Law & Economics
Association of New Zealand

SIR IVOR RICHARDSON'S ADDRESS TO INAUGURAL LAW AND ECONOMICS COURSE

This issue of LEANZ is devoted to reproducing the full text of the LEANZ Patron, and President of the Court of Appeal, Sir Ivor Richardson's, thought provoking address to Victoria University Law Faculty's Inaugural Law and Economics Course. Any comments on Sir Ivor's speech would be most welcome, and should be addressed to Samantha Sharif at Chapman Tripp Sheffield Young (contact details are on page 9 of this newsletter).

INTRODUCTION

There are two features of the New Zealand legal system which makes Economics and Law an important field of study. The first is that the courts allocate and reallocate resources and their decisions necessarily affect the use of society's limited resources. Justice may be priceless. But it is not costless. The acceptable resolution of disputes may involve balancing human rights and other values, fairness considerations and resource constraints. But the efficient use of scarce resources and the economic implications of suggested alternatives should never be ignored: Just as in the decisions we make as individuals as to how we will spend our energies and our money, there are always policy trade-offs between efficiency, fairness and other individual and community values.

The second feature is that, like economics, the legal system is concerned with behaviour. It seeks to influence behaviour by establishing rules of conduct and imposing sanctions for their breach. Rules and sanctions should be designed and decisions made having regard to resource implications.

Regrettably there is very little published empirical research and analysis of our laws and their administration. It is much easier to rely on intellect and to engage in intuitive reasoning in drawing conclusions, rather than to get out on the ground and try to ascertain what happens in practice and to explore the costs and benefits of legal rules and administrative approaches. But empirical analysis is important. It is crucial in any public policy analysis. In that inquiry the links between the disciplines of economics and law need to be emphasised rather than be seen

UPCOMING SEMINARS (DETAILS INSIDE)

- *Ninth John M Olin Annual Conference in Law and Economics*
  Canadian Law and Economics Association (CLEA)
  26 - 27 September 1997
- *Asia Pacific Economic Law Forum*
  Canterbury University School of Law and Asia 2000 Foundation of New Zealand
  5 - 7 December 1997

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as boundaries beyond which it is not necessary to travel.

It is true that in the great majority of cases before the courts there is no scope for economic or for that matter any other analysis of the law. The applicable legal principles are already settled, or the statute is clear. But in some cases there is room for divergent answers. This is true both at common law and under legislation. The direction of development of the common law depends on what analogies are used and on an assessment of the underlying values involved. In exploring what legislation means, the courts are required to consider the public policies which the legislation serves. Again in rare cases the courts consider whether an existing rule should be replaced as no longer meeting the public interest. In other cases it may be helpful for the courts to understand the economic and social policies underlying legal rules and their impact on behaviour. This is particularly so where the courts are exercising discretions; and an unthinking rejection of any cost benefit analysis of alternatives may well lead in the long run to results which the legislature or common law could never have intended. Intuitive assessments of the public interest are likely to be improved to the extent that they are supported by hard facts.

This leads to consideration of the role of law and economics in today's society. Any survey of democracies shows that different societies give different emphases to different values and the emphases may change over time. Particularly over the last 10 years the economic, social and political landscape has changed markedly. Apart from structural changes affecting the economy and the nature and degree of governmental involvement, there have been many changes in attitudes, in the way of looking at the economy, at the functioning of government and at society. Yet, while the level of government intervention has generally been receding, courts have in some commercial areas taken a more pro-active role. Courts in New Zealand, and in Canada and Australia, have not been backward in recent years in developing restitution principles and constructive trusts; in exploring unconscionability and unjust enrichment; in extending duties in negligence and tort law generally; in implying terms and remedies in contractual situations; in advancing controls over the exercise of state powers.

Major economic, social and political change inevitably calls in question public policies underlying legal rules. Where there has been so much economic and social change, it becomes all the more important to take stock of our laws; to enquire whether they truly reflect the values of today's society; to assess their economic and social implications. In that stocktaking the allocation of scarce resources necessarily involves weighing egalitarian and community values along with efficiency concerns.

In reflecting the scheme and purpose of legislation, those engaged in statutory interpretation can be expected to approach new or amending legislation conscious of those changes. Likewise, common law and public law rules may need to be reappraised through a contemporary lens. It does not follow that there will be less litigation. There may well be more if the community perspective is that the public policies underlying particular legal rules have themselves changed. Again, if as has been suggested, agreement on legislative change will be more difficult to achieve under MMP, more policy issues may reach the courts.

The "Old" and "New" Law and Economics

Lawyers and economists are familiar with the use of economic concepts and the engaging of economists in what has been called the "old" law and economics. Obvious examples are competition and regulation, planning and resource use, and valuations for various purposes. Some tax cases too, such as those involving transfer pricing and international tax questions, necessarily require economic analysis. And statutes such as the Commerce Act 1986 are written in language that calls for economic analysis.

Such litigation raises a familiar set of problems first for the lawyers involved and then for the judges. The first step for lawyers is to identify the relevant economic issues in a case and to ensure that the expert addresses all the questions that truly fall for consideration. The next set of problems involve comprehending the expert analyses, gaining depth and understanding of often complex ideas and testing and evaluating novel approaches. The *Telecom v Clear* litigation highlights the problems that that may involve.

In the last 30 years a much wider use of economic analyses of legal rules has developed particularly in North America. The great American Judge, Justice Holmes of the United States Supreme Court, foresaw this 100 years ago. He said *"For the rational study of the law the black letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics."*[1]

Positive economic analysis describes economic impacts of existing rules and predicts responses to proposed policy changes. It assumes that most individuals are motivated by rational self-interest. In terms of supply and demand analysis it assumes that in most contexts more goods and services will be supplied at higher than at lower prices, and that fewer goods and services will be demanded at higher than at lower prices. The fundamental assumption is that people respond to incentives in any pricing system. In buying and selling people respond to prices in the market. They also respond to the costs implicit in legal rules governing transactions and conduct, whether it is the law of contract, torts, equity, competition law, tax law – or human rights law.

Normative economic analysis is far more controversial than positive economic analysis. It is judgmental. It asks whether a particular existing rule or policy change will make those affected better off in terms of how they perceive their own welfare. It tends to reflect philosophical or ethical justifications for private ordering over collective methods of resource allocation. Both concepts of efficiency – Pareto and Kaldor-Hicks – reflect a philosophical as well as an economic justification for private ordering. Pareto efficiency asks whether the particular rule or policy change makes somebody better off without making anyone else worse off. Kaldor-Hicks asks whether the result overall is beneficial in economic terms. It is a utilitarian greatest happiness of the greatest number approach. Both tend to reflect the assumed virtues in many contexts of the private exchange or market process over collective methods of resource allocation.

It is this kind of use of economic analysis in determining economic and social policies that has attracted very mixed responses. A society where everyone is intent on maximising their own wealth has its limitations.

Economic thinking has made significant contributions to the development of old law and economics areas such as competition law and resources law. Rather than explore those fields I want to discuss quite briefly the application of positive economic analysis in two basic areas of private law – contract and tort and end with some comments on the exercise of discretion.

Contracts

To put the point directly, whenever the courts draw on fairness or other values to modify contracts, they change the price agreed on by the parties unless the parties have already factored the risk of court intervention into their pricing, which in turn inflates prices and cost and thus has consequences for the functioning of the market.

The *DHL*[2] case was a claim for consequential loss arising from misdelivery of a package by a courier firm. The airbill described the contents as documents of no commercial value. The package contained a bearer bill of lading which enabled the holder to obtain possession of goods. The holder went bankrupt and the goods were not recoverable. The exporter, Richmond, sued the courier, DHL. The courier's contract was to deliver the package to Italy, and for $22.50. Not surprisingly the contract contained exclusion and liability limitation clauses and time bars.

The significance of the case is not so much in the result as in the approach: the emphasis on the factual matrix; on the contractually agreed allocation of risks and responsibilities; on the commercial appropriateness of that agreed allocation.

In *DHL* we did not review the conventional approach to standard form contracts and exclusion clauses from a law and economics perspective. Courts tend to view standard form contracts and exclusion clauses with suspicion as the products of inequality of bargaining power and imperfect information available to the weaker parties.[3] Empirical analysis may not warrant such a critical approach on the part of the courts. No one complains that prices for goods and services are generally set on a take it or leave it basis. Constant haggling over price necessarily involves high transaction costs. For the same reason standard form contracts may in

many contexts also permit a dramatic reduction in transaction costs and so in prices. The whole market may be disciplined by the competition afforded by buyers who understand the terms and can negotiate or switch to other suppliers offering more favourable terms.

The reality is that intrusion by the courts on the opening of markets tends to add to the cost of the goods or services. Where resources are scarce, as they always are, trade-offs are always involved – here between greater protection for consumers and higher retail prices. That may involve balancing considerations of efficiency and fairness. And fairness values should recognise that the contractual price might well have been higher had the impugned exclusion clause or standard terms not been included in the contract. One only needs to consider the different sale prices attaching to different warranties or other terms of contract to appreciate that reality.

In respect of contractual remedies, the standard enquiry in law and economics analysis is which court designed remedy – specific performance or the payment of money damages – is more cost effective? In the case of party designed remedies, what may at first blush appear to be a penalty clause may be both economically efficient and fair as between the parties. Examples are where the owner places a high subjective value on early performance of a building contract and the builder is the best possible insurer of the loss of that value; and where in the absence of a trace record a prima facie steep damages clause may be the most efficient means of ensuring the provider's ability to perform the contract and so enable it to be awarded the contract. Again, interference under statute[4] with the contractual arrangements of the parties may be muted if it is shown that the likely long run effect is to increase costs and prices for the supply of such goods and services, and so to make it less likely that disadvantaged sections of the community will have reasonable access to goods and credit. Regrettably there seems to have been no economic analysis of the impact of discretionary decisions of the courts under that contracts legislation – at least we have never had any material of that kind referred to us.

A more down to earth example is *House v Jones*.[5] The Court of Appeal used movements in the Consumer Price Index to show that it would be unjust to allow the purchasers to complete a 1980 transaction paying in 1985 dollars. In the result the purchasers were refused relief under the Illegal Contracts Act 1970 for breach of the Land Settlement Promotion and Land Acquisition Act 1952.

TORTS

I turn to torts, and, in particular, negligence. Torts may be viewed as supplementing contract law by devising rules for allocating or spreading losses in situations where it is too costly for potential injurers and potential victims to enter into contractual relationships with each other to make that allocation. In classical legal theory the tort of negligence involves the defendant's breach of a duty of care to the plaintiff. The normative efficiency goal of tort law proposed by Calabresi in *The Cost of Accidents: A Legal and Economic Analysis*, is that the rule of tort liability should be structured so as to minimise the sum of precautions, accident and administration costs. Interestingly, that law and economics approach is reflected in leading cases in the United States and Australia. In United *States v Carroll Towing Co*,[6] the great American Judge Learned Hand put it in this way:

"Since there are occasions when every vessel will break away from her moorings, and since, if she does, she becomes a menace to those about her; the owner's duty, as in other similar situations, to provide against resulting injuries is a function of three variables: (1) The probability that she will break away; (2) the gravity of the resulting injury, if she does; (3) the burden of adequate precautions. Possibly it serves to bring this notion into relief to state it in algebraic terms: if the probability be called P; the injury, L; and the burden, B; liability depends upon whether B is less than L multiplied by P; i.e. whether B<PL."

Turning to Australia, there is an interesting passage in the judgment of the now retired Chief Justice, Sir Anthony Mason in *Wyong Shire Council v Shirt*:[7]

"In deciding whether there has been a breach of the duty of care the tribunal ... must first ask itself whether a reasonable person in the defendant's position would have foreseen that his or her conduct involved a risk of injury to the plaintiff or to a class of persons including the plaintiff. The perception of the reasonable person's

response calls for a consideration of the magnitude of the risk and the degree of probability of its occurrence along with the expense, difficulty and inconvenience of taking alleviating action."

As has been said, it is Learned Hand without the algebra. In short, the law demands no more and no less than cost-justified precautions against accidents.

City of Richmond v Scantelbury[8] is an example of cost-benefit consideration in nuisance. The plaintiff's house was damaged by the spread of roots from elm trees in the adjacent city park. Kaye J concluded that whether there were any reasonable precautions which the City Council could have taken to prevent or minimise the risk to the plaintiff's house from encroaching roots required comparison of the cost and convenience of removing or reducing that risk with the extent of the damage likely to be wrought by the nuisance if not prevented and the cost of repairing the damage. A concrete barrier costing $6,040 would have averted the risk and the extra cost of repairing the house was $13,400. It followed that the cost of avoiding the risk was not disproportionate to the resulting damage.

There is much to be said for identifying economic and social considerations underlying legal principles in their discretionary application and thus opening them up to scrutiny. A recent illustration is the *South Pacific* case.[9] We held that policy considerations told against imposing a duty of care in tort towards the insured on the part of a private investigator appointed by the insurer to report on a suspicious fire. The primary policy consideration so far as I was concerned was that any claims could and should be pursued down the contractual chain.[10]

These were commercial premises and commercial insurance contracts are frequently negotiated through brokers. The amount of the premium is the price paid for the particular cover agreed. If the insured have a remedy in contract against the insurer they should exercise that remedy. If they do not have an adequate remedy that is because they only paid a premium which gave them that lesser protection. In that situation I cannot see any justification for allowing them a greater recovery through tort than they were prepared to pay for in contract.

The second contract is between insurer and investigator. There too, the parties have their expressly or impliedly agreed remedies for any negligence in the performance of the contract[11] and in the absence of an exclusion of liability the duty of care applies both to the work of the investigator which results in the report and to the report itself.

I added that it was not suggested in argument that through oligopolistic trade practices or other market failure the parties to such commercial insurance arrangements could not be expected to arrive at commercially acceptable bargains. It was not suggested that state intervention through the imposition of legal obligations in tort was required in the public interest to redress that kind of imbalance.

Another recent tort case where public policy considerations were important was *Fleming v Securities Commission and Taranaki Newspapers Ltd.*[12] The newspaper published an advertisement for securities. The form of the advertisement did not comply with the Securities Act. The question was whether the Securities Commission had a duty of care to potential investors to prohibit investments in breach of the Act, and whether the newspaper had a duty to ensure that advertisements complied with the Act. We said No. In rejecting the plaintiff's claim against the newspapers I emphasised that to impose a duty of care could inhibit the free flow of information *"and change the cost structure of the media to the detriment of commerce and the wider public"*. [13]

Part of the current problem is the reluctance up to now of litigants and their advisers to go to the expense and effort of undertaking cost-benefit analyses. Litigants are understandably more concerned with resolving their own cases than with providing the court with the means of governing the future behaviour of others. But without adequate data and the consideration of a range of views there is a risk that an impressionistic economic analysis will add little to existing intuitive assessments of the public interest considerations.

The associated problem is the absence of any economic analysis of the likely impact of imposing a duty of care in the first place, for example on local bodies for the carelessness of building inspectors[14] or on a solicitor to unnamed intended beneficiaries under a will which the solicitor failed to prepare.[15] Who bears the cost in the short run? In the long run? At what price? What would be the likely effect on behaviour of all of those involved – including insurers? There are wider questions, too. Should tort law protect the public

purse by adopting a more onerous approach where the defendant is the government than where it is private enterprise.[16] Is the emphasis on reallocation of losses through the tort system the most efficient way to regulate behaviour? Is it equitable? Is it appropriate in today's society?

What I might call the Chicago label is often used pejoratively to dismiss the whole of law and economics as right wing ideology. But any misgivings or qualifications about the application of normative economic analysis cannot justify ignoring the importance of positive economic analysis in the evaluation of legal principles and policy changes.

Exercise of Discretion

Discretion implies choice. Conscious of the public interest in the efficient use of resources, New Zealand courts are likely to be increasingly interested in all the anticipated outcomes of the orders they are asked to make. They are likely to be increasingly interested in assessing the true costs to society when weighing communitarian or collective goals. They are likely to take that calculus of expected outcomes into account in making those choices.

For example, in relation to discretionary remedies in administrative law, what does experience indicate are the likely economic and social effects on the administration of a government department, on the individuals involved, and the ultimate outcome of the particular process challenged in the courts, if decisions of Ministers and officials are quashed?

Again, where appeal is by leave only, what are the likely direct and indirect costs and the likely effects on those concerned of granting leave, - including the indirect costs of clogging the court lists?

Conclusions

Economic analysis is not an Aladdin's lamp. There is more at stake than market trade-offs. Efficiency concerns are only one factor in an assessment of the public interest. But we need to appreciate the economic costs of less efficient solutions.

One of the major challenges facing the courts, the legal profession and the public sector generally is how to obtain and test economic and social data to ensure that existing rules and policy alternatives are assessed in an informed and systematic way. An understanding of law and economics will be crucial and I am very pleased that the Law and Economics Association of New Zealand and the Faculty of Law have taken the initiative to establish this course.

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1 *The Path of the Law* (1897) 10 HarvardLR 457.

2 *DHL International (NZ) Ltd v Richmond Ltd* [1993] 3 NZLR 10.

3 See for example *Macaulay v A Schroeder Music Publishing Co Ltd* [1974] 1 WLR 1308, at 1316 and *Livingstone v Roskilly* [1992] 3 NZLR 230, at 238; cf *Contractors Bonding Ltd v Snee* [1992] 2 NZLR 157, at 174-175.)

4 For example, under the Contractual Remedies Act, Credit Contracts Act, Fair Trading Act or the Illegal Contracts Act.

5 [1985] 2 NZLR 288.

6 (1947) 159 F 2d 169.

7 [1980] 146 CLR 40, at 47-58.

8 [1991] 2 VR 38.

9 *South Pacific Manufacturing Co Ltd v NZ Security Consultants & Investigations Ltd* [1992] 2 NZLR 282.

10 At page 308.

11 See *Gold Star Insurance Co Ltd v Dominion Adjusters Ltd* [1982] 2 NZLR 38.

12 [1995] 2 NZLR 514.

13 At page 533.

14 *Invercargill City Council v Hamlin* [1994] 3 NZLR 513; [1996] 1 NZLR 513.

15 *Gartside v Sheffield, Young & Ellis* [1983] NZLR 37.

16 *Cekan v Haines* (1990) 21 NSWLR 296, 307.