
Law and Economics – and Why New Zealand Needs It

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The so-called Chicago School of law and economics, which emerged in the late 1970s, was regarded by many lawyers with considerable suspicion. Much of this suspicion was due to the artificial and unrealistic nature of the assumptions about human motivation that underpinned that School's analysis. In the present paper, first delivered at the New Zealand Law Conference at Christchurch in October 2001, Sir Ivor Richardson reviews developments in the law and economics movement and highlights the growing sophistication of the economic analysis that can be brought to bear on legal issues. In Sir Ivor's view, neither judges nor lawmakers should make laws without regard to the full benefits and costs of those laws. He suggests that while economics alone cannot dictate their outcome, economics has an important role to play in a wide variety of cases.

1 THE VALUE TO LAWYERS OF LAW AND ECONOMICS

Economics is concerned with the use of society's limited resources. There are two reasons why I believe that as lawyers we should be concerned about modern developments in law and economics. Those reasons reflect two features of the New Zealand legal system.

The first is that the development and application of legal rules – whether through legislation or the common law – necessarily affect the use of society's limited resources. Those decisions will often involve balancing community values and resource constraints. But the efficient use of scarce resources and the economic and social implications of suggested alternatives cannot, or at least should not, be ignored. As the American judge, and law and economics scholar, Frank Easterbrook said:¹

“Economics is the study of rational behavior in the face of scarcity. Economics and law are, therefore, inseparable. The legal system, too, is about coping with scarcity. If there were an abundance of every good thing, there would be no need for law, no need for a state. Life would also be boring.”

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 invoking sanctions for their breach.

In short, we should not develop laws without regard to the economic and social implications and we need to understand how people make decisions if we want to change their behavioural response to legal change.

2 TWO POINTS ABOUT ECONOMICS

Nevertheless, it is important to appreciate the limits of economic analysis. As a prelude to the following discussion I want to make two short points.

¹ “The Inevitability of Law and Economics” (1989) 1 Legal Ed Rev 1, 3.

First, as I have just said, economics is the study of how humans behave in making resource-allocation decisions and of how they respond to incentives. Here it is generally assumed that each individual has a relatively stable set of preferences and that he or she acts rationally so as to maximise the satisfaction of these preferences, given the limited resources available to him or her. Michael Trebilcock, a well known New Zealand lawyer-economist working at the University of Toronto, put this well when he said recently that economic analysis:²

“proceeds on the assumption that most people are rational actors who will rationally calculate the expected costs and benefits of alternative courses of action open to them, given the constraints, including legal constraints, under which they are operating and choose that course of action that maximises net private benefits. On this approach to law, the legal system can be analogised to a giant supermarket with different legal options and constraints carrying different relative prices (which may change, or can be changed through time), to which individuals will respond in much the same way that they respond to relative prices and changes in relative prices in a supermarket setting. For example, tort liability and criminal sanctions raise the relative prices of certain activities. Tax deductions and subsidies reduce the relative prices of other activities.”

According to the “rational actor model”, the desire for preference-satisfaction determines what bundle of goods individuals buy each year, how much of their leisure time they are willing to sacrifice to earn money, whom they vote for in elections, how they will respond to a change in the law, and so on. Economists may thus use the simple theory just outlined to make predictions about how people will, for instance, respond to changes in the price of a good or to a new law. But as Trebilcock points out, such models of human behaviour may be overly simplistic if it is simply *assumed* that people will behave in a particular way.

Secondly, there is a crucial distinction in economics between a descriptive, or positive, theory and a prescriptive, or normative, theory. Economists using positive theory argue that their role is merely to observe objectively the way in which people make resource allocation decisions under constrained circumstances, or to predict how they will behave under different conditions. A positive analysis says nothing about what the government or anyone else *should* do. The aim is merely to predict how people *do* or *will* behave. Normative analysis, on the other hand, is concerned with ensuring that behaviour conforms to efficiency standards – and this may entail using the law to change behaviour to achieve an efficient (or more efficient) outcome. Those who accept the distinction between positive and normative economics maintain that statements about the way in which the world actually is, or will be under certain conditions, are different from statements about the way the world *should* be – although the first may of course be an important prelude to the second.

The distinction can be taken too far. As a descriptive theory, modern economics is sometimes portrayed as a science like molecular biology and astrophysics with complex graphs and equations leading to a seemingly inevitable conclusion. It can give quite a false sense of veracity: it looks impressive and therefore is easily taken to be true, when in fact its assumptions may be quite questionable. Here normative theory can masquerade as descriptive theory – with the assumptions that are being made masking standards being imposed by the person making the analysis.

In short, there are two important qualifications that need to be made about economics. First, that the rational actor model may be overly simplistic, and secondly that, although there are important

2 “The Value and Limits of Law and Economics” in M Richardson and G Hadfield (eds), *The Second Wave of Law and Economics*, Sydney, Federation Press, 1999, 12, 12-13.

differences between positive and normative economics, the use of untested assumptions may, in effect, blur the distinction between them. Concerns of these kinds have been levelled particularly at some of the work of “the Chicago School”, the most well known branch of the law and economics movement, particularly in the early days. But it is a mistake to equate law and economics with the Chicago School. Even in the United States things are changing, as I will now explain.

3 MODERN DEVELOPMENTS IN LAW AND ECONOMICS

I spoke a moment ago of the Chicago School. In 1977, the year I joined the Court of Appeal, Richard Posner published the second edition of his book *Economic Analysis of Law*.³ His approach there largely followed the first edition, published in 1973 – the edition that launched the law and economics movement at the University of Chicago, and established what is now called “the Chicago School”. There, economics was depicted as a scientific analysis, based on a model of the “rational actor” dreamed up by the economist sitting in his study – an analysis which could simply be applied to law.⁴ The assumption was that the main, if not the only, concern of most individuals is to improve their own position in some way (usually in a way that can be measured in terms of wealth) – and that the role of the law is to ensure their perceived individual good is consistent with the common good (again, usually in a way that will be measured in terms of wealth). So, according to Posner, the definition of “efficiency” is a simple one:⁵

“Efficiency means exploiting economic resources in such a way that ‘value’ – human satisfactions as measured by aggregate consumer willingness to pay for goods and services – is maximised.”

Implicit in this statement is a second assumption (and I put this as an assumption because it usually was untested empirically) that the unregulated market would generally lead to efficient outcomes. Therefore, the need for legal intervention was minimal.

There is some value in this approach. It represented a distinct improvement over the sort of intuitive, historically reasoned, black letter law approach of much of the legal analysis that predated it in many jurisdictions (including our own). But one problem is the assumptions. For instance, the Chicago School’s abstract approach to how the rational actor would – or should – behave took little account of how people actually behave in the real world. Sometimes it was accurate (or accurate in part). Other times it was not accurate, even when aggregating the responses of all participants in the market. That is not because people do not act so as to improve their own position, but rather because there may be several different courses of action they may adopt to improve their position and it is difficult to predict which one they would choose. In part, too, their conduct may be governed by social norms – the standards of social behaviour which society imposes on them – and which they themselves accept. Lawyers – who know through practical experience how divergently and unpredictably people behave in actual cases (and how constrained people may sometimes be by their social environments) – should understand this complexity well.

Since 1977, the law and economics movement has been actively engaged in addressing the problem of the divergence between the economic model and social behaviour. Starting with Michael Trebilcock’s work at Toronto from the 1980s, at least some law and economics became more

3 Boston, Little Brown, 1977.

4 G Hadfield, “The Second Wave of Law and Economics” in M Richardson and G Hadfield (eds), *The Second Wave of Law and Economics*, Sydney, Federation Press, 1999, 50, 50-52.

5 *Economic Analysis of Law* (2nd ed), Boston, Little Brown, 1977, 10.

rigorously empirical – with efforts made to really test the truth of the “rational actor model” and its application in particular cases. Robert Cooter at Berkeley, Thomas Ulen at Illinois, Cass Sunstein at Chicago, Lisa Bernstein at Boston University followed by Georgetown (and now Chicago), Lawrence Lessig at Harvard (now at Stanford), and Eric Posner at Pennsylvania (and later at Chicago), among others, built on this work in the 1990s – establishing the law and economics and social norms branch of the law and economics movement where law and social norms are seen as importantly interacting to regulate and constrain individual behaviour for the common good. In a recent issue of the *Journal of Legal Studies*, one of the leading law and economics journals, Lawrence Lessig went as far as to suggest (as he said, “playfully”) that there is now a “new” Chicago School, a more diversified, social norm-conscious, real world-friendly Chicago School, which had truly overcome the problems of the old Chicago School.⁶ One emerging new Chicago scholar Lessig particularly mentioned was Tracy Mears, a New Zealander then visiting at the University of Chicago, who has done some very interesting work on efficient ways to reduce consumption of illegal drugs – including using the pressure of social norms of the community, within which the individual lives, to constrain his or her behaviour, rather than simply relying on legal regulation.⁷

Clearly, then, law and economics has moved on from the old Chicago School, valuable as it might have been as a starting point for study of law and economics, to embrace a more sophisticated, hopefully more realistic, “second wave of law and economics”.

Further, and for reasons lawyers can readily understand, modern developments in law and economics put far more emphasis on the importance of empirical analysis and on the assessment of social norms. I believe this is a very useful development and one that would (or should) help the acceptance of law and economics as a valuable perspective for lawyers and lawmakers, including judges.

4 LEGAL ACCEPTANCE OF LAW AND ECONOMICS

However, I do not want to leave the impression that law and economics originated in America out of the blue 30 or 40 years ago or that, even now, it is solely an academic preserve (and an American one at that). In fact, in some fields of law economic analysis has not only been a feature of academic writing; it is a central part of legislative law-making and judicial decision-making throughout the common law world. I am referring of course to the so-called “old” areas of law and economics: trade practices law, corporations law, tax law where for some decades now the legislature has explicitly acknowledged the relevance of economic policy, and judges and lawyers have followed suit. More generally, at some level, regard for the economic implications of legal rules can almost be described as a fundamental common law value.

Why is this? Perhaps one reason is that many of the classical economists and philosophers, writing in the United Kingdom in the 18th and 19th centuries when the common law was being shaped, were very interested in legal rules: and their interests and influences were also extremely broad. In 1766, when writing *The Wealth of Nations*, Adam Smith criticised the statutes that regulated the professions. He claimed that they restricted competition and artificially inflated prices.⁸ More generally, he put forward a rigorous attack on protectionist trading policies, in favour of free trade.

6 “Social Norms, Social Meaning, and the Economic Analysis of Law: The New Chicago School” (1998) 27 J Leg St 661.

7 Ibid p 669.

8 *An Inquiry into the Nature and Causes of the Wealth of Nations* (Sutherland ed), Oxford, OUP, 1998, 60-61.

Similarly, writing in the 19th century, utilitarian philosopher and economist John Stuart Mill argued for restrictions on laws which impeded individual liberty in commercial and private affairs, Mill making these arguments on efficiency, not just liberal, grounds.⁹

Another example is the philosopher David Hume who, writing a century before Mill and Bentham (even before Smith), made a persuasive economic case for binding legal effect to be given to contractual promises – since otherwise (in words that could now be seen as reflecting an early social normative theory), as he said:¹⁰

“Men being naturally selfish, or endowed only with a confined generosity, they are not easily induced to perform any action for the interest of strangers, except with a view to some reciprocal advantage, which they had no hope of obtaining but by such a performance. Now, as it frequently happens, that these mutual performances cannot be finished at the same instant, it is necessary that one party be contented to remain in uncertainty, and depend upon the gratitude of the other for a return of kindness. But so much corruption is there among men, that, generally speaking, this becomes but a slender security ... Here then, is the mutual commerce of good offices in a manner lost among mankind, and every one reduced to his own skill and industry for his well-being and subsistence.”

As Hume recognised, it was only when the binding force of a contractual promise was legally enforceable and, as a result, socially accepted as morally appropriate, that a full market economy could begin to develop.

Perhaps one further reason the classical economists and philosophers were so successful in projecting economic values into the legal world, was the pragmatism and rigour with which they made their arguments. British legislators and judges of the 18th and 19th centuries certainly seemed to have been concerned to promote the sorts of moderately free market values that the classical economists/philosophers espoused. This was the period when freedom and security of contract was established, and when private property rights were radically expanded to cover many new types of resources, including intellectual property. We also see some interesting statements about economic policy in the judgments of the time.

For instance, in 1788 Lord Thurlow LC in *Fox v Macreth*¹¹ stated that the law would not interfere with a contract where the buyer knows that the property for sale is worth far more than the asking price, unless fraud is involved or the buyer is under an obligation to disclose his or her knowledge. The Lord Chancellor said that “the general transactions of mankind would be too much in hazard and uncertainty” were it otherwise.¹² His Lordship no doubt felt that uncertainty was unfair. But he also seems to have recognised that it was bad for commerce. Certainly, the sentiments expressed by Lord Thurlow were similar to those expressed (more forcefully) by David Hume some 40 years earlier.

9 See, eg *On Liberty* (1859), (1962 ed), 136-139, and the discussion in M Richardson, “The Utilitarian-Economic Model of Contractual Obligation: Unconscionability at the Frontier” (1995) 30 MULR 481, 482-488.

10 *Treatise on Human Nature* (1739-1740), 1888 ed, 519-520, and the discussion in M Richardson, “The Utilitarian-Economic Model of Contractual Obligation: Unconscionability at the Frontier” (1995) 30 MULR 481, 482-488.

11 (1799) 2 Cox Eq Cas 320.

12 *Ibid* p 321.

So too, the importance placed on commerce in Lord Wensleydale's speech in *St Helen's Smelting Co v Tipping*¹³ is unmistakable. Discussing the law of private nuisance, his Lordship said that:¹⁴

"in the county of Lancaster above all other counties, where great works have been erected and carried on, and are the means of developing the national wealth, you must not stand on extreme rights and allow a person to say, 'I will bring an action against you for this and that, and so on.' Business could not go on if that were so."

Many more cases could be cited. Staying in England, in *Davies v Davies*¹⁵ and explaining the rationale for law relating to restraint of trade, the Court said that:¹⁶

"it was considered a matter of essential importance to encourage all men to trade in order that the public might gain advantage by their trading – in other words it was considered public policy to assist England to become a nation of traders."

In America, Justice Holmes of the Supreme Court of the United States identified the importance for lawyers of statistical analysis and of economics as long ago as 1897. He said that:¹⁷

"For the rational study of the law the blackletter man may be the man of the present, but the man of the future is the man of statistics and the master of economics."

And in 1924 Benjamin Cardozo wrote that:¹⁸

"Some of the errors of courts have their origin in imperfect knowledge of the economic and social consequences of a decision, or of the economic and social needs to which a decision will respond."

Finally, as a contrast to the comfortable assurance that contemporary judges in our part of the world can reasonably make sound intuitive assessments of the economic and social underpinnings of legal rules, I mention two Australian judges.

Samuels JA of the Court of Appeal of New South Wales remarked in *A-G for New South Wales v John Fairfax & Sons Ltd* that:¹⁹

"There lie at the speculative core of many legal doctrines assumptions about the conduct and capacity of ordinary men and women to whom a disparate array of characteristics are attributed, ranging from extreme obtuseness to almost divine prescience depending on the interest to be advanced or protected."

Next, Finn J of the Federal Court of Australia, before he went on the Bench, noted three difficulties in the use by Australian judges of community values to justify decisions.²⁰ First, he says there is little in the cases to suggest that the standards or values attributed to the community are grounded in cogent empirical evidence which could sustain the claims made for them. Secondly, he draws attention to the

13 (1865) 11 HLC 642.

14 *Ibid* p 653.

15 (1887) 36 Ch D 359.

16 *Ibid* p 365.

17 "The Path of the Law" (1897) 10 Harv LR 457.

18 *The Growth of the Law*, Westport, Conn, Greenwood Press, 1973, 116.

19 (1985) 6 NSWLR 695, 699.

20 "Of Power and the People: Ends and Methods of Australian Judge-made Law" (1994) 1 Jud Rev 255, 277-278.

need for caution in citing authority external to the community – for example, comparative law materials – as justifying attributing that standard or value to the community. The point is that different societies give different emphases to different values and those emphases may change over time. Reference to the position in other countries may not fairly reflect our community standards and values. Thirdly, Finn J maintains that “to the extent that there is a majoritarian implication in the formula [of community values], it is one which in a variety of contexts the courts have every reason to resist and no more so than in the areas of human rights and criminal procedure”.²¹

Still in Australia, there is a fascinating article by Dr Russell Smyth of Monash University in the *Australian Business Law Review*²² in which he investigates the influence of economics in the High Court of Australia and the Federal Court of Australia. He does so by a quantitative analysis counting citations from law and economics literature in the *Commonwealth Law Reports* and the *Federal Court Reports*. The main finding of his study is that those Courts cite economics literature in areas of law where economics has had a traditional role, such as restrictive trade practices, but that the impact of law and economics in areas such as contract, torts, and administrative and constitutional law on judicial reasoning has been minimal. Interestingly, and whether or not it owed something to his early experience at Yale, Dawson J of the High Court of Australia made far more references to law and economics literature over the period studied than any other Australian judge.

To sum up at this point, I suggest that a certain amount of skepticism on the part of judges is healthy, and in some cases may be warranted, particularly if the approach being adopted bears little relation to reality. It suggests that we should be wary of intuitive assessments of how people actually respond or are likely to respond in their economic and social behaviour under both existing and proposed new rules. If the economic theory has no empirical basis whatsoever – is simply a matter of theory – we as lawyers and judges have to be cautious about simply assuming its value in the practical world in which we operate. But my concern is that, certainly in New Zealand, the skepticism now appears to be so great in some quarters that the value of *any* economic analysis – even the more flexible, realistic and empirically grounded economics of the second wave – is neglected, often with little knowledge or understanding of what it can contribute to good legal development.

5 LAW AND ECONOMICS: IN THE USA AND IN NEW ZEALAND

There are many measures which can be used to indicate how far away we still are in New Zealand from the regular consideration and application of economic insights in legal analysis, especially compared with America where law and economics has its “home”, so to speak, and where developments in law and economics (as I have briefly shown) have kept pace with the exigencies and complexities of the modern world.

For instance, we might consider the reception of law and economics scholars in academic institutions. Certainly, law and economics has been, and is, immensely important in this regard in the United States. Almost every major American law school offers papers on the subject. There are entire law reviews devoted to it. Elite law schools have research centres specifically for it. Legal academics with doctorates in economics command particularly high salaries and several US law schools employ economists to teach in their law and economics programmes. Then we might consider the reception

²¹ Ibid.

²² “Law or Economics? An Empirical Investigation into the Influence of Economics on Australian Courts” (2000) 28 ABLR 5.

which law and economics has had in mainstream law reviews. I conducted an unscientific survey of the law reviews of five top US law schools,²³ which revealed that 21.3% of the articles were solely about law and economics or contained substantial economic analysis. For the *Stanford Law Review* the figure was as high as 45.2%.

Similarly, recent United States texts explain the economic function of the law in considerable detail. For instance, *Farnsworth on Contracts*²⁴ devotes several pages to the economics of contract law. Farnsworth explains that voluntary exchange is beneficial to society, invoking Adam Smith and the concept of Pareto efficiency. He explains how contract law facilitates credit transactions and makes complex long-term transactions possible and observes that:²⁵

“From the perspective of society as a whole, the function of the law of contracts might have been seen as furthering the general economic good by encouraging parties to enter into . . . productive transactions . . . [I]t was essential to provide a general basis for the enforcement of promises that included purely executory exchanges of promises. The development of such a general basis closely paralleled the specialisation of labor and the development of competitive markets.”

To see generalists like Farnsworth commenting on the economics of contract law in this fashion shows just how embedded this sort of reasoning is in American academic circles. It is not just the experts who use it now, but academics generally.

Finally, a third indicator of the legal reception of economics is the extent to which law and economics scholars go on to have influential roles as judges and legislators. The United States again is a leader in this respect. Several prominent law and economics scholars have gone on to be judges (Frank Easterbrook is an example, as are Richard Posner and Guido Calabresi – all are judges of the US Courts of Appeals). This last feature particularly demonstrates the close relationship that exists in the US between academia and the judicial profession – and, beyond that, the practical value ascribed to law and economics in promoting good lawmaking, including in the courts.

Outside the United States, by contrast, law and economics has not taken off to a similar extent. Few academics write about it; fewer still are experts. Judges rarely use it and lawyer-economists do not fill our benches. Legislators sometimes use law and economics, but also quite often ignore it. More generally, it is still seen by some with limited awareness of modern developments as a wacky and nefarious outgrowth of New Right ideology.

As to New Zealand academic scholarship on law and economics, I have again conducted an unscientific survey. I looked through all the articles published in 1999 in the law reviews of the five New Zealand law schools and in the *New Zealand Law Review* and the *New Zealand Universities Law Review*. A mere 4.8% of the articles either were devoted solely to law and economics or contained substantial economic analysis. This low figure is very disappointing – a strong contrast to the excellent New Zealand academic literature on constitutional law and human rights. Interestingly – but commendably for the New Zealand Law Society – we have seen far more attention paid to law and economics in its legal education programmes and law conferences than in any of the law schools. The New Zealand Law and Economics Association has also played a valuable role here.

23 Law reviews used were the *Yale Law Journal*, the *Stanford Law Review*, the *Harvard Law Review*, the *Columbia Law Review* and the *New York University Law Review*.

24 (2nd ed), New York, Aspen Law & Business, 1998, 6-10.

25 *Ibid* p 9.

A survey of New Zealand's leading law texts is also instructive. As to contract law, the contrast between *Farnsworth on Contracts* and Burrows, Finn and Todd's *Law of Contract in New Zealand*²⁶ is stark. The authors of the New Zealand text hint at the economic rationale of contract law only in one footnote.²⁷ And that footnote is found in the context of an historical discussion of the influence of 19th century English liberalism on contract law. Similarly, with regard to tort law, New Zealand's only general torts text – Todd et al, *The Law of Torts in New Zealand*²⁸ – devotes about one page out of 1316 to the economic function of tort law. This page summarily dismisses the entire field as “open to serious objections”.²⁹ However, in Australia, leading torts texts – including Professor Fleming's book³⁰ and the text by Trindade and Cane³¹ – do in fact discuss the economics of tort law in some detail.

Another measure of the penetration of law and economics is the number of New Zealand law schools which offer law and economics papers. Some New Zealand law schools have done so in the past (and in 2001 the economics departments of several universities are offering them). But according to the websites of the five law schools, none is currently offering a law and economics paper.

Finally, if we look at our own judgments, we see that the New Zealand Court of Appeal has rarely had both the occasion and the material to analyse the economic implications of legal rules. A search of the database containing all Court of Appeal decisions since 1982 found only 44 cases containing substantial economic analysis and references to important economic terms such as “transaction costs” and “marginal cost”.

What I now want to do is to discuss three cases in the Court of Appeal in order to bring out points which seem to me to be important; next, to give a number of examples relevant to our experience in the courts; and then to provide a modest empirical analysis of decisions under s 9 of the Contractual Remedies Act 1979.

6 RECENT EXPERIENCE IN THE COURT OF APPEAL: THREE ILLUSTRATIVE CASES

The first of the three illustrative cases is *Fleming v Securities Commission*.³² The plaintiffs invested money in Star Investments Ltd as a result of reading advertisements in *The Taranaki Herald* and *The Daily News*. It was assumed that these advertisements breached various provisions of the Securities Act 1978. Further, by failing to obtain a certificate from Star's directors certifying compliance with the Act, the newspapers breached the Securities Regulations 1983. The plaintiffs sought damages from the Securities Commission and the newspapers. They claimed that the newspapers had breached a duty to take reasonable care to ensure that the advertisements complied with the Act.

26 Wellington, Butterworths, 1997.

27 *Ibid* p 13, n 8.

28 (3rd ed), Wellington, Brookers, 2001, 18-19.

29 *Ibid* p 19.

30 J G Fleming, *The Law of Torts* (9th ed), Sydney, LBC, 1998, 8-17.

31 F A Trindade and P Cane, *The Law of Torts in Australia*, OUP, Melbourne, 1985, and see especially chapter 18 (“Economic Analysis and the Law of Negligence”) and chapter 24 (“Economic Analysis and Strict Liability”).

32 [1995] 2 NZLR 514.

It was argued that we should apply *Anns v Merton London Borough Council*³³ and extend *Hedley Byrne & Co Ltd v Heller & Partners Ltd*³⁴ so as to impose liability on the newspaper. That would have had very serious economic consequences for the media. In my judgment in *Fleming I* observed:³⁵

“Advertisements are a feature of the mass media, print and electronic . . . They facilitate commerce in the area served . . . The volume of classified advertisements and the commercial need for them to appear in print within hours of their presentation for publication make it totally impracticable for a newspaper to investigate the factual accuracy of every advertisement, check compliance in all respects with legislation and the common law and verify authorisation for publication.”

Had we imposed a duty of care on the newspapers, every newspaper running advertisements for financial products would have been forced to put in place procedures to ensure compliance with the Act. Furthermore, the duty of care could not have been limited to the Securities Act. What about compliance of advertisements for medicines with the Medicines Act 1981? And would a newspaper running a classified advertisement for hotdogs at a school fair have been warranting compliance with all relevant food safety standards? Newspapers would have had to seek legal advice as to which advertisements triggered which statutes. They would have needed to employ additional administrative staff or in-house legal counsel. They would have had to check every advertisement before it went to print. Large newspapers would probably have had to increase prices or charge more for advertisements. Small community newspapers run by volunteers might have had to close. I felt that creating a duty of care simply did not justify these costs.

But I did not base my judgment solely on efficiency. The economics of imposing a duty were part of the *Anns* two-stage analysis, along with foreseeability of harm, reasonableness of reliance and moral fault.³⁶

The second case is *DHL International (NZ) Ltd v Richmond Ltd*.³⁷ Richmond engaged DHL to convey a package without disclosing that it contained a bearer bill of lading. Richmond indicated on the package containing the bill of lading that the package's contents had no commercial value and they did not obtain insurance. The bill of lading enabled the thief who stole it to obtain possession of valuable goods in Italy. The holder of the bill went bankrupt, and the goods were not recoverable. Richmond sued DHL for the value of the goods. The standard form contract contained an exclusion clause that excluded all liability “in any event” for consequential or special damages or other indirect loss “however arising” and imposed strict time limits on claims against DHL. The High Court, as many courts have tended to do, refused to give effect to the exclusion clause. The standard approach has been to treat such clauses with suspicion on account of assumed inequality of bargaining power and imperfect information.³⁸

We reversed the High Court's decision. As the exclusion clause was clearly worded, we felt that there was no justification for refusing to give it effect. Commercial parties know that the protection the contract provides is factored into the price – you get what you pay for. Commercial parties should be

33 [1978] AC 728.

34 [1964] AC 465.

35 [1995] 2 NZLR 514, 531.

36 *Ibid* pp 532-533.

37 [1993] 3 NZLR 10.

38 *Livingstone v Roskilly* [1992] 3 NZLR 230.

aware of business risks and know that they can obtain insurance to protect against them. If they enter into a low-priced courier contract (\$22.50 in *DHL*) that excludes liability on the part of the courier, then they are electing to bear any resulting losses. In return, they will have paid a lower price. The exclusion of liability will thus have been beneficial to both parties at the time of the contract. If, after entry into the contract and after losses have been suffered, courts refuse to enforce exclusion clauses, then they will be inhibiting mutually beneficial bargains. No one will be able to enter into a contract and negotiate a lower price in return for agreeing to an exclusion of liability for consequential damages.

Of course, this reasoning may not apply in consumer cases. Consumers may not be expected to understand the effect of an exclusion clause. But *DHL* was not such a case.

Before moving on to the third case I mention two other contract analysis considerations. First, in relation to contractual remedies, the standard inquiry in law and economics analysis is which court-designed remedy – specific performance or the payment of money damages – is more cost effective. Secondly, 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 against the loss of that value; and where in the absence of a track 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.

Next, and illustrating policy analysis linking contract and tort, is our discussion in *South Pacific Manufacturing Co Ltd v NZ Security Consultants & Investigations Ltd*.³⁹ 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.⁴⁰

“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 (*Gold Star Insurance Co Ltd v Dominion Adjusters Ltd* [1982] 2 NZLR 38); 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.

39 [1992] 2 NZLR 282.

40 *Ibid* p 308.

The third case I want to discuss is *Williams v Aucutt*.⁴¹ The question there was whether the testator had made “adequate provision” in her will for the “proper maintenance and support” of her elder daughter. The elder daughter’s assets were substantial. The younger’s were modest. Both were dutiful. The will left the great bulk of the estate to the younger daughter. The High Court concluded that there had been a serious breach of moral duty towards the elder daughter and split the residue of the estate 25% to her and 75% to the younger daughter. On appeal, we reduced the added provision for the elder daughter to \$50,000.

Relevant to the present discussion, we concluded that some orders in the High Court in recent years may have been out of line with current social attitudes to testamentary freedom relative to claims by adult children. We noted, with references, that there was a considerable volume of law reform material and other analyses in overseas jurisdictions, concerning the exercise by courts of their jurisdictions in favour of adult children who were not asserting economic need, with some suggestions for restricting awards to meet what were said to be prevailing social attitudes. In some cases, legislatures had enacted specific provisions precluding or curtailing awards to financially independent adult children.⁴² We went on to consider the assessment by the courts of community attitudes. We pointed to the difficulties for the courts in making their own unaided assessment of current community attitudes in a complex and changing social environment but added that social surveys of sufficient reliability may provide some assistance in assessing the public pulse.⁴³ In that regard, we referred to the limitations in the Law Commission’s assessment of succession law in 1997.⁴⁴ With more confidence, we referred to the *Report of the Working Group on Matrimonial Property and Family Protection*,⁴⁵ and the particularly helpful survey of 235 cases brought by children between 1985 and 1994 carried out by Nicola S Peart of the University of Otago and to the conclusions she drew from that empirical analysis.⁴⁶

Finally, we noted⁴⁷ – as reflecting on the assessment of social norms – that the intestacy rules in the United Kingdom were reformed in 1925 as the result of a survey of a large number of wills in Somerset House to see how ordinary people actually behaved and that the Law Commission’s proposals on matrimonial property were related to the extensive survey carried out by Todd and Jones. We could have added that in 1968 Peter Jenkin carried out for a Master’s research paper at Victoria University of Wellington an extensive empirical assessment of significant features of wills admitted to probate in the Supreme Court at Wellington in order to assess dispositions most commonly found in wills against the current intestacy provisions.⁴⁸

The conclusion I draw from the discussion in *Williams v Aucutt* is that courts must benefit in exercising statutory discretions from the availability of relevant empirical analysis and attitudinal surveys of social norms.

41 [2000] 2 NZLR 479.

42 Ibid p 489, para 42.

43 Ibid p 490, para 44.

44 Ibid p 490, para 45: see Law Commission, *Succession Law: A Succession (Adjustment) Act*, NZLC R39, Wellington, 1997.

45 Ibid p 491, para 47: see J Lowe (convenor), *Report of the Working Group on Matrimonial Property and Family Protection*, October 1988.

46 Ibid: see N Peart, “Awards for Children Under the Family Protection Act” (1995) 1 BFLJ 224.

47 Ibid p 490, para 44.

48 “Distribution on Intestacy” (1969) 3 NZLR 169.

7 OTHER EXAMPLES

The Court of Appeal and the High Court have decided hundreds of other cases in which economic analysis has been, or could have been, useful. Here is a list of just a few:

- *Bottrill v A.*⁴⁹ While the majority in the Court of Appeal referred to the economic implications of allowing recovery of exemplary damages in the absence of subjective appreciation of risk, counsel did not address this point in argument and no economic evidence in this regard was presented to the Court.
- *Turner v Superannuation & Mutual Savings Ltd.*⁵⁰ The High Court refused to permit a vendor to retain a deposit paid by the purchaser when a sale of land failed on the basis that the clause providing for forfeiture of the deposit created a penalty. But it may be economically efficient to enforce penalty clauses where the parties agree that a high subjective value should be placed on performance. Such issues should be explored in the future if penalty clause cases are appealed.
- *Autex Industries Ltd v Auckland City Council.*⁵¹ The Auckland City Council argued for a departure from the strict liability standard for escaping water under the rule in *Rylands v Fletcher*.⁵² Counsel presented the Court with no economic analysis of the social and economic assumptions underlying different liability rules.
- *House v Jones.*⁵³ 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 in 1985 dollars. The purchasers were refused relief under the Illegal Contracts Act 1970 for breach of the Land Settlement Promotion and Land Acquisition Act 1952. This case illustrates the use of efficiency criteria in the exercise of discretionary powers and also the value of economic data to courts.

The economic consequences of legislation are also often overlooked. The Government recently commissioned a report on the compliance costs which businesses face.⁵⁴ Three of the many problems the report identified were:

- Delays in the consent process under the Resource Management Act 1991. Businesses told the report panel that the employees of local councils often lack the expertise necessary to process applications quickly and correctly. They also complained about the length of time it takes for a case to be heard in the Environment Court. A cumbersome and slow process will add unnecessarily to the cost of commercial developments.
- Badly defined obligations under the Health and Safety in Employment Act 1992. The obligation to use “all practicable steps” to ensure safety in the workplace is seen as too vague by many businesses. They cannot know what steps they need to take to avoid liability under the Act.

49 [2001] 3 NZLR 622.

50 [1987] 1 NZLR 218.

51 [2000] NZAR 324.

52 (1868) LR 3 HL 330.

53 [1985] 2 NZLR 288.

54 *Finding the Balance – Maximising Compliance at Minimum Cost: Report of the Ministerial Panel on Business Compliance Costs*, Ministry of Economic Development, Wellington, 2001.

- Costs of complying with tax laws. The Pay-As-You-Earn tax system requires businesses to collect tax from their employees and to transfer what is collected to the government. Some businesses feel that this diverts essential resources away from core activities, productivity and revenue generation. The report also noted that seasonal and small businesses were concerned that the timing of provisional tax liabilities often did not match their income flows, creating cash-flow problems.

The relevance of economics extends beyond private law, regulation and taxation to the public law domain where the courts impose liability on the state. As Lord Hoffmann forcefully pointed out in *Stovin v Wise*,⁵⁵ the courts increase the financial outgoings of central and local government when they expand the scope for government liability. The state's financial resources are limited, and Lord Hoffmann noted that if its spending in one area – for example, roading – rises, then its spending in another area – for example, health or education – must fall. Or taxes must rise. “It is important”, he said, “before extending the duty of care owed by public authorities, to consider the cost to the community of the defensive measures they are likely to take in order to avoid liability.”⁵⁶ If politicians are considered better judges than the courts of how public money should be spent and of how high taxes should be, then the courts should be slow to expand government liability.

The courts have not always taken heed of this. In *Mount Albert Borough v Johnson*⁵⁷ – the first New Zealand case to impose liability on a local council for negligent building inspection – there was no reference to economic implications. Similarly, in *Baigent's* case,⁵⁸ the economic consequences of compensation for breach of the New Zealand Bill of Rights Act 1990 were not explicitly taken into account. And the effect of the High Court of Australia's decision in *Dietrich v R*,⁵⁹ that Australian courts should stay criminal proceedings where defendants cannot afford legal representation and the cost is not borne by the state, was to put budgetary pressures on Australian state governments.

In recent cases, New Zealand courts have explicitly identified the constraints on public finances. Thus, we said in *Waller v Hider*⁶⁰ that, when considering whether to grant leave for a second appeal under s 67 of the Judicature Act 1908, we would consider economic implications. We will consider the cost to the parties of an appeal, the amount at stake, and also the costs to the state of a hearing before the Court of Appeal. It would be odd to allow a second appeal where the amount at stake is small, where no significant legal issues are raised, and where the costs of a second appeal far exceed the amount in dispute.

Again, in the *Fleming* case which I have already mentioned, we refused to impose a duty of care on the Securities Commission. The Commission was charged with performing a very wide range of functions while having a very small number of staff and a very limited budget.⁶¹ Imposing a duty of care requiring the Commission to monitor newspaper advertisements would have diverted resources from its other statutory functions.

55 [1996] AC 923, 958.

56 Ibid.

57 [1979] 2 NZLR 234.

58 *Simpson v Attorney-General* [1994] 3 NZLR 667.

59 (1992) 177 CLR 292.

60 [1998] 1 NZLR 412.

61 *Fleming v Securities Commission* [1995] 2 NZLR 514, 529-530.

Finally, in *Federated Farmers of New Zealand (Inc) v New Zealand Post Ltd*,⁶² McGechan J in the High Court demonstrated how economic considerations can be relevant under the Bill of Rights. New Zealand Post introduced a rural delivery service fee. Mail delivery to the farm gate was made dependent on all farmers who wished to receive mail paying an annual fee. The fee was then increased from \$40 per year to \$80. Federated Farmers brought an action against New Zealand Post for, inter alia, breach of the Bill of Rights Act. McGechan J found that freedom of expression under s 14 of the Bill of Rights Act included the freedom to receive information and had been infringed. But he went on to hold that the delivery fee was a justified limitation of the s 14 right.⁶³ He found that justification under s 5 had been established because New Zealand Post could not continue to provide the rural deliveries for a fee of only \$40 per year and because subsidies were undesirable and unfair. McGechan J's approach to this case reflects the Court of Appeal's statement in *Moonen v Film & Literature Board of Review*⁶⁴ that the application of s 5 requires consideration of "all the issues which may have a bearing on the individual case, whether they be social, legal, moral, *economic*, administrative, ethical or otherwise".⁶⁵

Of course, courts should not go overboard in shielding the government from liability. I would not have adopted the same reasoning as Kirby P in *Cekan v Haines*.⁶⁶ There, he found that the State of New South Wales was not negligent in failing to keep prisoners under constant surveillance to prevent them from injuring themselves. He based his reasoning in part on the fact that a finding of negligence would have required the State to alter many police stations at great cost. While the economic consequences of imposing liability on the government should always be recognised, they must not trump all other considerations.

Next, I want to discuss two examples of how economics can tell us whether proposed legal rules are likely to achieve their objectives.

The first involves the United States' Endangered Species Act of 1973.⁶⁷ The legislation allows restrictions to be placed on the use of private land without compensation in order to protect endangered species. It was in part born of the need to save the bald eagle. Unsurprisingly, many landowners resent the Act because it reduces the value of their land. And unsurprisingly, it has been found that landowners are doing their best to frustrate the Act. Many people who have endangered species on their land are destroying their habitats before restrictions can be imposed.⁶⁸ There is now a vast law and economics literature discussing how the incentives the Act creates can be changed to make it more effective.⁶⁹

The second example involves a famous instance of tax avoidance. In 1748 it was decided that a tax proportional to the number of windows in a house should be imposed on house owners in parts of England and Scotland. The reasoning behind the tax was simple. The rich should pay more tax. Glass

62 (1992) 3 NZBORR 339.

63 Ibid pp 393-397.

64 [2000] 2 NZLR 9.

65 Ibid p 17 (emphasis added).

66 (1990) 21 NSWLR 296.

67 16 USC 1538.

68 Anon, "Similar Problems: The Endangered Species Act" (2000) 23 Regulation 6.

69 See, eg G M Brown Jr and J F Shogren, "Economics of the Endangered Species Act" (1998) 12 J Econ Persp 3.

is expensive, so those whose houses have many windows are likely to be rich. Unsurprisingly, far less tax revenue than expected was collected. The rich simply built houses with fewer windows and even closed up existing windows with bricks. The tax was eventually abandoned. Strange-looking houses are now a feature of many old villages in the United Kingdom. Similar taxes were imposed on hearths in the United Kingdom and on the number of rooms in a house in parts of the United States, and with similar results. Had the policy-makers consulted an economist, these episodes might have been avoided. They might have been told that the demand curves for luxury items are elastic, that an increase in the price of such items causes a large drop in the quantity sold, and that a tax on windows was, therefore, unlikely to raise much revenue. Many similar examples could be provided.

Some of those commentators who concede that the legislature should consider the economic implications of legal rules have argued that courts should not do so. Sometimes they argue that law and economics is merely a convenient excuse for a return to judicial conservatism and the strict application of the doctrine of precedent. But that is not the case. Law and economics does not generally counsel against judicial law-making. It simply stresses the need for judges to bear in mind the costs imposed on society by constantly changing and unpredictable laws.

Judges do and must at times, in a principled way, make law. It is too late to put an end to judicial law-making and too late to return to pretending that it does not exist. And if judges are going to make law, then they should take all relevant matters into account. They are rightly expected to consider fundamental human rights, New Zealand's international obligations and general notions of public policy. Why should they be blind to economic efficiency? It is relevant that during the past two decades Parliament has again and again stressed the importance of New Zealand's economic development by enacting statutes such as the Commerce Act 1986, the State-Owned Enterprises Act 1986, the Public Finance Act 1989, the Reserve Bank Act 1989, and the Fiscal Responsibility Act 1994. Judges cannot ignore Parliament's unmistakable emphasis on efficiency when developing the common law.

My thesis is this: economics is relevant whenever a court is reviewing existing legal principles or is considering alternative legal rules. And it may be relevant in the exercise of discretionary power. Obviously, no judge can or should always privilege efficiency over all other values. The justice of compensating those who find themselves drinking decomposed snails may outweigh the costs associated with imposing a duty of care on ginger beer manufacturers. And precedent may, and Parliamentary intention, when interpreting statutes, must, trump efficiency. But efficiency should at least be taken into account.

I want to return briefly to my subsidiary theme – the need for courts to rely on empirical data rather than untested intuitions when making predictions about human behaviour. Frequently, the Court of Appeal is asked to develop the law on the basis that it is out of line with patterns of social behaviour. Rarely, however, is any form of evidence adduced to support such claims. This is so, despite the fact that such evidence may well exist and could be of considerable assistance. In *Gisborne Herald Co Ltd v Solicitor-General*,⁷⁰ counsel for both sides presented arguments about the likely effect of public disclosure of a criminal defendant's prior convictions by a newspaper prior to his trial. No empirical evidence about the effect of such disclosure on jurors or the ability of the public to recall such information was presented to the Court. Again, in *Lange v Atkinson*⁷¹ we were asked to assume that

70 [1995] 3 NZLR 563.

71 [1998] 3 NZLR 424.

defamation law creates a “chilling effect” which harms our democracy. Again, no empirical material was supplied, but in our subsequent judgment⁷² we were able to draw and rely on a very helpful United Kingdom survey. Indeed, as long ago as 1990 concern was expressed in *Williams v Attorney-General*⁷³ as to the absence of any economics and law analyses of the potential effects on behaviour in cost benefit terms of imposing a duty of care on the Crown.

In essence, I am arguing for a more principled approach to judicial law-making in the small number of cases in which judicial law-making is required. When new legislation is contemplated by Parliament, extensive consultation is conducted. Submissions are received from interested parties and experts. All options are explored and a cost benefit analysis is undertaken. The economic implications will be explored. Furthermore, it is government policy for all requests from ministries and departments for funding to be submitted to the Treasury, which assesses their economic and fiscal impact. And following the 1993-1994 Organisational Review of the Inland Revenue Department, the government accepted that the economic implications of all future tax policy proposals should receive detailed consideration.⁷⁴ Again, when considering the need for legislative change, the Law Commission releases discussion papers, invites comment and canvasses all the options and policy questions.

Clearly, the ability of judges to consult experts and to conduct cost benefit analyses is more limited than Parliament's. And clearly judges should not conduct their own research without the benefit of expert advice and rely on this when deciding cases. But if judges are to have a law-making function, then there must be a principled approach to judicial public policy development. Judges need to assess all available options and take all the relevant facts into account, including economic impacts. And, as far as it is possible, they should rely on empirical evidence rather than on intuitive assumptions about how humans behave. The alternative is judicial law-making which is unpredictable, too heavily reliant on intuition, and unable adequately to address the needs of an increasingly complex society.

8 EMPIRICAL ANALYSIS: SECTION 9 OF THE CONTRACTUAL REMEDIES ACT 1979

Commercial clients place a high value on the legal certainty and predictability of the contracts they enter into. They want to know where they stand, what the law expects of them. For commercial people, fundamental functions of the law of contract are to provide certainty and to deter parties from engaging in opportunistic behaviour. Perceptions of risk factors, including litigation risks if performance breaks down, are built into prices.

How should the courts respond? Should the courts when exercising their broad discretionary powers under statutes such as the Contractual Remedies Act 1979, the Credit Contracts Act 1981, the Fair Trading Act 1986, and the Illegal Contracts Act 1970, be influenced by economic analysis? What if such analysis shows that the likely long-run effect of unpredictability in the exercise of discretion is to increase costs and prices for the supply of goods and services? Is it relevant that unpredictability may 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

72 [2000] 3 NZLR 385, 394, para 24

73 [1990] 1 NZLR 640, 681.

74 See, *Organisational Review of the Inland Revenue Department – Report to the Minister of Revenue and The Minister of Finance* (March 1994); I L M Richardson, “Directions for Tax Administration: Two Recent Reports” (1994) 22 Fed LR 461.

decisions of the courts under the contracts legislation – at least we have never had any material of that kind referred to us.

When the Contractual Remedies Act was passed, many commentators complained that s 9 would create uncertainty. I have conducted a modest empirical analysis of decisions under s 9. I reviewed the 36 cases decided between 1990 and 1999 by the District and High Courts in which relief under s 9 was granted. I relied on the Law Commission's *Contract Statutes Review*⁷⁵ for cases decided between 1979 and 1990. My aim was to test whether s 9 has produced unpredictable results. Three features of the case law are of concern.

First, virtually every judge who has applied s 9 has stressed the fact that the section confers a "wide discretion" or even a "very wide discretion". The risk is that, if individual judges feel they have an entirely free hand, the potential application of the section will be uncertain and unpredictable.

Secondly, in addition to having decided that s 9 permits recovery of expectation losses rather than merely restitution, the courts no longer consider themselves bound by the common law rules relating to mitigation and remoteness of damage.⁷⁶ As regards remoteness, general damages for emotional distress caused by breach of contract have been awarded under s 9 in at least two cases.⁷⁷ In another it was suggested that such damages might be available.⁷⁸ It may be possible to reconcile two of the cases, *Stephenson v Foster*⁷⁹ and *Herberger v Isbey*,⁸⁰ both of which involved contracts for the sale of recreational boats, with the holidays exception to the rule in *Addis v Gramophone Co Ltd*.⁸¹ But the third case, which involved breach of an employment contract, cannot be reconciled with *Addis*. The relevant events in *Burch v Willoughby Consultants Ltd*⁸² occurred before employment legislation made damages for emotional distress recoverable in employment law cases. The High Court awarded the dismissed employee \$10,000 for emotional distress because of the unpleasant manner in which he was dismissed and because of the manner in which the defence case was conducted in Court. Does it follow that any plaintiff under s 9 who suffered emotionally should recover damages?

My third point in relation to s 9 – and this is my most serious concern – is that it is no longer clear what the aim of relief under s 9 is. Before the enactment of s 9, an innocent party could rescind a contract for misrepresentation. The court then aimed to put the parties back into the position they occupied before the contract was formed. Alternatively, if an innocent party elected to treat a contract as discharged because of a fundamental breach or repudiation, the aim of the law was generally to place the innocent party in the position he or she would have occupied without the breach. However, the plaintiff could elect to be put back in the position he or she occupied before entry into the contract. The common law rules were tolerably simple and predictable in their operation.

75 NZLC R25, Wellington, 1993.

76 *Newmans Tours Ltd v Ranier Investments Ltd* [1992] 2 NZLR 68, 94 per Fisher J; *Thomson v Rankin* [1993] 1 NZLR 408, 410 per Cooke P.

77 *Burch v Willoughby Consultants Ltd* (1990) 3 NZELC 97,582, 97,590-97,591; *Stephenson v Foster* 11/11/98, Judge Macaskill, DC Dunedin NP593-97.

78 *Herberger v Isbey* 29/10/97, Laurenson J, HC Auckland CP105/95.

79 11/11/98, Judge Macaskill, DC Dunedin NP593-97.

80 29/10/97, Laurenson J, HC Auckland CP105/95.

81 [1909] AC 488.

82 (1990) 3 NZELC 97,582.

Section 9 simply instructs judges to order what is “just and practicable”. The section specifies a few factors which must be considered, but permits courts to take anything else they consider appropriate into account. I want to use two cases to illustrate how s 9 has made remedies unpredictable where a contract is cancelled.

The first is *Jackson v McClintock*.⁸³ The defendant undertook to supply the plaintiffs with a house. At the time of the contract, the house was already partly built, and the contract required the defendant to complete specified work before the settlement date. Some work was to be done by the plaintiffs personally, and they did this work at a cost of \$3,000. They also paid a deposit of \$8,000. On 25 January 1995 the defendant’s solicitors notified the plaintiffs that the defendant refused to do most of the work he had undertaken to do. After being uncontactable for some time, the plaintiffs gave notice on 22 February 1995 that they were cancelling the contract. They then commenced proceedings against the defendant, claiming \$8,000-\$11,000 for the deposit and \$3,000 for their work on the house. The defendant argued that the plaintiffs’ cancellation was invalid and brought a counter-claim for damages. The High Court found that the plaintiffs had validly cancelled the contract. But it awarded them only \$8,000 for the deposit. It refused to order the defendant to pay \$3,000 for the work done by the plaintiffs.

The High Court Judge twice noted that s 9 conferred a “wide discretion”. He appears to have refused recovery of the \$3,000 because of the time during which the plaintiffs could not be contacted. And among the considerations he took into account under s 9(4) was the fact that:⁸⁴

“The [defendant] incurred expenditure for the purpose of performance of the contract in the form of legal expenses. In addition he incurred the costs of mortgage finance, land agent’s commission, additional building insurance, and rates.”

Jackson v McClintock illustrates the unpredictability which s 9 creates. By introducing subjective notions of moral fault into the remedial assessment and departing from the common law’s rule-based approach, s 9 makes it impossible to predict what sort of remedial order can be made if a contract is cancelled. This means that parties, when entering into contracts, will find it difficult to assess the liability risks they are assuming.

Another case which illustrates the unpredictability of awards under s 9 is *Marsland v J Walter Thompson New Zealand Ltd*.⁸⁵ In that case, the plaintiff wished to exit an advertising company that he had built up. He entered into a contract with the company under which he agreed to stay on temporarily to assist the new management. He also agreed not to act privately for more than one of the company’s clients at any one time. The High Court found that the plaintiff had breached the restraint of trade clause and that the defendant had validly cancelled the contract. Under s 9, it ordered the plaintiff to account to the defendant for the profits he made by breaching the restraint clause.

Significantly, the High Court decision contains no finding of fact to the effect that, but for the plaintiff’s breach of the restraint clause, the profits which he made would have gone to the defendant. The order to account for profits thus cannot be seen as a conventional common law damages award designed to place the defendant company in the position it would have occupied without the plaintiff’s breach. This appears to be confirmed by the following passage from the judgment:

83 (1998) 8 TCLR 161.

84 Ibid p 166.

85 29/11/89, Gallen J, HC Wellington CP338/86.

"I do not think that in addition the defendant is entitled to claim in respect of alleged breach of fiduciary duty. The matters which would have been significant in this regard have been taken into account when considering the consequences appropriate under the [Contractual Remedies] Act."

It thus appears that the Judge awarded an account for profits – normally possible only for breach of an equitable duty – for breach of a simple contractual duty. And the justification for doing this appears to have been the wide discretion conferred by of s 9. If defendants to breach of contract actions now face the prospect of an account for profits, damages for emotional distress, and a relaxed duty to mitigate – all dependent on what a judge thinks is just – then it can justifiably be said that the provision has created unacceptable uncertainty.

All this has economic implications. Two points need to be made. Commercial parties to contracts – and even non-commercial parties – want to know what liability risks they are assuming by entering into a contract. "If this contract blows up in my face, what do I stand to lose in the worst case scenario?" This was recognised in the justly famous case of *Hadley v Baxendale*⁸⁶ – a case often lauded by law and economics writers. If it is difficult to predict the magnitude of liability risks when entering into a contract, then there are four options: do not enter into the contract; increase the price; obtain liability insurance and increase the price; or provide your own remedy by way of a liquidated damages clause. Empirical research and attitudinal surveys relating to the effect of s 9 on the behaviour of commercial contracting parties would be extremely valuable for contract law scholars and law reform work generally. Do contracting parties, whose legal advisers draw their attention to s 9, increase prices or contract out of the remedial regime under the Contractual Remedies Act? If they increase prices, then the Act is clearly inefficient. It has increased transaction costs. If contracting parties contract out frequently, then the Act is also inefficient. It is forcing them to spend time and money designing their own remedies when this would not be necessary if the common law or statute supplied default rules which operate predictably.

One further point. In some cases it is more profitable for a party to a contract to breach the contract and to do business with a third party than to perform the contract. As long as the innocent party to the contract is compensated, many people believe that there is nothing wrong with such conduct. In fact, it is desirable and efficient, because it makes at least two people better off without making anyone worse off. What I have just outlined is the theory of efficient breach. If s 9 makes remedies for cancellation unpredictable, then it will clearly be more difficult for parties to breach contracts efficiently. It will be difficult for a party considering an efficient breach to assess whether the profits from a new business opportunity will cover the damages recoverable by the innocent party. Further, if courts follow *Marsland*⁸⁷ and order those who breach contracts to account for their profits even in the absence of a fiduciary relationship, efficient breaches will be made impossible.

I am not suggesting that the law which existed before the Contractual Remedies Act was enacted was perfect, especially as regards remedies for misrepresentation. But it was more predictable and thus fairer and more efficient than s 9 as regards cancellation for breach of contract. The courts should bear the need for certainty in mind when exercising discretionary powers. It may be advisable for the courts to lay down clear rules governing the exercise of discretionary powers and to depart from them only in exceptional cases.

86 (1854) 9 Exch 341.

87 29/11/89, Gallen J, HC Wellington CP338/86.

9 LAW AND ECONOMICS: A BROAD MOVEMENT

The fact that the term “law and economics” refers to a wide range of separate ideas is often overlooked. Critics of law and economics often attack one of these strands but speak as though they are refuting law and economics as a whole.

Some law and economics scholars have claimed that the only aim of social policy – and therefore of the law – should be to maximise wealth. Forget equity, minority rights, fairness and gender equality. Focus only on increasing wealth. Unsurprisingly, this has created somewhat of an image problem for law and economics. But it must be noted that those who would elevate wealth maximisation above all other policy objectives are only one faction within a larger law and economics grouping. We can accept that economics is relevant to law without accepting that wealth maximisation should be the law’s only aim. We can accept that efficiency should be *an* aim of social policy, but not its *only* aim. In this paper I have identified many situations in which lawyers have or could have taken economics into account. But I did not link these to wealth maximisation. My point is that we should always recognise the economic consequences of legal rules, but that we can do so without automatically accepting efficiency as paramount. Put simply, we should aim to strike a balance between fairness and efficiency.

Related to wealth maximisation are the concepts of Pareto efficiency and Kaldor-Hicks efficiency.

Pareto efficiency, which takes its name from a famous economist, states that an act is efficient if it makes at least one person better off without making anyone else worse off. Pareto efficiency says nothing about what distribution of resources is just. It is also of limited value in public policy development because there is virtually no government policy which satisfies its requirements. Virtually every government policy involves taxing some people who resent being taxed and giving their money to someone else.

Kaldor-Hicks efficiency states that a change in the distribution of resources is efficient if it makes one person better off to such an extent that he or she could compensate all those who are made worse off. But Kaldor-Hicks efficiency does not actually state that compensation is required.

Some economists have claimed that Pareto and Kaldor-Hicks efficiency are value-neutral scientific concepts and that they are, therefore, a useful basis for government policy. Such statements require analysis. It is true that whether or not a government policy is Pareto or Kaldor-Hicks efficient is an empirical question. It is a factual matter. One can find the answer by asking people what value they place on various resources. Ethics, morality, and equity do not enter the equation at this stage.

But as soon as economists state that the government *should* buy back the Auckland rail network or that it *should* remove all tariffs because such policies are Kaldor-Hicks efficient, morality comes into play. The economist is no longer speaking as an economist, but as a moralist. That is because there is nothing in economic theory which justifies the conclusion that because something *is* efficient, it *should* be done. Thus we can accept that economics is relevant to law without accepting either Pareto or Kaldor-Hicks efficiency.

Another concern for law and economics is the use of economic arguments to support conservative or libertarian political views. The fact that economic arguments may sometimes be used to support political views which some people find unpalatable should not cause them to reject economics, and law and economics as a whole. Often economics can be used to support left-leaning political views. Witness, for example, the Keynesian revolution in economics which laid the foundations for large parts

of the modern welfare state. Economics itself is simply a theory which attempts to make predictions about certain aspects of human behaviour. It is not wedded to any particular ideology.

Finally, I want to refer briefly to three topics which are often discussed in the law and economics literature: rationality, economics as science, and the limitations of the legal process.

The claim that humans are irrational is at times advanced as an objection to the use of economic analysis. It has been claimed that humans are often altruistic, that they have all manner of cognitive limitations, that they lack perfect information, that their preferences are unstable and incommensurable, and so on.⁸⁸ These claims may be true to a large extent. But they do not amount to a significant objection to economic analysis. Deviations from rationality can be, and have been, taken into account in economic models. But more importantly, all these limitations are often not significant enough to be of concern to policy-makers. Not even the most ardent critic of law and economics would suggest that the anti-avoidance provisions in the Income Tax Act 1994 should be repealed on the basis that large corporations are either too altruistic or cognitively too deficient to devise tax avoidance schemes.

Next, it is sometimes argued that economics is not really a science because some economists do not test their theories and because their theories are non-falsifiable. But we cannot dismiss economics as unscientific on those grounds alone. Many core theories of the respectable physical sciences do not satisfy strict falsifiability criteria. And a vast amount of empirical work in economics has been and is being done. In fact, if empirical work is regarded as the yardstick for how scientific a discipline is, then modern economics may be more scientific than much of biology, ecology, and theoretical physics.

Finally, resolving public policy questions under the adversary processes of the courts requires relevant information and its assessment. It is sometimes said that judges may lack the expertise properly to assess the economic impact of legal rules. It is said, too, that they would need mountains of information which parties primarily concerned with the resolution of their own dispute may be unwilling to pay for.

There is some force in those concerns. But there are also the risks and costs of erroneous and inefficient decision-making which may run either way. Striving for the right answer is important.

Long before the enactment of the Commerce Act 1986, and certainly since its enactment, judges have had to grapple with complex economic concepts and expert evidence. I do not believe that judges are incapable of understanding the relatively simple economic concepts required for most law and economics analyses. It is, after all, not difficult to appreciate why it is that judicial hostility towards exclusion clauses might be undesirable.

Where empirical data and the wider advancing and testing of public interest considerations are required, representation orders under r 81 of the High Court Rules and amicus briefs may assist. It would be helpful, too, if scholars and the law schools contributed to the building up of a body of New Zealand law and economics material.

⁸⁸ For a useful summary of such claims, see R B Korobkin and T S Ulen, "Law and Behavioral Science: Removing the Rationality Assumption From Law and Economics" (2000) Calif LR 1051.

10 CONCLUSION

What I have sought to emphasise is that, while parts of law and economics are perhaps justifiably regarded with suspicion (particularly the early Chicago School), the law and economics movement is now far more sophisticated than it was some 20 years ago. We have a fascinating body of scholarship to draw on and could benefit from empirical analyses in appropriate cases. As judges, and inevitably as lawmakers, we should not make laws without regard to their full benefits and costs for the community. As well, when we give effect to legislative policy, we need to appreciate the economic and social impacts. While economic analysis alone cannot dictate the results of judicial decisions, it has an important role to play in a very wide range of cases.

I would hope that in the years to come we will see more use of rigorously argued and realistically grounded economic analysis – in the legislature, in and before the courts, and in the professional legal education arena – and also in the academic environment since it is there that the lawyers and judges of the future receive their first education (and there also where important research can usefully aid lawmakers in determining the direction their laws should follow).

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