generates benefits to Buyer of $5000 and costs to Heir of $2500. To prevent the possibility of settlement, also assume Buyer believes Heir's real costs are $100 and will not pay Heir a sum much greater than that; Heir believes Buyer's real benefits are $10,000 and will not accept a sum much less than that.[107] The cost of a lawsuit is $500 for each. If Buyer has no easement under current law, but has at least an eleven percent chance of distinguishing or overruling the precedent, a lawsuit has a positive expected value for Buyer and it would be rational for Buyer to sue.[108] If current law gives

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103. Cooter and Kornhauser call this "differential litigation." *See* Cooter & Kornhauser, *supra* note 99, at 139. But that term could mean variation in the decision to litigate, or variation in the amount spent in litigation, or both. Therefore, differential litigation is used here to refer to both aspects of litigant behavior, the choice of whether to litigate and how much to invest in the process. Differential selection refers only to the former and differential investment only to the latter. These theories should not be confused with those relating to the frequency of settlement. *See infra* note 110.

104. *See infra* Part IV.D.

105. *See* Cooter & Kornhauser, *supra* note 99, at 149-50.

106. It should be noted that the differential selection theory differs from the other three presented in this section in its support for the suggestion that status efficiencies might provide the key to unlock unclear areas of law. Differential selection presumes randomness in the outcomes of the decided cases. Therefore, according to this theory, the results of some cases should fly in the face of status efficiency.

107. Some experimental evidence of this sort of irrational behavior is presented in Kahneman, Knetsch & Thaler, *Fairness As a Constraint on Profit Seeking: Entitlements in the Market*, 76 AM. ECON. REV. 728, 736 (1986).

108. The expected value to Buyer is equal to the value of the easement multiplied by the chance of winning minus the litigation costs. This equals $5000 x .11 - $500 = $50.

Buyer an easement, and again there is an eleven percent chance of reversal, a lawsuit for Heir has a negative expected value and it would be irrational for Heir to sue.[109] In these circumstances, a lawsuit, through which the law might change, will occur only if the current law yields the inefficient result. Thus, the law might promote efficiency through differential selection.

It is quite possible for Buyer not to sue even when a lawsuit makes financial sense. She might find a way to settle the case, contracting around the law to reach the efficient result. Although settlement does eliminate some suits, it eliminates suits based on both efficient and inefficient rules. Thus, unless there is a bias that causes suits to be settled more often when the existing law is inefficient,[110] some frequency differential will remain in the litigation of inefficient and efficient rules. Buyer might also not sue if her subjective costs change her financial outlook. Subjective costs should have a similar effect on Heir's decisions, however, and in repeated play the greater rewards attending the efficient result should lead to more frequent suits to reverse the wasteful law.

In essence, this theory perceives judges as the creators of essential variation in rules, precedent as the means of the rules' inheritance or perpetuation, and society as the environment selecting the most efficient rules by throwing the bad ones back to the judges for another look. For this mechanism to work, judicial decisions need not be random from all perspectives, but only with regard to efficiency. For example, judges could decide cases according

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109. For Heir, the expected value is $2500 x .11 - $500 = -$225.

110. There is a substantial body of work on the conditions under which parties settle. *See, e.g.*, Cornell, *The Incentive to Sue: An Option-Pricing Approach*, 19 J. LEGAL STUD. 173, 180-81 (1990) (arguing that the various litigation options available to each party in the event a dispute should lead to trial affects a party's decision to settle or to proceed with the suit); Priest, *Reexamining the Selection Hypothesis: Learning from Wittman's Mistakes*, 14 J. LEGAL STUD. 215, 220 (1985) [hereinafter Priest, *Reexamining the Selection Hypothesis*] (arguing that a shift in a legal standard will lead to the litigation of a substantively different set of disputes and to differences in the terms of settlement of those disputes that are not litigated); Priest, *Selective Characteristics of Litigation*, 9 J. LEGAL STUD. 399, 421 (1980) (arguing that the behavior of parties to disputes is continually readjusted in response to estimates of the likelihood of the application of one legal standard or another, and is simultaneously constrained by selective characteristics such as the costs of litigation or settlement); Priest & Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 14 (1984) [hereinafter Priest & Klein, *The Selection of Disputes*] (theorizing that the determinants of settlement and litigation are solely economic, and include such factors as the expected costs of favorable adverse decisions, the information possessed by parties regarding their likelihood of success at trial, and the direct costs of litigation versus settlement); Stanley & Coursey, *Empirical Evidence on the Selection Hypothesis and the Decision to Litigate or Settle*, 19 J. LEGAL STUD. 145, 163-64 (1990) (analyzing the effect of legal costs, estimates of the probability of prevailing at trial, and the relative expectations of the bargaining parties on the process of settlement negotiations); Wittman, *Dispute Resolution, Bargaining, and the Reduction of Cases for Trial: Study of the Generation of Biased and Unbiased Data*, 17 J. LEGAL STUD. 313, 345 (1988) (considering factors such as trial costs, differential quality of information obtained by the litigants, differential bargaining strength, differential expectations regarding both the probability of the award and the amount of award given a verdict for the plaintiff, and differential stakes in the outcome).

to justice or class biases or what they had for breakfast without harm to the theory. If judges decide for justice and justice correlates positively with efficiency, efficiency advances even more quickly. But so long as the governing inclination, if there is one, is not negatively correlated with efficiency, the law can evolve, fitfully, toward more efficient rules without any conscious or unconscious effort by judges to achieve efficieney.

One critical assumption of the theory is that rules are reversed more frequently if they are reviewed more frequently. When the difference in frequency of review is extreme, the assumption is well-founded. A rule never reviewed can never be reversed and a rule reviewed frequently has at least some chance of reversal. But the assumption is dubious in other circumstances. At some frequency of review, reversals may stop becoming more likely. Moreover, reversals may actually decrease above that threshold.

The speed of reversal may level off as the frequency of potential litigation increases. If, for example, the efficient rule generates thirty potential cases that could reach the highest court and the inefficient rule ninety, precedent might be strong enough to prevent the large difference in opportunities for reversal from resulting in any real difference in the number of actual reversals. If the court is willing to overturn precedent and change the law, it has plenty of opportunities to do so in either direction. In addition, courts are unlikely to ignore recently decided precedent. So, even though an inefficient rule will generate more potential litigation, the near-zero likelihood of reversal during the period just following any decision prevents most suits.

Why might the number of reversals decrease as the number of reviews increases? Judges may feel more constrained by recent precedent than older case results, and more limited by frequently reaffirmed precedent than by precedent approved less often.[111] Lawyers and judges frequently argue that an old rule is based upon an antiquated rationale.[112] This argument, however, which often diverts attention from the appropriate issue of whether the old rule has current value,[113] is less available to judges wishing to overturn recent decisions. In addition, judges are more likely to overturn the decisions of others than their own decisions. Panels having the opportunity to overturn a recent precedent may include one of the judges that participated in the decision creating that precedent. Because older cases were decided by other

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111. *See* Landes & Posner, *supra* note 99, at 262-63 (pointing out that rules, regardless of their level of efficiency, are strengthened by the greater accretion of precedent because of the influence that precedent has on each successive decision involving that rule).

112. *See, e.g.*, Prah v. Maretti, 108 Wisc. 2d 223, 321 N.W.2d 182 (1982).

113. *See generally* Epstein, *The Static Conception of the Common Law*, 9 J. LEGAL STUD. 253, 254 (1980) (arguing that the substantive principles of the legal system need not continually change in response to social conditions, but rather can perform their essential functions only when they remain constant).

judges and older cases are more easily characterized as obsolete, older rules are easier to overturn.

The possibility that judges hesitate to change recently reaffirmed rules creates a serious problem for the differential selection theory. By suggesting that rules litigated more often are more likely to survive, it turns differential selection against efficiency. Frequent review confirms and entrenches inefficient rules rather than efficient ones. If this critique is true, we should expect that rules litigated frequently, such as negligence, would not move toward efficiency, although they may already be efficient. On the other hand, rules litigated rarely, say perhaps the *Zimmer* rule on recording priority in a race-notice jurisdiction,[114] could feel the pull of efficiency.

This frequency of review problem hints at one more question for the theory that rational litigant behavior naturally selects efficient legal rules. Have judges changed the rules in any areas of law often enough for selection to occur? Under the differential selection theory, the law flips back and forth between the efficient and inefficient rules. But we have not seen that much change on any one point of law, making it unlikely that particular rules have undergone evolutionary changes. Nevertheless, the theory could still work on a larger scale. Though in any specific area the law may not have arrived at the efficient rule, the whole set of rules looked at collectively may appear more efficient than inefficient.

Professors Louis De Alessi and Robert Staaf have recently cast another doubt on the ability of differential selection to achieve the efficient rule. They point out that the overall efficiency of a rule depends on the aggregation of the gains and losses resulting to parties on both sides of the rule.[115] The frequency of litigation ignores the magnitude of the efficiency differential. Suppose for example that in every fifth case involving an easement like that above the defendant's losses are ten times as great as in the example. Because of these large but infrequent losses, it would seem that the rule selected by differential litigation would be the inefficient rule. Although this is entirely possible, there is no obvious reason to believe that the magnitude of the amount at stake on one side of the case is negatively correlated to the frequency of that side's having the greater amount at stake.

D. THE LAW EVOLVES BY DIFFERENTIAL INVESTMENT

The fourth theory is quite similar in approach to the theory of differential case selection, but it differs slightly in the postulated behavioral response from litigants. Whereas the third theory assumes that parties litigate ineffi-

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114. Zimmer v. Sundell, 237 Wis. 270, 276, 296 N.W. 589, 591 (1941).

115. *See* De Alessi & Staaf, *The Common Law Process: Efficiency or Order*, 2 CONSTITUTIONAL POLITICAL ECONOMY 107, 112-12 (1991).

cient rules more often than efficient ones, the fourth theory assumes that the party litigating for the efficient rule will spend more in litigation than the party urging the inefficient rule.[116]

A slight change to the facts of the easement example illustrates this theory of differential investment. Suppose that neither party is favored by precedent because the highest court in the state has not decided the issue and other states are equally divided. Buyer should be willing to invest up to $2500 for a fifty percent chance of winning. Heir should be willing to invest no more than $1250 for a similar chance of success. If the two parties have lawyers whose efforts per dollar appear to be equally efficacious, there may come a point in the diminishing utility of further investment beyond which it is worthwhile only for Buyer to invest. Presuming that additional lawyer time and effort increase the chances of winning in court, the law will move toward efficiency. Because the resolution of each dispute is directly connected to the efficiencies, the aggregation problem identified by De Alessi and Staaf should be less pronounced for differential investment.

This theory does not assume that judges respond to the greater efficiency of one position. Rather judges respond randomly to efficiency but positively to better prepared, more expensive arguments. They reach the efficient result more often because the parties on the efficient side spend more to convince them. Thus, the efficiencies propel the lawyers, and they in turn move the court.

Differential selection and differential investment are two manifestations of the same basic idea: persons that would gain from the adoption or continuation of an efficient rule are willing to spend more to achieve that result than persons that would gain from applying an inefficient rule.[117] The difference between the two theories is not the principle at work but the cases we study to examine the principle. Differential selection compares the number of cases in which the efficient side decides that the investment in litigation should be zero to the number of cases in which the inefficient side will decide to invest nothing in litigation. Differential investment compares the amounts spent in situations in which both parties decide to invest something in judicial resolution of the dispute. The two theories also differ as to the case results they contemplate. Differential selection assumes decisions are randomly distributed on efficiency. Differential litigation predicts efficient decisions to be more frequent. Despite these differences, the two theories share the basic notion that the party on the side of the efficient rule systematically invests

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116. *See* Cooter & Kornhauser, *supra* note 99, at 139.

117. There are a host of other factors that may influence the frequency or investment in litigation, but it is not obvious that they are correlated with the efficiency of the outcome. *See* Wittman, *supra* note 110, at 345.

more in litigation than the party on the side of the inefficient rule.[118]

V. IMPLICATIONS OF THE STATUS-INCENTIVE DISTINCTION FOR EFFICIENCY THEORIES

The last section presented four theories which argue that the law moves in an efficient direction. Those theories support the idea that a close look at status efficiencies might provide an understanding of unclear areas of law. In this section I take the opposite perspective, asking what insights the status-incentive distinction might provide into the operation of these proposed mechanisms of efficiency.

A. JUDICIAL VALUES AND BEHAVIORS

According to the judge-based theories, judges try—consciously, subconsciously, or unconsciously—to avoid inefficiency, and they do so with some success. If the ability and inclination of judges might vary with the kind of efficiency at issue, the status-incentive distinction may help illuminate when they might succeed.

1. The Ability of Judges to Create Efficient Incentives

The incentive efficiencies of a decision seem difficult for a judge to divine. The judge must take into account all of the situations in which the rule created by the decision will be important. Only the rare judge could intuit the magnitudes of the marginal incentives a given decision would create for unknown actors across the jurisdiction. In some cases it might be difficult to tell whether the efficiency implications of incentives of a decision will be good or bad.

Consider an appeal on the question of whether a promise to pay homeowners' association assessments runs with the land, when the previous cases appear to have followed the simple rule that promises to pay money do not touch and concern. To achieve the incentive-efficient result other than by chance, the judges would have to determine the costs of additional lawsuits caused by muddying the doctrine with an exception to the previously simple and unbroken rule that promises to pay money do not run with the land. On the other hand, the incentive effects would also include any benefits of en-

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118. The work of Professors George Priest and Benjamin Klein suggests another way in which efficiency may be served by differential stakes. According to their analysis, differential stakes may lead to differences in success rates of litigation (independent of differences in investment in or the rate of litigation), with greater success going to the party with the higher stakes in the outcome. *See generally* Priest, *Reexamining the Selection Hypothesis, supra* note 110, at 220; Priest & Klein, *The Selection of Disputes, supra* note 110, at 28-29 (using empirical data to support the proposition that the party with the higher stake in the outcome of a particular dispute will prevail more frequently at trial and recognizing that cases involving injunctions or spite may have unbalanced stakes).

hanced covenant validity, such as the reduced use of inferior alternatives. Judges do not have, in their libraries or experiences, the information they need to weigh these and make the decision for incentive efficiency.

The litigants will also not be of much help. First, they might miss incentive efficiencies because the incentives created by a decision will fall mostly upon someone else—persons that are not yet in the position of the parties. For example, neither Shylock nor Antonio seemed to care much about how the resolution of their dispute would change their future contracting behavior. As suggested by Antonio's prediction that a decision for him would hurt trade,[119] the parties may be conscious of some incentive effects. Nevertheless, the degree to which lawyers have ignored incentives suggests that they frequently go unnoticed.[120]

Finally, recognizing incentives can be tricky. Assume, for example, that in a state with a race-notice recording act, *O* transfers to *A*, who does not record immediately. *O* then transfers to *B*, who also fails to record. *B* then transfers to *C*, who records. Finally, *A* records, just before bringing suit against *C*. At first glance one might think that a decision for *C* would lead to more frequent recording of deeds than a decision for *A*. Holding for *C* would indeed increase the incentives for future *A*s to record promptly and reward *C* for recording promptly. But the marginal increase in recordings would likely be small. Holding for *A*, on the other hand, would increase the incentives for *C* to ensure that *B*'s deed was placed on the record. The marginal increase in recording caused by making successors' rights dependant on the recording of earlier deeds in the chain of title would likely be greater than the increase resulting from a holding for *C*. The difficulty law & economics scholars have had in determining the best rule of tort liability is more evidence that incentive effects present stubborn problems not easily solved by judicial intuition, even if aided by the litigants' briefs.[121]

2. The Ability of Judges to Divine Status Efficiencies

A judge has a better chance of divining status efficiencies. The parties help uncover status effects by presenting the very situation giving rise to the status effects in their briefs and describing the bad effects that will result if the judge decides against them. Merely by projecting herself into the facts before her, the judge can appreciate many of the status concerns. It is easy for a judge to understand the argument of a homeowners' association that a refusal to uphold a covenant to pay homeowners' dues will prevent the association from

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119. *See supra* text accompanying note 8.

120. *See, eg.*, Javins, Saunders & Gross v. First National Realty Corp., 428 F.2d 1071 (D.C. Cir.), *cert. denied*, 400 U.S. 925 (1970).

121. *See* Epstein, *supra* note 46, at 1740-44 (discussing the difficulty of determining the efficient tort rule).

raising the funds needed to complete projects beneficial to all of its members. A judge can also easily see that Antonio will contribute little to the productivity of Venice if he is dead. The factual situation alone can thus alert judges to the various status-efficiency concerns, even those not argued by the parties.

Status effects are not limited to the parties before the court. They also fall on similarly situated persons that are not represented before the court. Because they are similarly situated, however, their efficiencies should mirror those of the parties. Therefore, the status-efficient decision for the parties will be the status-efficient decision for others. This close similarity of status interests between parties and nonparties stands in important contrast to the looser relationship between the incentives seen by nonparties and the interests of the parties. Status efficiencies are assured representation before the court; incentive efficiencies are not.

With or without explicit consideration, courts might do a fair job of determining the result that will avoid many status inefficiencies. Judges might be justified in saying, "I don't know how the public will respond, but I do know what my decision will do to these parties." And judges might act that way even if they would not be justified in saying so. In either event, the law would tend to develop more toward status efficiency than toward incentive efficiency.

3. Comparing Status and Incentive Efficiencies

Two conclusions can be drawn regarding the theories that judges are the agents creating efficiency in the common law. First, the common law is more likely to find an efficient rule when the key efficiencies are status related than when they stem from incentives. Second, in areas of law in which the incentive effects oppose and outweigh the status effects, judges will often reach an inefficient result. Parties are more likely to brief status effects and judges, who are better able to appreciate these types of effects, will be more secure in giving them weight in their decisions. The inefficiencies of Antonio's death might impress the court too much. Those concerns might inappropriately outweigh the less palpable incentive inefficiencies associated with the refusal to uphold the contract.

Consider an appellate court facing the argument that the Rule against Perpetuities ought to be eliminated. To make the more efficient decision other than by chance, the court would have to determine whether the Rule creates an incentive to consume assets and whether allowing grantors more freedom in transferring their property to others would reduce that incentive. In addition, the court would need to assess the costs associated with the additional

advice, drafting, and litigation possibly saved by eliminating the Rule.[122] Against these incentive effects, the court would have to balance the negative status effect that some property would be less useful because grantors would use their new freedom to tie up their property. Even if judges correctly guess the direction of the incentives without the help of theory, they could only speculate on the size of the incentive for each person and the number of persons subject to the incentive. Without such information, reliable determination of which efficiency concern is the greater seems unlikely.

B. DIFFERENTIAL LITIGANT BEHAVIOR

The theories of differential litigation claim that the common law evolves toward efficiency because inefficient rules generate greater incentives for litigation than efficient rules.[123] For this to happen, one party must see the efficiency gains as incentives or rewards for successful litigation.[124] It is not clear, however, that the litigants capture the benefits from the change to an efficient rule.[125] The status-incentive distinction can further the examination of this proposition.

The clarity of legal rules affects the incentives for suit; the muddier the rules, the more room for rent seeking.[126] But the possibility of winning in court creates incentives for suit, regardless of the rules' clarity. Because precedent can be overturned, there is always a possibility that the stakes will be high enough to justify the effort to change the law through litigation. The question here is whether the efficiency of the pivotal rule makes a difference to those incentives.

1. Natural Selection of Status Efficient Rules

In some cases, such as the easement example set out earlier,[127] the incentives for litigation differ on the efficient and inefficient sides of the rule. In other cases there is no systematic disparity in the incentives for litigation. Take a simple case involving the liability for latent defects known to the nonbuilding seller of a house. The common law rule was *caveat emptor*.[128] If, after the closing, a buyer finds that her house has a defect costing $10,000 to fix, she has a $10,000 reward for a successful challenge to the common law

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122. For a more complete analysis of the factors, see Stake, *supra* note 18, at 716.

123. *See supra* Part IV.C.

124. *See* Cooter & Kornhauser, *supra* note 99, at 154.

125. As Posner put it: "[T]he parties to the litigation have no interest in the future. Their concern is limited to the financial consequences of a past accident." POSNER 3D, *supra* note 2, at 22.

126. This does not mean there will be more suits. Muddier rules may create even greater incentives to settle.

127. *See supra* text accompanying notes 106-09.

128. *See* Annotation, *Liability of Vendor or Grantor of Real Estate for Personal Injury to Purchaser or Third Person Due to Defective Condition of Premises*, 48 A.L.R.3D 1027, 1035 (1990).

rule. If the jurisdiction has already adopted a modern rule imposing liability, the seller has a $10,000 incentive to challenge the modern rule. Because the rewards from successful litigation are equal and opposite, there is no reason to believe that the efficient rule will ultimately prevail or be in effect for more time than the inefficient rule.

The absence of status efficiencies makes this *caveat emptor* example different from the easement example above. The presence of status efficiencies in the easement case ensures that not all of the benefits of the efficient rule are external to the parties' decisions to litigate. Status efficiencies accrue at least in part to the prevailing litigant. Therefore, parties will consider them when deciding whether to litigate and how much to spend. How often and how vigorously parties argue a particular position on a legal issue is directly connected to the efficiency of its status effects. The greater the ratio of status efficiencies to the cost of a lawsuit, the more quickly the law should move in the direction of status efficiency by differential litigation.

2. Evolution Toward Incentive Efficiencies

Incentive efficiencies, unlike status efficiencies, may be wholly external to the parties to the dispute and in such cases have comparatively little ability under differential litigation theories to affect the law. This occurs when the litigants think they will never be in the same position again. If Antonio were rich enough, or dead enough, never to have to post a bond again, the incentives relating to such contracts would not matter to him. In other words, the improved efficiency of a better rule is a public good.[129]

When one of the litigants is a repeat player, however, the litigant will be affected by the incentive effects, and an inefficient rule is more likely to be differentially litigated. For example, real estate brokers engage in enough transactions to care about the incentive effects of the rules governing broker liability for latent defects. Therefore a broker deciding whether to litigate would consider a portion of the inefficiency caused by the incentives generated by the wrong rule. She might add that inefficiency, to the extent she will bear the loss, to any gains from the particular suit and decide to sue when the benefits would not otherwise justify the costs of litigation.[130] Repeat players such as the real estate broker do not have to suffer all of the societal inefficiency to be part of a tendency toward an efficient rule. They do not even

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129. *See* J. HIRSHLEIFER, ECONOMIC BEHAVIOR IN ADVERSITY 258-59 (1987); Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 57-58 (1977) (if neither party is a repeat player the current rule will persist regardless of efficiency).

130. An insurance company is another example of a party with a continuing interest in incentive efficiencies. Any benefit is diminished by the fact that the decision will also benefit competitors and they will bid away any new profits to be made from the reduced liability. But if the demand for insurance is highly elastic, the reduction in premiums might increase the demand for insurance.

have to suffer enough of the inefficiency to overcome the costs of suit. They only have to suffer appreciably more than their opponent would if the rule were the opposite.

Repeat players will challenge incentive-inefficient rules under the following conditions. First, the person whose actions will be influenced by the rule must recognize that the rule will influence her future actions in an inefficient direction. Next, she must see how she will bear part of that inefficiency. In other words, the potential litigant must recognize that she is a repeat player with a meaningful stake in the incentive effects created by the rule. She must also see an alternative rule that would reduce the incentives for inefficient behaviors. Furthermore, she must not think that competitors, who could also benefit, would bid away any potential profits from the better rule. Finally, she must overcome the freerider's urge to wait for someone else to change the rule. Under such conditions, a rule of law may develop that favors such repeat players.[131]

There are other ways for the efficient rule to be urged to a court. It is possible that someone would be willing to prosecute a suit solely for the perceived advantages to society. Indeed, this is common in environmental, civil liberties, and civil rights litigation. But how often does someone sacrifice her own well being when the greater cause is efficiency?

Coase teaches us to ask, when the incentives fall almost entirely on nonparties, whether those nonparties can internalize the positive (and negative) externalities by offering payment to the parties. When trade associations underwrite the litigation expenses of their members they make some of the positive externalities of the litigation internal to the member in litigation. Often, however, this will not occur because bargaining difficulties may prevent joint action within one side of the case in the same way that they prevent settlement between the two sides.

Collective action as a means of reducing the public good problem is not limited to internalizing incentive effects. Just as a group of developers might pay the costs of a suit to reverse a ruling that a dues covenant does not touch and concern if that rule would lead to incentive inefficiencies, a group of homeowners' associations might pay the costs of the same suit if the rule would carry status inefficiencies. Collective action may improve the ability of the law to evolve toward both status and incentive efficiencies. Unless there is some reason to believe that groups affected by incentive efficiencies are better able to overcome bargaining obstacles than groups affected by status efficiencies, the rules will remain biased toward status efficiency because of its direct connection to the parties' incentives to expend resources in litigation.

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131. It is also possible for repeat players to challenge efficient rules.

3. Impediments to the Development of Efficient Rules

Although the following points do not relate to the status-incentive distinction, the discussion would be incomplete without at least a mention of these obstacles to the evolution of efficient common law rules. First, it is always possible for courts to reverse an earlier decision and change to a less efficient rule. This may be done for justice or some other efficiency-neutral reason. The potential disregard for precedent upon which the theory relies makes it possible for the courts to abandon the efficient rule.[132]

Second, some inefficient rules may remain in effect because social customs prevent their litigation. Local custom may supplant the law with other rules.[133] Closely knit cultures can have rules of their own that may include a rule that members of the group will not use the legal system to resolve disputes.[134] If so, there is little likelihood that persons in such groups will bring inefficient rules to the attention of the courts. Therefore, areas of law for which most of the potential disputants are members of such groups will generate less litigation and will be less likely to evolve toward status or incentive efficiency.

Third, as Antonio would be quick to point out, the litigant's limited resources might prevent him from litigating the efficient position. Had Antonio's sympathizers not gained access to resources useful in pleading his case, the same bad fortune that prevented him from repaying Shylock on time would have prevented him from putting up much of a legal battle. Rules that work to the disadvantage of wealthy parties are more likely to be relitigated than rules that operate to the disadvantage of poor or middle class parties because wealthier parties have more resources to invest in litigation.[135] Where efficiency takes the side of the poor man, his limited resources may prevent the evolution of law in that direction. Moreover, Cooter and Kornhauser point out the possibility that rules that work to the advantage of the rich are disproportionately inefficient rules.[136] If that is so, differential litigation will create a bias toward inefficient rules.

A final note: even when the court chooses the efficient rule, that choice does not mean that the process of litigating and reaching that rule is efficient. Because the parties do not bear all the costs of the battle—the public pays for

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132. *See* Cooter & Kornhauser, *supra* note 99, at 141-42.

133. For an illustration, see Professor Robert Ellickson's study of the rules governing Shasta County ranchers, in Ellickson, *Of Coase and Cattle: Dispute Resolution among Neighbors in Shasta County*, 38 STAN. L. REV. 623, 672-85 (1986) (rural residents of Shasta County rely mainly upon self help to enforce own rules on damage done by stray livestock). Another example is the internal rules governing the behavior of members of organized crime.

134. *Id.* at 679 (ranchers pride themselves on being able to resolve disputes on their own land and rely on official help only to deal with rustlers).

135. Legal services programs may reduce this effect.

136. Cooter & Kornhauser, *supra* note 99 at 152.

the courts—the costs of making the change may outweigh the gains from changing the law to a more efficient rule.[137] Even if we set aside the costs born by the public, the dynamics of legal fights can cause the parties themselves to spend more on the fight than they stand to gain from winning.[138] Therefore, an efficient set of rules does not necessarily justify, even on efficiency grounds, the process that generated those rules.

C. DIFFERENTIAL DISPUTE GENERATION

Neither the judge-oriented nor litigant-oriented theories of efficient law propose a mechanism that would lead the law strongly toward efficiency when the primary economic concerns relate to incentives. There is, however, another means by which the law might evolve toward efficiency in these situations.

The differential dispute generation effect hypothesizes that inefficient rules lead to more disputes than efficient rules. For example, if a court imposes a duty on sellers of houses to warn buyers of any latent defects known to the seller, sellers will probably start warning buyers. If the warnings become a regular part of the transaction, the opportunity for relitigation of the issue will not arise. If it is more efficient for the seller to warn the buyer, placing the burden of discovering latent defects on the buyer will result in more disputes and therefore more opportunities for suit.

Stated more generally, if the law places the incentive to avoid the situation leading to the dispute on the party that can more cheaply avoid the situation, the situation will arise less often.[139] Thus the law could tend toward rules that create more efficient incentives. Even with random judicial decisions, the incentive-efficient rule would be in effect longer than the inefficient rule because disputes would not arise as quickly.

Not surprisingly, this differential dispute generation effect has limits as well. At least two are obvious. First, this mechanism can work on only a limited class of incentives, those for which inefficiency results in a dispute as opposed to those that generate some other waste of resources such as idle plants or workers. Second, like the differential litigation theories, this theory might not work on rules litigated frequently.[140]

As illustrated above, there are a few different ways the law could flow,

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137. *See generally* Rose-Ackerman & Geistfeld, *The Divergence Between Social and Private Incentives to Sue: A Comment on Shavell, Menell, and Kaplow*, 16 J. LEGAL STUD. 483, 484 (1987) (arguing that efficiency will occur only if one party is responsible for all legal costs or if its costs are below damages at optimal care).

138. *See* Tullock, *Efficient Rent Seeking*, in TOWARD A THEORY OF THE RENT-SEEKING SOCIETY 97, 102 table 6.2 (1980).

139. *See generally* G. CALABRESI, THE COST OF ACCIDENTS (1970).

140. *See supra* PART V.B.

gently and with contrary eddies, toward efficiency. Some mechanisms may foster status efficiencies; others may encourage incentive efficiencies. As biological evolution has not led to one efficient organism, however, legal evolution has not led and will not lead to the efficient set of laws.

VI. IMPLICATIONS FOR THE FIFTY PERCENT HYPOTHESIS

Recent law & economics research has generated a substantial body of work on how and why legal disputes are litigated and settled.[141] One of the keystones of this literature is a theory about the selection of disputes for trial and rates of success at trial. Important within this theory is the fifty percent hypothesis, which states that half of the cases litigated will result in a victory for the plaintiff and half for the defendant.[142] The status-incentive distinction, however, exposes an important limitation on this theory by identifying situations in which the fifty percent hypothesis does not apply.

The fifty percent hypothesis applies only when the stakes are the same for both parties.[143] The literature recognizes that the stakes will be unbalanced when one party is an institution or other repeat player, with a greater stake in the outcome than the opposing litigant.[144] Some of the status effects that would ordinarily fall on nonparties may accrue to the institutional party. And the result of the case may generate incentives that influence future behaviors and transactions involving the institutional player.

The literature does not pay enough attention to the additional possibility that the stakes can be unbalanced even when neither party is an institution. Status effects can include inefficiencies that will be felt by ordinary parties.[145] It is possible, and in situations such as Antonio's it is likely, that one party places a higher value on the rights in question. Moreover, even when ownership of the rights generates the same benefits for both parties, it is possible that success by one party will allow the party to transfer the asset to a more appreciative third party through a market exchange, whereas success by the other would impede such a transfer. In either of these situations one party will have a greater stake in the outcome than the other. The fifty percent

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141. *See, e.g.*, BAXTER, THE POLITICAL ECONOMY OF ANTITRUST: PRINCIPAL PAPER BY WILLIAM BAXTER (R. Tollison ed. 1980) (discussing impetus and constituencies behind antitrust rules); Eisenberg, *Litigation Models and Trial Outcomes in Civil Rights and Prisoner Cases*, 77 GEO. L.J. 1567, 156 (1989) (factors such as bias, regional influence, type of case, and quality of counsel and of resources all affect litigation outcomes); Priest & Klein, *The Selection of Disputes*, *supra* note 110, at 4 (factors determining which cases settle and which are litigated are economic, including expected costs, likelihood of success, and other direct costs).

142. Eisenberg, *Testing the Selection Effect: A New Theoretical Framework with Empirical Tests*, 19 J. LEGAL STUD. 337, 338 (1990).

143. *Id.* at 339.

144. *Id.*

145. *See supra* Part III.D.

hypothesis should, therefore, be limited to cases lacking substantial status efficiencies.

VII. CONCLUSION

Judicial decisions make rules, creating incentives for future actors and shaping their behaviors. At the same time, judicial decisions distribute rights and duties, changing the status of the parties and those similarly situated in the present and future. Status effects—the changes to the state of being of parties and others in their position—have not only distributional but also efficiency ramifications. Because both incentive and status efficiencies are important to the balancing of economic costs and benefits in a judicial decision, a normative analysis that ignores either type of efficiency is incomplete. Hence, systematic attention to status and incentive effects can help us critique normative applications of economic theory to issues confronting judges, and can build a more comprehensive normative position.[146]

Sensitivity to both incentive and status effects may also help us generate hypotheses for descriptive and predictive analysis of the law and aid in the understanding of the law when the rules are clear. In areas of law that lack clear rules, status efficiencies might prove especially fruitful because unclear law is difficult to understand using incentives. Examples from the Rule against Perpetuities and servitude law demonstrate the effectiveness of the status approach in positive research. The theories of how law becomes efficient offer a theoretical reason to believe that attention to status efficiencies may further our understanding of the law.

Professors Ernest Gellhorn and Glen Robinson once considered it puzzling that the new law & economics scholarship developed models earlier and more extensively in the area of tort law than in property.[147] The distinction between incentive and status effects may explain that pattern of development. As the balance of the economic effects of judicial decisionmaking shifts from incentives to status, the method of the new law & economics, focusing on inefficient incentives, becomes less useful. Those scholars may have paid comparatively little attention to property doctrine because there the incentive effects are relatively minor. Property law often involves planning, and changed incentives lead mainly to changes from one sort of legal document

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146. Though the distinction has been applied here only to the consequences of common law judicial decisions, separating status and incentive effects might also help us understand legislation, *see supra* note 19, and judicial reactions to legislation, *see* Welch v. Henry, 305 U.S. 134, 147-48 (1938) (upholding a due process attack on a retroactive state statute when the statute would have had no incentive effects and distinguishing earlier cases invalidating retroactive taxes that would have had incentive effects).

147. *See* Gellhorn & Robinson, *The Role of Economic Analysis in Legal Education*, 33 J. LEGAL EDUC. 247, 268 (1983).

or transaction to another. The incentives of decisions in such areas of law fall primarily on lawyers rather than the public.

The distinction between status and incentive effects also illuminates problems with theories explaining how the law tends toward efficiency. Regarding theories that judges favor efficient results, there are reasons to believe that courts lack the institutional competence to assess fully the efficiencies of the incentives they create. Yet an evolved distaste for waste might lead judges to avoid case results having status inefficiencies. Because the facts important for making the status efficient decision are usually palpable to the parties and apparent to the court, it may be within the judge's ability to achieve the status efficient result. Posner has argued that courts are better placed to seek efficiency or wealth maximization than distributional goals.[148] The analysis here supports a narrower view of the economic role of courts. As a normative matter, because judges are better suited and situated to achieve status efficiency than incentive efficiency, it might be more appropriate for courts to aim for status efficiency than to attempt to achieve overall efficiency by their decisions. The decision that the achievement of status efficiencies comes at too high a cost in incentives might best be left to legislatures.

This normative observation about relative suitability suggests an explanatory point as well. Where incentive efficiency is the key objective, the courts may need legislative help. If the goals and effects of an area of law relate primarily to status efficiency, on the other hand, legislative intervention will be little needed and even less observed. This could explain why in the antitrust area, for example, Congress left much of the development of the law to the courts after granting the power to achieve status efficiencies by breaking up monopolies.

The status-incentive distinction also helps us to see that theories predicated upon a differential in the behavior of litigants do not fully account for the possibility that incentive efficiencies are more likely than others to be external to the calculus of potential litigants. Because they are mostly external to the parties, it is hard for incentive inefficiencies to create a differential in the frequency or vigor of litigation. Status inefficiencies have, by contrast, a direct impact on the parties to the suit and should therefore influence the litigation behavior of the parties. The attenuated nature of the mechanisms favoring incentive efficiencies partially undermines both suggested theories of the evolution of an efficient common law. A theory of differential dispute occurrence might help explain how incentive efficiencies filter into the law.

Still, none of the theories offers a promising way for the two sorts of efficiency concerns to be balanced against each other when they conflict. Be-

148. R. POSNER, THE PROBLEMS OF JURISPRUDENCE, *supra* note 98, at 359.

cause of this, status efficiencies that drive the law may lead to inefficient incentives. If status efficiencies do indeed pull more strongly on the law than incentive efficiencies, they will draw the law away from overall efficiency when the two conflict and the incentives are more important. There is, however, no reason to believe that the two correlate negatively as a general matter. Therefore, the net effect should be one of moving the law in the direction of efficiency, even if not in all particular areas.

Despite their limitations the theories give some reason to believe in a weak bias in the direction of more efficient rules and decisions. That is a hopeful note, but not one that should generate any confidence that existing rules, or the processes by which rules are made, are in fact efficient.

I have used the status-incentive distinction to cast some light on general theories of legal evolution and the behavior of judges and litigants. I have also given examples of how status effects can be used to generate understanding in particular areas of the law. The theories presented to explain how status efficiencies can make their way into judicial decisions and the law offer a theoretical reason to believe that other areas of the law can also be understood by attention to status effects. Where prior cases and relevant statutes leave decisionmakers discretion, judges have an opportunity to follow their natural or learned inclinations to avoid inefficiency. And the facts of the case and the arguments of the parties will impress the status efficiencies upon judges and juries. The less these decisionmakers are constrained by prior cases and statutes, the more they will decide in the direction of status efficiency. On the other hand, where the rules of law are clear, status efficiencies may draw the law in their direction by selective litigation, with the inefficient rules getting more chances to be overturned. These two points could be combined to form a general theory of status efficiency in the law: decisionmakers decide cases as if guided toward status efficiency. But such a theory is some distance away. For the time being, it is enough to see whether the status approach can achieve additional microsuccesses. The general hypothesis will seem more reasonable and worthy of examination if particularized applications of the status approach succeed in explaining the law.

Efficiency in judicial dispute resolution might be likened to a current in the ocean: it can work without being seen or heard. Just as sailors overcome the currents of the ocean, judges may overcome the pull of efficiency when they have somewhere else to go. Efficiency may determine the outcome of a case as rarely as a current controls the movement of a ship at sea. And, most of the time, we may predict the motions of courts and ships better by listening to judges and captains than by charting the currents. But their lack of ultimate control does not make the currents unimportant. Judges are not always as sure of their direction as are captains, and currents of efficiency may carry the law when the judges row in opposite directions. Economic hypotheses

may explain the drift of cases when other sources of understanding fail. The distinction between status and incentive effects may help us to understand the currents flowing deep in the judicial decisionmaking process.