Fault Lines in the Positive Economic Analysis of Tort Law

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1. INTRODUCTION

Positive economics is in principle independent of any particular ethical position or normative judgments . . . It deals with “what is,” not with what “ought to be.” Its task is to provide a system of generalizations that can be used to make correct predictions about the consequences of any change in circumstances. Its performance is to be judged by the precision, scope, and conformity with experience of the prediction it yields. In short, positive economics is, or can be, an “objective science,” in precisely the same sense as any of the physical sciences (Friedman 1966, 4).

Economists routinely engage in positive analysis to identify the efficiency properties of a practice without expressly taking any position on the normative question of whether the practice should be conducted in an efficient manner. Economists confidently do so, as Milton Friedman observed in his famous essay on this methodological approach, simply because “[t]he conclusions of positive economics seem to be, and are, immediately relevant to important normative problems, to questions of what ought to be done and how any given goal can be attained” (ibid.). Friedman was discussing problems of “economic policy,” illustrated by the issue of minimum-wage legislation (ibid., 5). Regardless of one’s position on what the minimum wage ought to be, no one seriously doubts that this matter of economic policy depends on the costs of regulation, such as
increases in the unemployment rate. Merely identifying those costs and any resultant inefficiencies enables an economist to make an important contribution to wage-regulation policy without adopting any normative position about the matter.

Consistent with the approach of mainstream economics, the positive economic analysis of tort law evaluates the efficiency properties of tort rules without otherwise taking a stance on whether efficiency is an appropriate norm for tort liability. Tort law is not expressly a matter of “economic policy,” however, and so the value of positive analysis is less obvious than it is for wage regulation. But like positive economic analysis in general, the positive analysis of tort law would seem to have only a limited or contingent normative message for legal decisionmakers: “To the extent that you care about efficiency as a value, you should pay attention to the following conclusions” (Coleman 1980, 548–9).

Despite their evident similarities, positive economic analysis of the type championed by Friedman importantly differs from the positive economic analysis of tort law. Friedman (1966, 3–4) observed that positive analysis “is in principle independent of any particular . . . normative judgments.” Unlike positive economic analysis, the positive economic analysis of tort law is tied to a particular form of normative judgment. Because there is no consensus about the normative purpose of tort law, one must engage in an interpretive exercise in order to figure out the substantive rationale for tort liability. The interpretive exercise has been conceptualized in different ways by different scholars, but there is widespread agreement that any viable legal interpretation must first offer a minimally plausible description of the important doctrines and practices comprising the body
of law in question. This question of “fit” is addressed by the positive economic analysis of tort law, making it necessarily relevant to legal interpretation—a normative role that is absent from positive economic analysis in general.

For example, positive analysis could show that tort law can be plausibly described as furthering the objective of allocative efficiency, in which case the interpretive inquiry would then try to identify an appealing norm or value that justifies this function for tort law. So, too, if positive analysis were to show that the important doctrines of tort law are inefficient, it would effectively rule out any normative rationale for tort liability that requires efficient rules. Positive analysis is normatively valuable even if tort law ultimately cares nothing about allocative efficiency.

Due to its inherent normativity, the positive economic analysis of tort law may be subject to greater biases than positive economic analysis in general. This point has been sharply made by Kahan (2010, 1645), who claimed that the economic analysis of law suffers from a “recurring bias” based on “a preference for storytelling that bolsters the credibility of [law and economics] as a general framework of analysis by showing that [economic] arguments ‘fit’ rather than conflict with existing doctrine.” Legal economists purportedly do so “to demonstrate the plausibility of economic frameworks generally—often in the face

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1 “It is a commonplace among most jurists that theoretical accounts of any area of the law, including tort, must fit some of the law’s principal structural and doctrinal features. It is also often assumed that such accounts must, where possible, make those features both intelligible and normatively respectable” (Lucy 2007, 648). For example, according to the highly influential interpretive theory of Ronald Dworkin (1986, 67–8), a constructive interpretation of law has two distinct dimensions of fit and justification, each of which provides a basis for evaluating the plausibility of different interpretations.
of skepticism by noneconomic theorists—by showing that these frameworks cogently explain why these rules have the content that they do” (ibid., 1619).

Regardless of what one might otherwise think of Kahan’s claims, the persuasiveness of the efficiency interpretation undoubtedly depends on its ability to describe existing tort doctrine. “[M]ost economic analysts agree that the principle of efficiency by itself cannot provide moral justification” (Kraus 2007, 357). Consequently:

the economic analysis of the common law would not have had such a deep and widespread impact in the legal academy if it did not have something even more important going for it. Its impressive level of fit with case outcomes, combined with its comparatively high degree of determinacy, makes it at least a force to be reckoned with for any common law scholar and a dream come true for the law professor in the classroom…. The relative explanatory clarity, precision, and coherence of the economic analysis, compared to all its predecessors, has been self-evident even to many of its harshest critics (ibid., 357–8).

The appeal of economic analysis is most apparent in its explication of negligence liability, the default rule of tort law that obligates dutyholders to behave in compliance with the standard of reasonable care.

[T]he negligence standard is abstract and general. Within wide bounds, the finder of fact does not identify a pre-existing norm, but simultaneously determines for itself what would constitute reasonable behavior under the
circumstances and then applies this norm to the situation at hand (Abraham 2001, 1191).

As Posner (1972) argued, the norm of reasonable care is one of allocative efficiency as determined by cost-benefit analysis under the Hand formula. Not only does this efficiency interpretation fit the general description of reasonable care in the Restatement (Third) of Torts, it also is at least as determinate (in principle) as other accounts (Kraus 2007, 303–13).

The question of fit—whether tort law can be adequately described in terms of efficiency or a rights-based principle of justice—is one of the most contentious issues in the ongoing scholarly debate over the rationale for tort liability. A number of critics have questioned the descriptive power of efficiency analysis, arguing that positive economic analysis cannot persuasively explain the bilateral structure of tort liability, the substantive content of important liability rules, and the form of judicial reasoning in tort cases. These critiques are separately considered in the ensuing three sections, with much of the analysis focused on the default rule of negligence liability.

This analysis shows that the structure of tort liability does not pose a challenge to the efficiency interpretation; that challenge instead resides in the substantive content of the negligence rule and the form of judicial reasoning in

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2 The Restatement (Third) of Torts expressly recognizes that its test for determining whether the actor exercised reasonable care can “be called a ‘cost-benefit test,’ where ‘cost’ signifies the cost of precautions and the ‘benefit’ is the reduction in risk those precautions would achieve” (American Law Institute 2010, § 3 comment e).

3 Compare Landes and Posner (1987, 1, 313 (defining “the positive economic theory of tort law” as being based on the hypothesis “that the common law of torts is best explained as if judges who created the law through decisions operating as precedents in later cases were trying to promote efficient resource allocation” and concluding that the evidence supporting this hypothesis is “considerable”)), with Coleman (2001, 12 (“Whether or not it fails as a moral ideal, economic analysis certainly fails as an explanation [of tort law].”)).
negligence cases. Economic analysts have been studying a version of the negligence rule that fundamentally differs from the rule actually applied by courts. A positive analysis of the correct rule strengthens the efficiency properties of negligence liability vis-à-vis strict liability, thereby tightening the fit between allocative efficiency and the practice of tort law, but a more complete analysis of the negligence rule substantially undermines the positive claim that tort law can be plausibly interpreted as furthering a norm of allocative efficiency.

2. THE STRUCTURE OF TORT LIABILITY

According to a number of leading tort scholars, the efficiency interpretation of tort law is fatally undermined by its inability to persuasively explain the bilateral structure of tort liability, which limits the compensatory damages remedy to cases in which a defendant dutyholder violated the plaintiff’s correlative tort right (e.g., Coleman 2001; Weinrib 1995). The inefficiency of the right-duty bilateral structure finds ample support in positive economic analyses of the type developed by Calabresi (1970), which effectively treat the tort system as a variable component of a broader regulatory system concerned about the efficient reduction of accident costs. These analyses show that the tort system will often be less efficient than alternative institutional mechanisms, such as administrative regulation and social insurance. The appeal of these alternative mechanisms also finds historical support in the legislation that eliminated employer tort liability in favor of workers’ compensation schemes. In light of the evident inefficiencies of the bilateral structure of tort liability, one can see why an efficiency rationale for tort rules would seem to be largely beside the point.
The structural critique, however, does not disprove the efficiency rationale for tort liability. The structural critique assumes that the relevant policy question is one of devising a set of regulatory institutions that could efficiently reduce accident costs within society. If valid, the structural critique at most implies that such a regulatory system would not employ the bilateral structure of the existing tort system. In a tort case, though, the policy question is one of determining how the court should interpret the liability rule in order to resolve the dispute at hand. For historical and institutional reasons, a court can interpret the liability rule in terms of efficiency, even if the bilateral structure of tort liability is not currently the most cost-effective mechanism for regulating the social cost of accidents.

The bilateral structure of tort liability originates from the twelfth and thirteenth centuries when the legal system (based on pleading devices known as writs) enabled the victim of a crime to receive compensation from the criminal wrongdoer. Liability in these cases was clearly based on a norm of corrective justice, which by definition involves the correction of an injustice or wrong (defined as the breach of duty in violation of a correlative right). The resultant bilateral structure of liability was firmly established when the Industrial Revolution occurred in the United States during the nineteenth century, the period when the modern tort system first emerged from its embryonic state in the writ system.

Due to the limited number of regulatory alternatives at that time, “[t]he courts had become the American surrogate for a more fully developed administrative apparatus” (Skowronek 1982, 27). Aware of their regulatory role,
courts understandably considered the economic consequences of their rulings. “The state and federal courts . . . developed policies in the form of common law rules that tended to spark commercial activity and economic development” (Feldman 1997, 1406). In this era, the most efficient institution for regulating accidental harms, quite plausibly, was the tort system.

To be sure, the tort system could not wholly reject its corrective justice origins in favor of an overtly instrumentalist approach guided by the concern for allocative efficiency, as any change in judicial decisionmaking is constrained by the requirements of *stare decisis*—the need to maintain consistency and uniformity of the law over time. But the constraints of *stare decisis* were considerably weakened during the nineteenth century. One by one, the states abolished the writ system, which used pleading requirements in a manner that often masked difficult issues of substantive law. Although this procedural reform was not supposed to affect the substantive law, eliminating the practice meant that some substantive issues of great importance, such as the choice between negligence and strict liability, were for the first time presented in their most general form to the courts.

The abolition of the writ system accordingly created an opportunity for tort law to evolve into something new (Geistfeld, 2001, p. 254). This opportunity occurred at a time when judges were increasingly embracing a pragmatic jurisprudence that conceptualized law as an evolutionary process rather than as a body of rules eternally fixed by principles of natural justice. The question, then, is how courts in this historical context developed the newly emergent tort system.
The courts, quite plausibly, responded to this evolutionary opportunity by pursuing the objective of allocative efficiency. The “historical record shows that the tort system in the nineteenth century began pursuing the instrumentalist objectives of compensation and deterrence in a manner consistent with the minimization of accident costs” (ibid., 256). That these rules are often efficient finds extensive support in the positive economic analyses that evaluate liability rules within the traditional bilateral structure of the common law tort suit (e.g., Landes and Posner 1987).

As a matter of precedent, common law courts could then further develop tort law in an efficient manner. Today, other institutions might be more cost-effective modes of regulation, but that prospect is irrelevant in a tort dispute. A common law court does not have the authority or competence to replace tort law with an alternative regulatory mechanism.

Thus, even if the bilateral structure of a tort suit is now a less efficient form of regulation than other institutional alternatives, tort law can still be plausibly interpreted in terms of allocative efficiency. The positive economic analysis of tort law cannot be rejected simply because judicial decisionmaking is constrained by the institutional requirement of a bilateral structure of tort liability that limits the compensatory damages remedy to cases in which a defendant dutyholder violated the plaintiff’s correlative tort right.

3. THE SUBSTANTIVE CONTENT OF TORT RULES

In its conventional form, the economic analysis of tort law seeks to determine whether the particular formulation of a tort rule is allocatively efficient.
This literature is broad and reaches varying conclusions. Some analyses find that important tort rules, including the Hand formulation of negligence liability, are not allocatively efficient (e.g., Feldman and Kim 2005). But as Landes and Posner (1987, 1, 313) have concluded, there is “considerable” evidence to support the hypothesis “that the common law of torts is best explained as if judges who created the law through decisions operating as precedents in later cases were trying to promote efficient resource allocation.”

To evaluate this conclusion, we can consider negligence liability, the default rule governing accidental harms that is the most important feature of the torts landscape.

A. The Entitlement Structure of the Negligence Rule

The conventional economic analysis of tort law models the negligence entitlement as being constituted by a liability rule, or more precisely, a liability rule held by the potential victim with respect to unreasonable risks, and a property rule held by the risky actor with respect to reasonable risks (e.g., Kaplow and Shavell 1996, 753). So formulated, negligence liability only prices unreasonably risky behavior and gives risky actors the option to act unreasonably whenever doing so would be less costly than complying with the duty to exercise reasonable care (e.g., Shavell 2007).

The conventional economic model erroneously assumes that a rightholder’s entitlement with respect to unreasonable risks is wholly defined by a liability rule, which is a method for pricing behavior governed by the duty. For this purpose, a price represents “money extracted for doing what is permitted”
A dutyholder who is willing to pay compensatory damages, however, does not thereby gain permission to act unreasonably. Compensatory damages do not function as a price, and so the negligence entitlement governing unreasonable risks cannot be wholly constituted by a liability rule.

Even if a dutyholder fully expects and is able to pay compensatory damages for all injuries caused by the unreasonable conduct, the unilateral decision to act unreasonably in exchange for the prospective payment of compensatory damages would clearly constitute the “bad state of mind” that subjects the dutyholder to liability for punitive damages and criminal negligence, the conclusion reached by courts in a number of cases (Geistfeld 2011b, 165–9). The requisite “bad state of mind” can be established by the manner in which the breach of the duty to exercise reasonable care exhibited a conscious or flagrant “indifference to risk” (Dobbs 2000, 1064). Such a breach of the duty is reprehensible and subject to punishment even if the dutyholder is willing and able to pay compensatory damages.

As established by these punitive penalties, the negligence entitlement prohibits dutyholders from choosing to act unreasonably in exchange for the prospective payment of compensatory damages, and so the entitlement fundamentally differs from a liability rule that simply prices unreasonably risky behavior. Instead, the negligence entitlement is a behavioral rule that primarily obligates dutyholders to exercise reasonable care (Geistfeld, 2011a). The breach of this primary duty can create a secondary duty to pay compensatory damages for the resultant injuries, but that secondary obligation is not fungible or fully
interchangeable with the primary obligation to exercise reasonable care (Geistfeld, 2011b).

In cases of negligence liability, compensatory damages are a *sanction* imposed on the dutyholder for having violated the tort right—a term meaning “detriment imposed for doing what is forbidden” (Cooter 1987, 1523). When compensatory damages are a sanction for the breach of a duty, a defendant who pays those damages can still incur further liabilities as punishment for having violated the primary duty in a forbidden or prohibited manner.

To be sure, punitive damages are the exception and not the rule within tort law, but most forms of unreasonable behavior do not involve the type of conduct prohibited by the negligence entitlement. The sanction embodied in an award of compensatory damages justifies further punitive penalties only for the exceptional cases in which the dutyholder engaged in the prohibited conduct, that is, when the dutyholder did not simply act unreasonably, but did so with the requisite “bad state of mind.”

Although this fundamental component of the negligence entitlement has

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4 The standard of reasonable care is defined by the objective standard of the reasonable person, and punishment is not warranted for cases in which the rightholder could not realistically comply with that standard:

Unreasonable risky behavior is often the result of inadvertence, mistake, or even adherence to conventional practices (like exceeding the speed limit on a highway). As illustrated by these common forms of negligent behavior, the duty to exercise reasonable care often involves unrealistic behavioral demands (always pay attention, never make mistakes, and never exceed the speed limit when others routinely do so). By not complying with an unrealistic behavioral demand, one can violate the duty without being personally blameworthy or at “fault” in the colloquial sense. In this critical respect, the objectively defined negligence rule is a form of “strict” or “no fault” liability. In these cases, the negligent actor breached the primary duty to exercise reasonable care without reprehensibly rejecting that obligation. The payment of compensatory damages does not fully substitute for the breach of the primary duty to exercise reasonable care[,] … but that difference does not merit a punitive response in these cases. (Geistfeld 2011b, 168) (citation omitted).
been ignored by the conventional economic analysis of tort law, accounting for it provides a clear efficiency rationale for the default rule of negligence liability. Consider the standard economic account of negligence liability, which formulates the duty of reasonable care (as per the Hand formula) to require any precaution with a cost or burden (denoted $B$) that is less than the reduction in expected injury costs (the probability, $P$, that an accident will occur multiplied by the social value of the loss, $L$). Instead of complying with the duty to exercise reasonable care ($B < PL$), a dutyholder will rationally choose to violate the duty whenever the cost of compliance exceeds her expected liability costs (the probability, $P$, that an accident will occur multiplied by the total amount of compensatory damages, $D$, for which the dutyholder would be liable). This decision ($B > PD$) will often be inefficient, explaining why the efficient rule prohibits dutyholders from choosing to breach the duty in exchange for the payment of compensatory damages.

In a case of wrongful death, the dutyholder is not obligated to pay any compensatory damages for the decedent rightholder’s loss of life’s pleasures Geistfeld (2008, 356–9). The dutyholder will rationally ignore these harms ($D = 0$) in deciding how safely to behave, reducing and potentially eliminating her incentive for taking costly precautions that would reduce the risk of a fatal accident ($B > PD = 0$). Rather than making an efficient safety decision, the dutyholder has instead exploited the inherent limitations of the compensatory damages remedy in a case of premature death. The identical safety problem exists under strict liability as well. To address this inefficiency, tort law must rely on a default rule of negligence liability that does not merely price risky behavior in
terms of the dutyholder’s expected liability for compensatory damages, but instead uses compensatory damages as a sanction that can serve as the basis for punitive measures that deter dutyholders from inefficiently rejecting the primary duty to exercise reasonable care.

This type of negligence rule is currently employed by the tort system. The standard of reasonable care specifies those precautions that a dutyholder must take in order to eliminate a risk of loss faced by rightholders. This obligation is based on the legal valuation of the loss (denoted $L$), which includes the loss of life’s pleasures in a case of wrongful death. Because the risk of fatal injury is included in the standard of reasonable care, the negligence rule can require dutyholders to act efficiently with respect to the risk of fatal injury ($B < PL$). To create the requisite financial incentives, however, negligence liability cannot always be limited to compensatory damages ($B > PD = 0$). Negligence liability must instead be complemented by other remedies that are formulated to deter dutyholders from unilaterally rejecting the duty to exercise reasonable care in exchange for the payment of compensatory damages, the type of remedies (punitive damages and criminal negligence liability) that are now recognized by the legal system (for cases in which the dutyholder violates the duty with the requisite “bad state of mind”). The negligence rule is capable of inducing dutyholders to exercise the efficient amount of care despite the limitations of liability for compensatory damages.

This deterrence problem could be addressed in other ways, but none can

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5 The Restatement (Third) of Torts defines “physical harm” to include physical impairment of the body caused by death, and then states the general rule of negligence liability for having caused “physical harm” (American Law Institute 2010, §§ 4, 6).
be accommodated within the firmly established bilateral structure of tort liability. The bilateral structure originated as a form of corrective justice based on the compensatory damages remedy. In a case of wrongful death, the loss of life’s pleasures is not a compensable injury for the obvious reason that money cannot compensate a dead person.

To be sure, placing the burden of compensation on the negligent party also serves as a deterrent, but purely punitive damages—that is, those which have no compensatory purpose—are prohibited unless the harmful conduct is intentional, malicious, outrageous, or otherwise aggravated beyond mere negligence.6

Unable to rely on the compensatory damages remedy, tort law can only address the problem of wrongful death with a safety obligation—the duty to exercise reasonable care.

This justification for the default rule of negligence liability is not limited to the problem of fatal injuries. Wrongful death is the paradigmatic instance of an “irreparable injury,” the common law term for a harm that cannot be adequately redressed by the compensatory damages remedy (Laycock 1990). The common law concept of an irreparable injury applies to the broader category of physical harms—bodily injury and damage to real or tangible property—governed by the ordinary standard of reasonable care (Geistfeld 2011b, 159–64). In cases of irreparable injury, “judges have been brought to see and to acknowledge . . . that a remedy which prevents a threatened wrong is in its essential nature better than a remedy which permits the wrong to be done, and then attempts to pay for it”

In addition to explaining why the payment of compensatory damages is not an adequate substitute for the exercise of reasonable care, the problem of irreparable injury provides a deterrence rationale for the default rule of negligence liability.

This deterrence rationale considerably bolsters the efficiency properties of negligence relative to strict liability. Due to the high cost of tort compensation as compared to other forms of insurance, the efficiency properties of a tort rule depend on its relative capability for reducing risk. According to the conventional economic model, negligence and strict liability each induce risky actors to take only those safety precautions that are cost justified, with the two rules instead having different effects on the frequency or scale of the risky activity (Shavell 1980). For example, in the context of risky interactions between automobile drivers and pedestrians, negligence liability places the cost of unavoidable accidents (those that cannot be avoided by cost-justified precautions) on pedestrians (the potential accident victims) and accordingly will reduce the frequency of that activity (walking), whereas strict liability has the opposite effect of reducing the activity of automobile driving. If the choice between negligence and strict liability were to turn only on this factor, then strict liability would be a more pervasive form of tort liability than is currently the case, creating a problem for the efficiency interpretation: “The negligence rule is usually the base line around the world. . . . Given the basic [economic] analysis of negligence versus strict liability, it is difficult to see what explains this” (Schafer and Muller-Langer 1998, 625–31, 639–43).

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7 For more extended discussion that explains why tort liability substantially increases insurance costs as compared to other insurance mechanisms, including data that support this conclusion, see Geistfeld (1998, 625–31, 639–43).
An efficiency explanation for the default rule of negligence liability can be derived from the problem of irreparable injury. Unlike negligence liability, strict liability exclusively relies on the compensatory damages remedy in order to induce precautionary behavior. Due to the inherent limitations of the compensatory damages remedy in cases of irreparable injury, the precautionary behavior induced by a rule of strict liability will often be inefficiently low. That problem is avoided by negligence liability, yielding the type of deterrence rationale for the base line rule of negligence liability that is required in order for it to be allocatively efficient.

B. The Efficient Specification of Duty

The negligence rule obligates risky actors to exercise reasonable care. To determine the safety precautions or burden (the term $B$) required as a matter of reasonable care, tort law must first determine the risks for which the actor is legally responsible (the $PL$ terms). These risks are defined by the element of duty.\(^8\)

When adequately enforced, a negligence rule would induce risky actors to exercise the first-best efficient amount of care if it required any precaution that costs less than the associated reduction in total injury costs, a standard of reasonable care embodied in the Hand formula, $B < PL$. But in order for this standard to require the first-best amount of care, the duty must encompass all injuries that comprise the total social costs of accident.

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\(^8\) The discussion in this and the ensuing subsection is largely derived from Geistfeld (2011b, 172–80), which contains more extensive analysis and also supplies support for the various legal propositions stated throughout this argument.
Such a conception of duty was integral to the development of tort law in the nineteenth century (White 2003, 18). This conception was also famously relied on by Judge Andrews in his dissenting opinion in *Palsgraf v. Long Island Railroad*: “Every one owes to the world at large the duty of refraining from those acts that may unreasonably threaten the safety of others.” A duty owed to the world encompasses the full social cost of accidents, yielding a negligence rule that can require individuals to exercise the allocatively efficient amount of care ($B < PL$).

The total social cost of accidents is also comprised of the cost of insuring against those injuries that do occur. As previously discussed, the tort system (which ordinarily requires legal representation) is a substantially more expensive method for compensating injuries as compared to alternative insurance mechanisms that do not ordinarily require the insured to procure legal representation in order to receive indemnification for covered losses. Moreover, monetary compensation for nonmonetary injuries can be inefficient. For both reasons, insurance costs are usually reduced when a tort rule channels injury costs to other insurance mechanisms, and so the total social cost of accidents is minimized by a tort rule that limits liability to the amount required to induce dutyholders to exercise the efficient amount of care.

Once again, this efficiency objective could be attained under the conception of negligence liability articulated by Judge Andrews. If it would be

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10 See supra note 7.
11 By definition, a nonmonetary injury does not reduce the victim’s wealth, and so it must otherwise increase her marginal utility of wealth in order for monetary compensation to be allocatively efficient (e.g., Calfee and Rubin 1992).
inefficient to provide tort damages for a class of injuries, courts could exculpate the defendant from liability under the element of proximate cause for reasons given by Andrews:

What we do mean by the word “proximate” is that, because of convenience, of public policy, of a rough sense of justice, the law arbitrarily declines to trace a series of events beyond a certain point. This is not logic. It is practical politics.\(^{12}\)

Based on the “public policy” of allocative efficiency, courts could rely on the element of proximate cause to deny liability for categories of cases. Doing so would yield a negligence rule that both induces the first-best amount of care (based on a duty owed to the world) while efficiently minimizing the costs of injury compensation (by limiting liability as a matter of proximate cause). Under the formulation advocated by Andrews, the negligence rule can attain the first-best safety outcome while minimizing the insurance inefficiency that is characteristic of tort damages, yielding the maximal or first-best efficient outcome.

To illustrate, consider how this approach applies to emotional injuries suffered by someone who is not physically harmed, such as the trauma experienced by family and friends who deeply care about someone badly injured or killed in an accident. The compensation of stand-alone emotional harms is ordinarily an inefficient form of insurance, and so liability can be cost-effective only because of the value of deterrence (Geistfeld 1995, 843–51). Under the formulation of negligence liability advocated by Andrews, the value of deterrence

\(^{12}\) *Palsgraf*, 162 N.E. at 103–4.
can be retained and the insurance inefficiency minimized.

Pursuant to Andrews’s formulation of a duty owed to the whole world, stand-alone emotional harms are included within the standard of reasonable care. The dutyholder, therefore, can be obligated to exercise the amount of precaution that would be efficient in light of the total social cost of injury (assumed for present purposes to consist only of an accident that causes physical harm to some individuals, which in turn causes others to suffer stand-alone emotional harms):

\[ B < P(L_{\text{physical harm}} + L_{\text{stand-alone emotional harm}}) \]

For cases in which the dutyholder negligently caused physical harm, those who suffer consequential stand-alone emotional harms can be denied recovery on grounds of proximate cause—the “public policy” of allocative efficiency would not be furthered in such a case, justifying the denial of liability for the reasons given by Andrews. The common law had long denied recovery for stand-alone emotional harms on the ground that such injuries were too “remote” and not proximately caused by the defendant’s negligence (e.g., Bohlen 1902, 146). An approach that categorically limits liability for stand-alone emotional harms as a matter of proximate cause had ample precedential support at the time of Palsgraf.

To be sure, such a limitation of liability would undermine the financial incentive for complying with the duty, but that incentive is restored by the threat of punitive damages and criminal liability. If the dutyholder were to reject the safety obligation for the reason that it would be cheaper to pay compensatory damages, she would be subject to punitive damages and perhaps even criminal
negligence liability for cases in which the risky conduct causes physical harm.\(^\text{13}\)

When the risky conduct threatens both physical harm and stand-alone emotional harm—the problem analyzed above—the safety obligation encompassing both types of harm can be rendered enforceable with the threat of punitive damages and criminal negligence liability limited to cases of physical harm. The different elements of the negligence claim can serve as two different instruments for attaining the efficient outcome in the two dimensions of care and injury compensation.

**C. The Current (Inefficient) Formulation of Duty**

Instead of concluding that risky actors owe a duty “to the whole world” as argued by Judge Andrews in his dissenting opinion, *Palsgraf* instead held that duty is limited to those who are foreseeably threatened by the risky conduct in question.\(^\text{14}\) According to the *Restatement (Second) of Torts*, this requirement is satisfied only if the defendant “create[d] a recognizable risk of harm to the [plaintiff] individually, or to a class of persons—as for example, all persons within a given area of danger—of which the [plaintiff] is a member” (American Law Institute 1965, § 281 comment c).

The appropriate interpretation of *Palsgraf* continues to be controversial, but the implications of the case for present purposes are clear. Consistently with the majority ruling in *Palsgraf*, courts now foreclose recovery for general categories of harms by a limitation of duty. For example, courts deny recovery for pure economic loss and stand-alone emotional harms by limiting duty, not on the

\(^{13}\) See *supra* subsection A.

\(^{14}\) *Palsgraf*, 162 N.E. at 100.
grounds of proximate cause as argued by Andrews in the *Palsgraf* dissent. As explained by the *Restatement (Third) of Torts*, “in some categories of cases, reasons of principle or policy dictate that liability should not be imposed. In these cases, courts use the rubric of duty to apply general categorical rules withholding liability” (American Law Institute 2010, § 7 comment a).

By limiting duty, courts have formulated the negligence rule in a fundamentally inefficient manner (Geistfeld 2011b). In general, the total social cost of accidents includes physical harms, stand-alone emotional harms, and at least some forms of pure economic loss.\(^{15}\) For risky conduct threatening each type of harm, the allocatively efficient first-best amount of care (denoted \(B^\ast\)) requires any precaution with a burden less than the associated reduction in the total social cost of injury:

\[
B^\ast < PL_{\text{physical harm}} + PL_{\text{stand-alone emotional harm}} + PL_{\text{pure economic loss}}
\]

Due to the limitation of duty, the standard of reasonable care does not consider the total social cost of accidents. Leaving aside exceptional cases, risky actors have no duty with respect to stand-alone emotional harms and pure economic loss, resulting in a negligence standard that is largely limited to the foreseeable risk of physical harm:

\[
B < PL_{\text{physical harm}}
\]

\(^{15}\) Some forms of pure economic loss like lost profits may not be social costs but instead could be an individual loss that is fully offset by another’s gain (e.g., Bishop 1982). However, not all forms of economic loss can be characterized in this manner. Medical monitoring claims, for example, seek recovery for the financial costs of diagnostic treatment for physically noninjured plaintiffs who are at risk of suffering physical harm (like cancer). Although courts are sharply divided on the issue of whether these damages should be recoverable, there is no question that medical monitoring is a social cost that ought to be included within the duty for purposes of efficiency analysis. At least some forms of pure economic loss, therefore, contribute to the total social cost of accidents.
This limited duty excludes social harms from the standard of reasonable care and will ordinarily require less precaution than the first-best efficient amount based on the full set of social harms \( B < B^* \), making negligence liability inherently inefficient.

Others have argued that any limitation of duty is inefficient for essentially the same reason that any other limitation of liability could be inefficient: it reduces the incentive to take costly precautions that would avoid those injuries for which the dutyholder is not financially responsible (e.g., Coleman 2001, 23). This argument assumes that dutyholders must be subject to liability for compensatory damages for any given injury in order for them to have an adequate financial incentive to exercise the efficient amount of care with respect to that injury. As previously established, however, the threat of punitive damages and criminal negligence liability make it possible for courts to fully enforce a duty to exercise reasonable care governing risks (such as premature death) for which the injury in question is not compensable by the damages remedy.\(^{16}\) A limitation of liability, therefore, does not necessarily reduce the financial incentive for complying with the duty to exercise reasonable care. The inherent inefficiency of a limited duty instead pertains to its omission of social costs from the calculus of reasonable care, thereby yielding an inefficiently low standard of care.

This inefficiency in the standard of reasonable care did not inhere in the bilateral structure of liability that the modern tort system inherited from the writ system. The existence of duty in tort law is an “historical accident” of the English

\(^{16}\) See *supra* subsection A.
common law (Winfield 1934, 66). In developing this new element, courts could have formulated duty to require the first-best efficient amount of care, with the element of proximate cause then serving as a separate instrument for limiting liability for the general class of cases in which tort compensation would be inefficient. Instead of taking that approach, courts have inefficiently formulated the element of duty so that it excludes important categories of accident costs from the standard of reasonable care. Courts had a choice about the matter, and they chose a fundamentally inefficient formulation of duty.

Because courts could have formulated the negligence rule to require the allocatively efficient amount of care, their failure to do so creates a problem for the efficiency interpretation of tort law. A comparison of total social costs and total social benefits is obviously required by any effort to allocate scarce resources in an efficient manner. So, too, this efficiency calculus is obviously skewed by the varied limitations of duty that exclude a considerable number of social harms from the cost-benefit exercise. Indeed, courts have also excluded an obvious social benefit from the duty—the manner in which the dutyholder’s exercise of care reduces the risk of self-injury (Cooter and Porat 2000). Courts have formulated duty so that the negligence calculus fundamentally diverges from the calculus of allocative efficiency, substantially undermining the positive claim that courts have formulated the negligence rule in an efficient manner.

4. THE FORM OF LEGAL REASONING IN TORT CASES

If there is a poor fit between a legal rule and the objective of allocative efficiency, then the rule is likely to require reasoning different from that required
by the efficiency analysis. “[C]ommon law decisions are cast in the language of morality, not efficiency” (Kraus 2007, 289). Consequently, the positive economic analysis of tort law has been widely criticized for its failure to explain the moral reasoning employed by judges in deciding tort cases, with a leading critique supplied by Coleman (2001).

One of Coleman’s central objections to the economic analysis of tort law is that it “reject[s] the self-understandings of the developers and participants in the practice.” He argues that tort liability is predicated on “an inference warranted by the acceptance of certain claims, many of which employ concepts such as harm, wrong, duty of care, but-for and proximate cause, and so on,” yet the economic analysis, by reducing tort law’s core concepts to efficiency, “assign[s] to the central concepts of tort law contents that bear no immediate relationship to the actual structure of inferences those concepts warrant in the practices of tort law.” Instead, the economic analysis “suggests a scheme of practical inference altogether different from the one actually in place[,] and . . . jettison[s] concepts that are in fact central to our legal practice.” According to Coleman, “the economists tell us that the process of reasoning in which participants in our tort institutions engage is a kind of ideological illusion” (Kraus 2007, 293) (citations omitted).

In defense of positive economic analysis, Kraus (ibid., 299) argued that
“the express terms in common law decisions have a specialized meaning within the common law and that the transparency of a judicial decision therefore should be determined relative to the contextual, rather than plain, meaning of the judicial language.” As a matter of contextual meaning, common law terms that would seem to plainly express deontic or moral reasoning—rights, duties, wrongdoing, and so on—can instead embody the rationality of economic analysis. Insofar as these deontic concepts are too indeterminate to resolve the case at hand, courts had to develop the concepts with consequentialist reasoning. As a result of this process, over time judges could retain the language of morality as embedded in early common law doctrines while actually employing economic reasoning. “It is this specialized meaning, evolved and grasped through common law reasoning itself, that judges take themselves to be using when they express their legal reasoning in opinions” (ibid., 335). Judges speak the language of morality while reasoning in economic terms.

This interpretation of judicial reasoning is both elegant and conceptually coherent, but to avoid being a “just so” story, it must be testable. Can the reasoning that judges employ to decide tort cases be plausibly reconstructed in these terms?

To address this question, Kraus considered the concept of duty, which we have already found to be of central importance for evaluating the descriptive capabilities of efficiency analysis. The issue, as Kraus recognized in a related context, “is whether the economic analysis is a plausible candidate theory for explaining not merely what duties tort law recognizes but how tort law itself
affirmatively determines the content of the first-order duties it vindicates” (ibid., 323).

The concept of duty clearly supports Kraus’s claim that a term with a plain deontic meaning can nevertheless be developed by courts so that it becomes imbued with consequentialist meaning. In California, for example, courts recognize that the determination of duty

is a matter of policy and involves the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant’s conduct and the injury suffered, the moral blame attached to the defendant’s conduct, and the policy of preventing future harm.17

Whether courts will recognize a duty clearly depends on consequentialist reasoning. The legal conception of duty, however, would only be sufficiently “economic” in nature if courts were to then determine the content of that duty with the consequentialist reasoning required by efficiency analysis.

According to Kraus (2007, 347), courts plausibly do so because “[t]he concept of duty is necessary for tort law to serve the purpose of efficient regulation[,] . . . it allows judges to modify the scope of liability to create optimal incentives for individuals to choose efficient levels of activities and to take efficient levels of precautions.” The economic logic of duty is more fully developed by Hylton (2006, 1502), who concluded that the “core function” of

duty “is to regulate the frequency or scale of activities that have substantial external effects.”

The economic logic of duty cannot be squared with the manner in which courts have actually developed this area of the law. As established by Section 3 above, courts have formulated duty in a fundamentally inefficient manner by excluding large swaths of social harms from the calculus of reasonable care. In doing so, courts have limited duty for reasons that do not support Kraus’s hypothesis that the meaning of duty, when placed in legal context, can be plausibly interpreted in the consequentialist terms of allocative efficiency.

Consider the limitation of duty for pure economic loss. On the economic account, the limitation of duty is efficient because pure economic losses, like lost profits, typically involve private losses that do not translate into a social loss: the lost profits of one are ordinarily the increased profits of another (Bishop 1982). This rationale for the limitation of duty, however, is not expressly invoked by courts, which instead limit duty for pure economic loss based on “an age-old concern about extending liability ad infinitum for the consequences of a negligent act” (Rabin 1985, 1526).

A concern about too much liability could reflect the conclusion that there is no net social loss caused by the negligent behavior as per the economic account, but if that is the real reason for limiting liability, courts could easily say so. The issue is simply one of determining the relevant terms for inclusion in the cost-benefit safety calculus, an issue that courts expressly address in other contexts. Based on this accepted form of common law reasoning, courts could
limit duty by expressly concluding that cases of pure economic loss involve private losses that are not cognizable as social losses for purposes of reasonable care. Their failure to do so makes it implausible to conclude that courts have limited duty for this economic reason.

In product cases, for example, courts have rejected the claim that lost profits and related forms of pure economic loss are relevant to the cost-benefit (or risk-utility) test for determining whether a product design or warning is defective. As one court explained in a case alleging that cigarettes fail the risk-utility test:

In essence, defendants argue that in determining liability, a jury engaged in the risk utility analysis may take into consideration profits made, employees hired, benefits to suppliers of goods and services, taxes generated and even charitable activities or contributions made by the defendant manufacturer. The analysis was never meant to balance the risk to the consumer against the general benefit to society. Rather, the sole question presented is whether the risk to the consumers exceeds the utility to those consumers. The manufacturer of a highly dangerous or defective product with no or limited utility to a consumer, should not escape liability by demonstrating that the manufacturer of the product makes money for stockholders, for workers, for contractors, for suppliers, for municipalities, for the IRS, etc. It is the benefit and utility to the cigarette smoker which is here in issue, and not the benefit to the cigarette industry or those in turn, who benefit from

As this case illustrates, courts will not recognize a private loss (such as lost profits) as a legally valued social loss when doing so would be contrary to the nature of the duty in question (in this instance, of supplying a nondefective product or one passing the risk-utility test). This accepted form of common law reasoning would enable courts to limit duty for pure economic loss on the express ground that the private lost profits suffered by the plaintiff are not a cognizable social loss that factors into the cost-benefit safety calculus. Instead of using this form of reasoning, however, courts have invoked other rationales for excluding pure economic loss from the duty to exercise reasonable care. By foregoing an available form of common law reasoning that could have expressly justified the limitation of duty in the manner required by allocative efficiency, courts appear to have been motivated by some other concern.

Finally, consider the standard of reasonable care within negligence law. According to the conventional economic analysis of tort law, the standard of reasonable care is defined by the Hand formula and accordingly entails the type of cost-benefit exercise required by an allocatively efficient negligence rule (e.g., Posner 1972). Once again, the language actually employed by judges is hard to square with the logic of the efficiency argument.

Judges do not frame jury instructions in a manner that is likely to promote the cost-benefit reasoning required by efficiency analysis. Jury instructions in the vast majority of jurisdictions first define negligence as the failure to exercise ordinary care, and then define ordinary care in terms of the conduct of the
reasonably careful or reasonably prudent person (Kelly and Wendt 2002, 622). At most, only five jurisdictions rely on jury instructions consistent with the allocatively efficient cost-benefit test for negligence, but that formulation is not the most plausible interpretation of these instructions (ibid., 618–20). As empirical studies have found, judges, jurors, and lay individuals typically interpret the requirements of reasonable care to mandate safety precautions in excess of the allocatively efficient amount for risky behavior threatening severe bodily injury to others (Viscusi 1999; 2000; 2001).

In light of this practice, why wouldn’t efficiency-oriented judges expressly instruct juries to evaluate reasonable care in terms of the cost-benefit test entailed by the Hand formula? This question has been extensively addressed by Gilles (1994), who concluded that although there are some reasons why an efficiency-oriented court would not expressly define reasonable care as a matter of cost-benefit analysis, “the Hand Formula is, to a significant extent, an unjustifiably underenforced norm” (ibid., 1020).

The courts’ failure to enforce the Hand formula with appropriately formulated jury instructions cannot be attributed to the difficulties that they would otherwise face in trying to express the concept of reasonable care with the economic reasoning required by the Hand formula. In product cases, for example, courts have adopted jury instructions that expressly define the safety standard in the cost-benefit terms of the risk-utility test.\footnote{E.g., N.Y. Pattern Jury Instr. Civil 2:120 (2007) (stating that the safety standard “depends upon a balancing of the risks involved in using the product against (1) the product’s usefulness and its costs, and (2) the risks, usefulness and costs of the alternative design[s] as compared to the product the defendant did market”).} The common law is clearly capable
of defining the standard of reasonable care in cost-benefit terms, and yet courts have not done so outside of products liability.

As in cases of pure economic loss, courts do not invoke the express reasoning required by efficiency analysis, even though they employ such reasoning in other contexts and therefore could do so if those reasons, in fact, truly explain the rule in question. The mode of reasoning that courts employ in negligence cases further undermines the positive or descriptive claim that tort law is best understood as pursuing the objective of allocative efficiency.

5. POSITIVE ANALYSIS AND THE ORIENTATION OF TORT THEORY

Of the varied rules of tort law, negligence liability is arguably the one that is most persuasively explicated in terms of efficiency analysis, and yet this rule is hard to reconcile with the objective of allocative efficiency. The inability of the efficiency interpretation to fully describe the negligence rule, however, does not necessarily undermine this theory of tort law.

The claim that a theory must fit its theoretical object is not incompatible with the claim that a theory need not fit every detail of that object. Furthermore, there is considerable doubt as to the utility of a theory that accommodates every detail of its object. . . . The core of this doubt is that the theory envisaged runs the risk of being literally pointless. This is because a theory that accommodates every detail of its object is simply a redescription of that object and, without more, such a redescription prima facie lacks epistemological value (Lucy 2007, 652).
Although tort rules can be inefficient in some respects, one can still plausibly interpret tort law in terms of allocative efficiency provided the fit requirement is understood as a demand that a theory of an object must fit enough of that object to be a theory of it. How else, besides employing such a requirement of fit, can we be sure that a theory accurately captures that which it purports to explain? (ibid.)

Whether tort law can be adequately described with efficiency theory is ultimately a comparative exercise. Any shortcomings that inhere in the efficiency interpretation must be compared to those inherent in other interpretive approaches. As should be evident by now, tort law expressly relies on both economic and deontic reasoning, giving each interpretation descriptive power.

The principal difference between them is thus not that one account fits the detail or structure of tort law and the other does not. Rather, they differ in the aspects of the law that they fit and those that they fail to accommodate. The problem then arises (which is not tackled here) of how to determine where the balance of explanatory advantage lies between these accounts (ibid., 609).

The interpretive exercise need not result in stalemate, however. Positive analysis can be, as Friedman (1966, 4) observed, “an ‘objective science,’ in precisely the same sense as any of the physical sciences.” The claim is not that a positive inquiry must be entirely objective—the uncertainty principle in physics illustrates the problematic nature of such a claim even for the physical sciences.
The claim instead is that positive analysis should not be wed to a particular normative commitment, including one of allocative efficiency: “Positive economics is in principle independent of any particular ethical position or normative judgments” (ibid.). So conceptualized, positive analysis strives to be a method for identifying the important properties of existing tort rules that can then serve as “data points” or the empirical foundation for constructing and testing alternative interpretations of tort law. As with scientific inquiry in general, the motivation for positive analysis is to derive data that can be used to tentatively formulate and then revise theoretical analysis as necessary, creating a role for positive analysis that is not limited to the problem of selecting between competing theories that only partially fit the data.

By framing the problem in this manner, positive analysis points towards a theory of the individual tort right or duty that is sensitive to, but not wholly defined by, allocative efficiency. The most obvious basis for such a tort right resides in the deontic value of individual autonomy or self-determination.

In the context of contract law, for example, “efficiency and autonomy often coincide” (Craswell 2003, 906). This result is unsurprising in light of “the natural link between liberty and Pareto efficiency, which is the fundamental normative concept in contemporary economics” (Cooter 1987, 524).

Indeed, autonomy-based tort rights satisfy the relevant distributional requirements of modern welfare economics (Geistfeld 2009):

It should come as no surprise that autonomy-based tort rules satisfy the distributional requirements of welfare economics,
since the promotion of autonomy is consistent with the important value judgments of contemporary welfare economics. “Put most simply, to be autonomous is to be one’s own person, to be directed by considerations, desires, conditions, and characteristics that are not simply imposed externally upon one, but are part of what can somehow be considered one’s authentic self.” Individual choice, of course, also has foundational importance for welfare economics. In addition to the Pareto principle, the “main value judgment” involved in modern welfare economics “is called individualism” which maintains that “social ordering ought to be based on individual orderings of alternative states, that is, on individual preferences, where it is implicitly assumed that each individual is the best judge of his or her own preferences.” Like autonomy, individualism rests on the normative judgment that the individual is the best person for deciding how to pursue her own life. By promoting autonomy, rights-based tort rules recognize the value of individualism embraced by welfare economics (ibid., 248–49) (citations omitted).

When rigorously developed, the deontic value of individual autonomy can justify a compensatory tort right that structures liability rules to permit socially valuable forms of risky behavior—those myriad activities like automobile driving that further the value of individual autonomy within the community—while striving to fully compensate those threatened with physical harm (Geistfeld 2008).
As a matter of positive analysis, such a compensatory tort right persuasively explains or “fits” the important doctrines and practices of tort law (ibid.).

These autonomy-based compensatory tort rules do not maximize individual or social welfare as required by the objective of allocative efficiency, but the value of autonomy nevertheless accounts for efficiency concerns in important contexts. In many cases, the best protection of the rightholder’s autonomy will reside in promoting her welfare. Important examples include tort rules governing contractual relationships (like products liability), risky interactions that are reciprocal as an objective matter (like those between two automobile drivers), and risk-risk tradeoffs (ibid., 192–201). Autonomy-based compensatory tort rules are allocatively efficient for a wide range of risky activities, thereby accounting for the manner in which efficiency analysis can explain important areas of tort law.

By contrast, in cases of nonreciprocal risky interactions, the autonomy-based tort right can justify compensation even when the liability has no deterrence value and is allocatively inefficient for insurance reasons, thereby accounting for those portions of tort law that cannot be explained by efficiency analysis (ibid., 201–04, 330–33). A compensatory tort right is sensitive to welfare concerns but not wholly defined by them—a conception consistent with the positive analysis showing that tort law relies on both deontic and economic reasoning to resolve tort claims.

For reasons revealed by this conception of tort law, positive economic analysis does not have to slavishly adhere to a norm of allocative efficiency.
Rights-based tort rules are not formulated to promote measures of aggregate welfare like allocative efficiency, but these rules must nevertheless find justification in the manner by which they fairly or justly distribute the benefits and burdens of tort liability between the rightholder and dutyholder. The distributive dimension of tort law depends on consequential considerations that can be identified by positive economic analysis, confirming that this methodological approach is not inextricably tied to a particular normative conception of tort liability.

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