Dispute and Its Resolution: Delineating the Economic Role of the Common Law

Yoram Barzel, *University of Washington*

1. Introduction

Parties to contracts naturally agree to the terms they set. These terms, however, are never all-encompassing. Contractors do not deem it worthwhile to provide for all low-probability events or for every feature of their transactions. The economic conditions that prevail when contracts are formulated and signed are subject to unexpected changes, and low-probability events do occasionally occur. As conditions change, some of the issues that a contract left undelineated may gain in importance and become a source of dispute. Some of the emerging problems that the existing law does not cope with may be resolved by new legislation or judges' deliberate actions. There now exists an extensive literature analyzing the nature of the new legislation and its efficiency (Cooter and Kornhauser, 1980; Landes and Posner, 1979; Priest, 1977; Rubin, 1977), as well as judges' role (Hadfield, 1992; Posner, 1977; Priest, 1977). Focusing on the common law of contracts, I show that contract design and self-selection among

During its exceptionally long gestation period, this paper has changed beyond recognition. Therefore, some useful comments may be difficult to trace. Thanks to Douglas Allen, Thomas Armitage, Patricia Danzon, Harry DeAngelo, Linda DeAngelo, Aaron Director, Christopher Hall, John Hause, Bruce Johnsen, Levis Kochin, Evan Koenig, Keith Leffler, Mark Plummer, Richard Posner, Eugene Silberberg, the late Ted Stein, Tom Ulen, the late Dean Worcester, and the referee for their comments.

Send correspondence to: Yoram Barzel, Department of Economics, University of Washington, Seattle, WA 98195; E-mail: yoramb@u.washington.edu.

litigants activate self-correcting features in the common law and that these features tend to restore the level of rights delineation that transactors desire.[1] I also elaborate on the efficiency of these legal changes.[2]

Contracts are subject to the jurisdiction of the common law. After signing their contract, however, contractors may encounter problems that have not been subject to common law rulings. As it stands, then, at any given point in time this law may be unable to resolve the disputes brought to it. In anticipation of such inadequacy, private contractors will attempt to write contracts that, among other things, induce the courts to resolve disputes satisfactorily. A by-product of the way individuals write contracts and choose to litigate contract disputes is that rights in general become better delineated, increasing the aggregate net wealth of all individuals. As Goodman (1978), Posner (1977), Priest (1977), and Rubin (1977) do, I argue that individuals' maximizing behavior is the force that leads to the better delineation of rights. While their arguments apply primarily to tort law, and to changes in it, my own pertains to contract law—that is, to situations in which contractors choose the provisions of their contracts and delineate their rights.

Hadfield (1992), concerned primarily with the interaction between selectivity and the role judges play, observes that "the courts are restricted to collecting information only from those litigants who have chosen to become involved in activities clearly within the ambit of an existing legal rule" (p. 605). Thus, judges are confronted with a biased sample of all potential disputes. I fully agree with this view (including the conclusion that judges are unlikely to be the source of efficiency). Central to this paper is the notion of individuals' anticipation of litigation and the prior actions they therefore take. This selectivity, rather than judges' direct action, is precisely what makes the common law attractive to transactors. It is also what makes the process "efficient."

---

1. My analysis is confined to the common law of contracts. However, it seems to apply more generally. This, as the referee notes, is especially so with regard to the force of selectivity. Unfortunately, my familiarity with legal institutions is limited, so I do not make larger claims.

2. Goodman (1978) and Cooter (1996) consider the effects of selectivity forces. As I indicate in note 13, Goodman's conclusions are flawed. Cooter (p. 1694) claims that "selective-litigation pressure and blind evolution fail to explain the level of efficiency observed in common law." The selective mechanisms I introduce, however, are not among those considered by Cooter.

Disputes constitute disagreements over property rights. Litigation and the resulting court decisions are means for resolving disputes. Analyzing the cause of legal disputes and the mechanisms by which such disputes are resolved in court requires a clear understanding of the economic meaning of rights, which I name "economic property rights." These rights are discussed in section 2 and disputes are discussed in section 3. Four propositions are then developed in sections 3–7: First, disputes are endogenous: when people form contracts, they imply that disputes may emerge at future periods. Second, in maximizing the value of their contracts people structure them to take account of the expected costs associated with resolving disputes. Third, selectivity in litigation causes the common law courts to clarify the legal constraints on the delineation of rights. Fourth, contractors in the aggregate mold the common law of contracts so that it encourages more complete delineation of rights. Efficiency considerations are discussed in section 8, and section 9 concludes.

2. An Economic View of Property Rights

I adopt a definition of economic property rights (distinct from legal rights) that is useful for the analysis of resource allocation in a world of costly transacting. It is helpful first to review some features of the costless-transacting Walrasian model. In this model, individuals' ownership of goods is complete, and the distribution of the gains from trade is costlessly determined. The costlessness results from the combination of complete ownership with the costless determination of prices under which all trade is effected. In the Walrasian world ownership is unambiguous: if one were to define economic and legal rights separately, one would still easily arrive at identical definitions. More to the point, legal institutions are redundant in such a world, because it is free of dispute.

As will become clear below, unambiguous ownership implies that transactors know the precise level of every attribute of each of the commodities they exchange. The full-knowledge condition would not radically abstract from reality if commodities were homogeneous; however, numerous commodities are not homogeneous. Full knowledge of nonhomogeneous commodities requires the measurement of every attribute of every specimen. The costliness of measurement renders full knowledge prohibitive.

When measurement is costly, what people perceive as owning and exchanging cannot be entirely accurate.

The legal definition of rights, concerned with what the state delineates and enforces, does not capture all aspects of ownership; it is also inadequate for analyzing allocation problems. For instance, when slavery was practiced in the American South, slaves had no legal rights. Owners were virtually unconstrained by law as to what they could do with, and to, their slaves. Nevertheless, slaves had control over some economic goods and were able to accumulate wealth. Some even bought their own contracts, despite the fact that their wealth legally belonged to their owners. The converse also holds: though escaped slaves remained the legal property of their owners, these slaves obviously possessed something of value.

Automobile theft provides a more applicable example of the distinction between legal and economic rights. Thieves do not legally own the cars they have stolen, which, nonetheless, are of value to them. Although thieves are not legal owners, their possessions meet Cheung's (1974, p. 57) criteria for property rights since thieves can consume or exchange the goods they have stolen. It is sufficient to go only one small step further to recognize that a person's rights over a commodity depend on factors such as his valuation of the commodity, his and the state's expenditures to protect the commodity, and the expenditures made by others to capture it. Following Cheung, I define the "economic property rights" an individual has over a commodity as the *individual's ability to consume the commodity, or to gain from it indirectly through exchange* (the mutual ceding of economic rights). Wealth maximization implies the maximization of the net value of these rights.[3]

Ignorance of commodity features is at the heart of the difference between a zero- and a positive-transaction-cost model; the former is free of conflict, and the latter is rife with conflict. In the zero-cost model, every attribute of every commodity is owned by just one individual, and all know who that owner is. In the positive-cost model, people are never certain who owns what and are not sure how much effort the state will make to enforce any given right. Individuals must spend resources to estimate the values of such variables and to enhance their ability to consume or to be able to sell any attribute.

3. The distinction between the economic and the legal notion of property rights is elaborated in Barzel (1997).

Efforts to protect and enhance rights vary across attributes of individual commodities because not all attributes are equally easy to measure and protect. Moreover, the extent of ownership may vary across attributes. For instance, homeowners' rights over the center of their lots are more complete than over the areas near the boundaries. The economic ownership can be enhanced or retarded by the state. I assume an individual who believes that legally he owns an attribute also believes that the state will help him enjoy that attribute.

3. The Cause of Disputes

Disputes erupt when two or more individuals claim the same asset. A necessary condition for disputes to erupt is that (economic) rights are not delineated clearly. The Coase Theorem, of course, is not operative then. Individuals spend resources to resolve their disputes and, in the process, they delineate their rights more clearly. The focus here is on disputes that may be resolved by the courts.

In order to maximize the value of their holdings, individuals must engage in the delineation of their rights. Disputes play a central role in the relationship between individuals' delineation and the evolution of legal rights. Delineation effort is needed because attribute levels of commodities are not known automatically: resources must be spent in order to estimate these levels. Individuals spend resources on the measurement and protection of commodity attributes; together the two constitute the efforts individuals exert in delineating their rights. A Robinson Crusoe must have a notion of the levels of the attributes of his commodities, yet such knowledge is more important in a social setting, where protection against theft is required. The legal owners who fear theft must determine whether commodities are worth protecting. Moreover, owners must spend resources to ensure identification and recovery of their possessions in case of theft. Thieves spend resources to determine whether their efforts will yield something of value. For exchange, too, in order to best pursue their own interests, the parties require information on what is being exchanged.

The costs of delineation are not the same for all attributes, and they depend on when delineation is attempted. In order to economize on delineation costs, transactors will transfer only attributes that are relatively

easy to delineate at transaction time. For instance, condominium developers usually transfer to individual buyers only a subset of the attributes the buyer desires; the common, difficult-to-measure and difficult-to-police attributes, such as the heating plant, are not included in the set of attributes placed under the control of the individual owner.

The attributes in a non–caveat emptor exchange can be classified into three subsets: (1) those transferred to the buyer, (2) those retained by the original owner, and (3) those placed in the public domain.[4] The salt restaurants provide is one of the attributes usually placed in the public domain. Meal price, averaged across all patrons, is expected to cover the cost of the salt; however, the marginal charge for the salt is zero, and therefore patrons use it as if it were free.

Exchange contracts are seldom explicit about the attributes placed in the public domain. Attributes, then, are placed in the public domain only implicitly: contracts often simply fail to stipulate for some attributes, presumably because formulating and policing the stipulations is considered more costly than inaction. So long as conditions remain unchanged, the outcome regarding attributes placed in the public domain will be the one (implicitly) desired. When conditions change, the value of such undelineated attributes may increase sufficiently to make delineation of them worthwhile. The ownership of attributes unstipulated within contracts that are in force, however, is moot, and disputes regarding them may erupt.

Disputes cannot arise in caveat emptor transactions, however complex they maybe. In such transactions, the seller instantaneously transfers all the attributes of a commodity to the buyer; no obligations remain between the parties.[5] When only a subset of attributes is transferred, there may be no dispute at contract time. Any ambiguity in the contract is potentially disputable, however, as long as the transaction is not fully executed. Since perfect delineation is prohibitively costly, all noninstantaneous transactions may result in disputes.

---

4. Attributes of the first two classes that are not delineated perfectly are also placed in the public domain to the extent that the measurement is imprecise.

5. Posner (1977, pp. 65–66) recognizes that instantaneous transactions are free of dispute. If a seller makes promises such as "satisfaction guaranteed or your money back" or "will not be undersold," transacting with him is not instantaneous. Because a written contract can be referred to later on, its presence suggests that the transaction it governs is also not instantaneous.

Private contracts are supplemented by the common law. When the common law is clear with regard to an aspect of a transaction, rights concerning that aspect are well delineated, even if the parties do not provide for it in their contract. As the parties to a transaction perceive it, however, the common law may be silent or unclear with regard to a certain issue. The parties' view of that part of the law may diverge, engendering dispute, unless the parties provide clear delineation for such an issue in their contract. The more uncertain the law is, the greater the likelihood of a dispute.

Under this reasoning, contract disputes are endogenous, and transactors are expected to optimize with respect to them when structuring contracts.[6] Since disputes are expected, contracting parties predict the general pattern of possible dispute resolution and react accordingly. People, therefore, do not just "write contracts": they form expectations about court action under various circumstances, and they structure contracts to avert the least desirable court rulings, thereby reducing the costs associated with disputes.

Rulings in common law litigation (particularly when they reach the appeal stage) resolve legal ambiguities. Being precedents, these rulings also resolve similar ambiguities in actual and potential disputes. Moreover, when the existing law does not anticipate new developments, individuals attempt to formulate their contracts to bridge the gaps in the law. Litigation tends to transfer such activity from private contracts into the common law. Through their private actions, individuals effect the adaptation of the common law to new conditions, which is a valued public good.

4. Contract Stipulations and the Predictability of Court Rulings

Dispute may be resolved privately, by arbitration, or through the courts. I focus on the decision to go to court. Transactional attributes that are not well delineated lie in the public domain, and to that extent the value of their relationships is reduced. In trying to capture undelineated attributes, each disputant spends an amount such that one extra dollar spent will increase his valuation of his expected wealth by one dollar. Given the

6. Breach of contract, like other disputes, is endogenous to contracting. Transactors who do not explicitly provide for abrogation of contract (or do not make arrangements to settle disputes out of court) implicitly assign the resolution of this potential problem to the courts.

actions the courts take, the primary factor affecting the litigation decision is the total value of the undelineated rights. A risk-neutral transactor will spend up to $1,000 for each 1% increase in the probability of winning a court award of $100,000 and will spend $10,000 for each 1% increase in probability of a court award of $1,000,000. On the margin, then, the gains to each individual are exhausted, though the average or total gains are likely to be positive. Transactors can affect the cost of disputes in general, however, and the cost of going to court in particular by the way they form their contracts.

The dispute-associated costs expected by transactors depend on two factors: (1) the predictability of a court ruling in a given dispute, which, as I argue below, is partly a function of similar disputes, and (2) the probability that a dispute will occur, which is a function of the *expected* court ruling. In turn, the expected rulings by the courts depend, in part, on contract stipulations.

A crystal clear legal interpretation of a contract stipulation will result in a fully predictable court ruling; the associated legal rights constraining the contractors are then well defined. Indeed, no dispute should then arise.[7] The expected ruling may be predictable because of clear precedent. Additionally, it may be predictable because the court is known to use some well-understood criteria that clearly apply to the case at hand. If such criteria are consistently used, rights in applicable cases are well defined, and no dispute occurs. Not only will people refrain from going to court when rulings are predictable, but such predictability altogether removes the grounds for dispute.

When the legal standing of an issue, and with it the predictability of court ruling, are uncertain, a dispute can occur. Since perfect prediction is prohibitively costly, (neutral) prediction errors are to be expected. In any given case, each party will commit its own errors, making him either overoptimistic or overpessimistic about the effect of the ruling. The less predictable a court ruling, the higher the chance for a sizable discrepancy between the parties' evaluations of the outcome on the basis of the information available. When both parties happen to err in being overoptimistic about their success in court, they favor litigation (Gould, 1973; Landes, 1971; Priest, 1980; Priest and Klein, 1984). They are then willing

7. In this case the Coase Theorem applies and resource allocation is Pareto optimal.

to spend resources in order to secure the favorable ruling. Given a dispute, the amount the disputants are expected to spend depends on how uncertain they are, and therefore how divergent their views may be, regarding the way the courts will rule on the value of rights not fully stipulated in the contract. Therefore, as stated, the less clear the law, the greater the likelihood of litigation and the larger the parties' legal expenditures. As also stated, the occurrence of a dispute depends on the prior actions by the parties.

Risk aversion aside, the parties attempt to maximize the joint value of their contracts, net of the expected costs of litigation. Their interests are symmetric: they are expected to formulate their contract to constrain the costs that arise because of legal uncertainty. The narrower the expected range of rulings is on a disputed contract stipulation, and the less latitude the court has to rule, the less the range of disagreement between the parties. The more care the parties devote to the crafting of their contracts, the smaller the scope of dispute among them. As the range of disagreement between the parties narrows, their expected expenditures in attempting to affect the ruling fall. The success of such attempts reduces both the probability of going to court and the cost of litigation when litigation is nevertheless chosen.

Contracting parties are expected not only to delineate rights specifically, but also to provide a general coverage of contingencies. Seemingly, the most reasonable rule of delineating rights not specified in contracts is to settle on what the parties themselves would have agreed to had they considered each particular contingency at contract time. This rule provides the courts, and thus indirectly themselves too, with clear guidance and thereby lowers the chance of dispute.

Although this rule is based on past conditions, its application is triggered by a change in conditions that may require extra transactions. It is sometimes claimed that in cases in which the costs of reaching agreement privately are high the courts may be able to effect a desired change more cheaply than the parties can. This notion seems to miss one of the sources of dispute. The crucial cost here is that of delineation. The costs of reaching agreement depend, in part, on how well the relevant rights are delineated; the less well rights are delineated, the higher the costs of reaching agreement. Once rights become well delineated, the courts have no advantage in deciding on the parties' course of action. In his discussion of the

assignment of liability, Coase (1960) similarly states that "[t]he immediate question faced by the courts is *not* what shall be done by whom *but* who has the legal right to what" (p. 15, italic in original). Indeed, had the courts' intervention been expected to affect the distribution of wealth, wealth-capture expenditures would then be expected. The courts could attempt to avert such action by requiring that the winners compensate the losers, but arriving at a compensation formula is a costly procedure; it is also error-prone, and therefore likely to induce dissipation.

5. Litigation Selectivity: An Instrument for Rights Delineation

If, indeed, the courts tend to generate clearer delineation of private rights, judges' pecuniary incentive is unlikely to be the main force bringing about this outcome. The remuneration of judges seems to depend only remotely on the resource savings brought about by good decisions.[8] Rather, I hypothesize that selectivity in what individuals choose to litigate enhances the clear delineation of rights under the common law.[9] When pairs of transactors face similar disputes, the ruling on the one litigated first is of special importance. If the ruling on that case sufficiently clarifies the law, it will remain the only one litigated. The reason is that, given the precedential nature of a ruling, the rest of the cases cease to be in dispute, and no further litigation will ensue.[10] If the ruling is not clear enough, some of the transactors will disagree on its interpretation and additional litigation will take place.[11] The process will continue until the law becomes sufficiently clear.

8. Ambiguous rights are the raw material for judges. Remunerating judges by their performance would require a costly determination of the "quality" of this raw material and would open the door to wealth capture by judges.

9. Rubin (1977) was apparently the first to advance the "natural selection" character of the common law. His argument, as well as those of Priest (1977), Cooter and Kornhauser (1980), and Landes and Posner (1979), do not apply to contract law, however—to situations where individuals rather than the courts decide which rights to cede to each other.

10. The "public goods" nature of precedents is considered in section 7.

11. For this reason, the legal advice the disputants seek is meant not only to help them win their case, but also to induce a clear court decision. One of the attributes of a "good" lawyer, then, is the ability to help produce a decision that will not be legally contested.

A ruling may clarify the applicable legal principle and its use. I will illustrate how rights are delineated with regard to the application of a rule. Consider a dispute on an originally unstipulated impurity in a transacted commodity, and suppose that people expect that if litigation occurs the court will rule that the contract implies the "prevailing industry standard" of impurity. Were this standard unique, there would be no dispute in the first place. If the term conveys different meanings to different people, not all pairs will agree on the contents of the ruling and how it will affect them, and new cases will then be litigated. The process will continue until a sufficiently specific ruling such as "so many parts per thousand," is reached, at which point litigation will cease.

Selectivity encourages clear decisions in an additional, subtler way. When a ruling is not clear, disputants will spend additional resources on capture. The less clear the ruling of a dispute is expected to be, the lower the parties' net payoff from litigation, because of high subsequent expenses that they expect an ambiguous ruling to entail. Conversely, the clearer a ruling is expected to be—given that it is unknown whom the ruling will favor—the lower the expected postlitigation expenditures, and consequently the greater the expected payoff.

Consider, in this light, a number of pairs of transactors who made similar contracts and thus are prone to the same kind of dispute. Suppose that a change in the economic environment now occurs, and that contract ambiguity that was inconsequential before the change becomes a source of dispute for all the pairs. How will the dispute be resolved? In particular, which pair of transactors is likely to litigate? Transactors are seldom identical; for instance, their shipping costs are not the same, the age and make of their equipment vary, and they differ in their access to various courts. They may also differ in their perception of how clearly the courts will delineate their rights. The payoffs to the resolution of the dispute, then, will vary across the pairs of transactors. The disputants most likely to litigate are those expecting the highest payoff from litigation. These are the disputants who perceive, all else being equal, that their particular dispute is likely to elicit rulings clearer than those anticipated by other disputants. Returning to the commodity-impurity example, we expect that a pair of transactors anticipating a ruling in terms of "parts per thousand" is more likely to litigate than a pair expecting one in terms of "prevailing standards." Because of selectivity, then, the actual ruling is likely to be

at the upper end of the distribution of decisions with regard to clarity. If this ruling is generally applicable, it will become a new precedent. Even in the absence of a direct mechanism for clear court rulings, self-selection among disputants encourages such rulings, and the surviving rulings are those that delineate rights still more clearly.

This argument assumes that the courts are consistent in their rulings and that they respect contract provisions (not in conflict with fundamental legal principles). Selectivity in litigation ensures that whatever principle judges *consistently* follow, the law will ultimately become well defined, since, as was just demonstrated, litigation will continue so long as valued rights remain ambiguous. I discuss next the interaction of selectivity and courts' willingness to honor contract provisions.

6. The Molding of Common Law by Private Contractors

The common law evolves spontaneously by accumulating precedents. These precedents reflect actions by individuals who face new conditions that induce litigation. I argue that contractors, in the course of pursuing profit, as if by invisible hand, effect changes in the common law governing contracts, changes that best fit the new conditions in general.

Contracts are extended, in part, by the common law. Provisions that are not explicitly stipulated in contracts may be stipulated by existing common law. In any case, contracts are ultimately governed by the common law. As conditions change, a previously satisfactory provision of the common law may become unattractive in new transactions. Transactors have leeway in shaping their contracts and control what they include in them and what they exclude. They are free to introduce stipulations that will supersede the common law stipulations currently in force. When common law features become unattractive, then transactors may explicitly introduce contract stipulations to bypass or supplant them. Such contracts are in turn susceptible to disputes as conditions continue to change. Since the new stipulations deviate from existing precedents, the transactors must be aware that unless these stipulations are carefully drawn, the probability of challenge is high. Nevertheless, stipulations are never *perfectly* drawn and, therefore, occasionally will be challenged. The courts encounter, then, and

account for, the new stipulations. Sooner or later the new stipulations become part of the common law, and with time replace the old, less satisfactory precedents. In this way transactors, through their individual maximizing behavior, effect changes in the common law, changes that best suit contractors' interests in general.

Consider, for illustration, a line of business in which caveat emptor has long prevailed and where the common law has fully incorporated the notion that the seller is not liable. Were the assignment of responsibility in a transaction subject to litigation, the courts would rule that the seller is exempt so long as the contract failed to specify otherwise. Indeed, caveat emptor contracts are not expected to stipulate who is responsible. Suppose now that conditions have changed, making the seller's responsibility, or "caveat venditor," the preferred arrangement. Immediately after such a change occurs, a sales contract not stipulating who is liable will still be interpreted by the courts as caveat emptor—the direction in which all precedents point. Moreover, if a contract between, say, an uneducated, poor farmer and a large food-processing company buying his crop stipulates caveat venditor, the court may still absolve the farmer of responsibility because there has been no "meeting of minds." When legal counsels aid both transactors, or when a well-informed seller unilaterally assumes liability, the courts are expected to sustain the caveat venditor. As new circumstances emerge disputes may erupt and the courts will sooner or later uphold the stipulations it finds in contracts. Thus, eventually the common law will incorporate the new contract stipulations that conform to the desires of most contractors.[12]

In a similar vein, consider litigation costs that transactors expect to incur in case of dispute. The greater these costs, the greater the return from averting the dispute by the appropriate contract stipulations. The greater the costs that ill-defined common law constraints induce, the more effort transactors will expend on the corresponding rights delineation in their contracts. If litigation nevertheless occurs, the contents of the contracts become incorporated in the common law, replacing the existing, more ambiguous, law.

Contractors' maximizing effort enhances the clear delineation of rights in still another way. Transactors can choose between litigation and

12. Whoever still desires caveat emptor must explicitly stipulate it.

arbitration as the method to resolve disputes. Consider transactors who take part in several similar transactions. A ruling on a dispute in one may affect the others. As Landes and Posner (1979) show, such transactors tend to litigate when they expect clear rulings, since the precedents they help create will lower the cost of disputes in their other transactions.[13] On the other hand, if the expected outcome is not clear, the transactors do not gain from setting precedents and may choose to arbitrate their disputes. This force too, then, is expected to enhance rulings that delineate rights clearly.

The assumption that the law is consistently applied by the courts, particularly with regard to litigation selectivity and of the molding of common law by private contractors, has been maintained throughout this discussion. The principles of justice the courts follow, however, seem to change from time to time. A new principle the courts choose to follow will obviously prevail in the litigation before them, at least for contracts signed after the adoption of the new principle. Still, as long as the new principle is not repudiated, the power of the courts over future contracts is limited. Suppose, for example, that contrary to the prevailing view of precedent, the judicial principle regarding annuities for women were to alter, prohibiting insurers from requiring higher premiums of women than of men. A new contract in which women are charged a premium higher than men, or, more generally, one using sex in the premium formula, would be voided. The privately preferred arrangement, nevertheless, may be that the premiums be based on life expectancy. In that case, new policies may be written, for example, for occupations held mostly by men, or lower premiums may be offered to heavier persons. In general, new contracts will contain those features that, subject to the legal constraint, are found most desirable by the parties. When future disputes occur, as long as still newer principles of justice are not adopted, and subject to the residual effect from the new principle, the rulings will again correspond to the wishes of the transactors.

The delineation of rights may be impeded not only by changes in the principles of justice, but also by whimsical rulings and by the sheer

13. Goodman (1978) dwells on the asymmetry between transactors who seek legal resolution for their disputes. His argument, however, is flawed. He recognizes that the interests of a single seller who sells to many buyers differ from those of the individual buyers. In terms of the effect on the law, and contrary to Goodman's conclusion, it is the seller whose interest is closer to the aggregate social value.

diversity of such principles from judge to judge. The singularity of the highest court, combined with the hierarchical court system and with judges' long tenures, may be explained as an attempt to enhance consistency. Consistency is a necessary condition for clear legal constraints. The greater the inconsistency, the less well defined rights are, and the greater the amount of resources spent in litigation and the capture of wealth in general. A total lack of consistency makes the argument of this paper inapplicable. This situation is irrelevant, however: the legal system is not viable when court rulings entirely lack consistency.

7. Common Law Precedents as Public Goods

Litigation concerns rights that lie in the public domain, and the court rulings serve to delineate these rights and in that way make them private. Private litigants that induce changes in the common law produce a peculiar public good. These litigants, as a rule, bear the bulk of the direct costs of producing the change. The clarification of rights that particular litigation produces affects all individuals with the same or similar problems.

When a common law court creates a precedent that clarifies the law that affects pairs of nonlitigating transactors, these transactors cease to be in dispute.[14] Indeed, the anticipation of a court ruling tends to delineate rights and will deter capture expenditures by individuals who seem to be in dispute. Suppose, for instance, that the rights to a pool of oil lying underneath two neighbors' plots are not initially delineated because of the pool's low net value. If as a result of an increase in the price of oil the value of the pool appreciates, each neighbor will attempt to capture the newly valued resource. Consequently, together they will gain less, in total, than if the rights had been delineated. Had these newly valued rights been somehow delineated by an exogenous force, such as a precedent created by similarly situated neighbors, the expenditures to capture the rights would have become redundant. The neighbors would not have been in dispute in the first place had they expected these rights to be delineated.

The Coase Theorem nicely applies to this case. Suppose the neighbors do not know how the rights will be delineated. They do know, however,

14. This may be the reason why litigants are not required to pay court costs, whereas in cases of arbitration the parties bear the costs of effecting the arbitration.

that they will be exogenously (and clearly) delineated. They cannot then gain from capture expenditures. Given that rights are expected to become (and thus are) well delineated, transferring them to the more efficient user will not consume resources, either. Therefore, resource allocation is expected to be independent of the way the rights are divided.

Were numerous identical pairs of transactors involved in identical disputes, none would have the incentive to litigate first; each pair would have gained by "taking a ride on" litigation by others. It may seem that the externality problem here can be solved by (class action–like) consolidation. Before the eruption of the dispute, all parties to one side of the issue could have entered into joint ownership, as all parties on the other side could have, too. The dollar magnitude of a dispute arising from an increase in the value of the undelineated rights would approximately equal the sum of the values of the individual, unconsolidated disputes. Since the amount of resources disputants are expected to spend to resolve their dispute is primarily a function of the value of the disputed rights, in the joint-ownership case in which the value of the disputed rights is large, the expected expense to capture the rights is commensurably large. It is seen, then, that the "free ride" that noncooperating individuals take on others' dispute resolution has the desirable property of saving resources that fail to be saved when each of the two sides pools resources.[15]

When out of many pairs of disputants only one pair spends resources on litigation, wealth-capture expenditures are largely avoided. Most of the disputants refrain from spending resources on capture because of the cost of joint action and the opportunity to "take a ride on" others' expenses. Since transactors are not identical, some of them will choose to litigate, not waiting for dispute resolution by others.[16] Still, the incentive for obtaining clean, quick delineation is inadequate. In one major class of cases to which I now turn, the effect of delineation is internalized.

---

15. The role played here by noncooperating individuals is analogous to the role of competition in determining the distribution of gains (i.e., the delineation of rights) from exchange. If all the buyers on one side and the sellers on the other were to pool resources in order to negotiate the division of the gains from trade, some of these gains would be lost to the cost of negotiations.

16. Such litigants tend to concentrate on the components of the dispute unique to them, but eventually litigation will provide clarification of the common components of the dispute.

Organized exchanges, such as futures markets, seem to delineate rights effectively. In these markets, ultimate buyers and sellers do not deal directly with one another; rather, individuals in each class contract with their particular exchange. A buyer dissatisfied with the merchandise he has received is in dispute with the exchange on which he traded, not with the seller. Instead, it is that exchange which may have a dispute with the seller. The incentive of exchanges to win any particular case is weak since the gain from winning on one side is likely to be counterbalanced by the loss on the other. Exchanges, however, have a strong incentive to effect clear delineation. Fees, such as those on futures contracts, constitute the main source of income for the exchanges. The more the exchanges facilitate trade, the higher the fees they can charge, and the higher the volume of trade. Since the main service exchanges provide is facilitation of trade, they gain from the clear delineation of rights and are expected to spend resources in pursuit of that objective, perhaps even subsidizing plaintiffs. The exchanges, by internalizing the gains from delineation, supply a mechanism for the (private) production of a public good.[17]

8. The Efficiency of the Common Law

The literature on spontaneous or induced changes in legal rules attempts to determine, among other things, whether they meet the criteria for Pareto efficiency or of the related Kaldor-Hicks efficiency.[18] Applying these efficiency criteria within the context of legal institutions and changes in them,

17. A primary function of organized exchanges seems to be the production, or the setting of, prices. Prices, like precedents, are public goods. Absent the exchanges, market participants tend to "ride" on each other's expenditures in the production of prices.

18. Roe (1996) is an interesting exception. He is concerned with the efficiency of institutions as they actually evolved, as opposed to what might have been. I am concerned primarily with "local" issues. Thus the two approaches are largely independent of one another.

There is a point worth making in this connection, however. In market activities where there are many players, individuals may choose, or happen on, solutions that deviate from the already-existing path. Among these may be a solution at, or near, the path that would have been chosen if today's conditions had previously prevailed. More importantly, individuals may make experimental investments. This means, by the evolutionary terminology, that they are willing to first go down before eventually moving up if successful. Indeed, it seems to me that this last point also applies to selection in nature and not only to human social activities.

however, is at best curious. In a Pareto world, as pointed out in section 2, legal institutions are redundant, as they are in a Kaldor-Hicks world. The Pareto and the Kaldor-Hicks criteria are concepts that fit only a frictionless world. They are not useful for studying a world where legal institutions are required to deal with frictions and with dispute. As Coase pointed out, a necessary condition for efficiency is well-defined property rights. One fundamental function of legal institutions is the delineation of rights. Since the act of delineation consumes resources, and given the need to economize in these resources, delineation is never perfect. Therefore, by the above definitions of efficiency, an economy that requires a legal system to delineate rights cannot be efficient. Indeed, given its costliness, the act of delineation itself fails to meet the efficiency criteria. It should not be surprising, for instance, that Cooter and Kornhauser (1980) conclude that the "best state," as they characterize the (Pareto) efficient outcome, cannot be attained. Hadfield recognizes that there exist "costs of acquiring information" that limit "the ability of the courts to develop efficient rules" (1992, p. 603). But his definition of efficiency requires information to be costless. Thus, his conclusion that that "even the 'efficient' rule will produce inefficient outcomes in some cases" (1992, p. 585) is obtained under an internally contradictory set of assumptions.

More damaging, changes that seemingly meet the Kaldor-Hicks but not the Pareto conditions, that is, changes that increase aggregate income but do not make every individual better off, contain the seed for inefficiency. The reason is that the adoption of policies that redistribute income is likely to encourage people's attempts to direct the redistribution in their favor. Indeed, as maximizers, they are expected to take such action when the opportunity arises. Such resource-consuming behavior is definitely inconsistent with the Kaldor-Hicks criterion. Some of the changes in legal rules that are proposed in the literature seem prone to the same problem.

Exploring the relationship between the delineation of rights and efficiency is a more promising endeavor. The Coase Theorem implies that a legal system that encourages clear delineation is likely to enhance efficiency.[19] I argue that profit seeking, directly and indirectly, results in clearer delineation.

19. The reason for the caveat "likely" is that the Coase Theorem itself is applicable only in an ideal state.

Consider an economy in which Pareto inefficiencies exist. In the presence of such inefficiencies, profit-seeking individuals may try to gain from closure between the benefits and the costs. Individuals must spend resources to discover inefficiencies and arrange to take advantage of the resulting profit potential. Suppose that after one takes account of these costs, some of these activities are still found profitable but some are not. The former will be eliminated, whereas the latter will be allowed to stand. These latter ones, however, are not worth eliminating, despite the flanking of the Pareto efficiency criteria. It is tautological that under the conditions just spelled out, given profit maximization, efficiency will prevail.

This view of efficiency, despite its being tautological, enables us to derive refutable implications, which is a reason to be concerned with efficiency within a positivistic framework. An economy operating under stable conditions is expected to be in an equilibrium free of inefficiencies that profit-seeking individuals find worthwhile to remove. Exogenous changes, however, may produce new discrepancies between benefits and costs, as well as increase old ones. The emergence of these new inefficiencies is likely to generate profit opportunities. A fundamental hypothesis is that when a change producing new inefficiencies occurs, forces in the economy will move it back towards the Pareto optimum, though never reach it.

This paper argues that given an "efficient" equilibrium, when the economy is jarred delineation of rights will become inadequate. However, there exist self-correcting forces within the common law system that enhance delineation, restoring efficiency in conformity with the new conditions. Thus, for instance, when the price of a commodity increases, the existing common law (regarding impurities in it, say) may not delineate it sufficiently. Disputes may then erupt. Selectivity forces in litigation induce the fuller delineation. We expect, then, that the common law will adjust to better delineate the commodity. The attributes of the higher-priced commodity are expected to be delineated more fully, including delineating attributes that were not previously delineated, when all profitable opportunities for enhancing delineation have been exhausted. The resulting more complete delineation means that resource allocation is again efficient.

The greater-efficiency outcome should not be surprising. As stated, the existence of inefficiencies implies the potential for profit, and individuals may gain from eradicating them. Although not all such profit opportunities will be realized, the acts that eliminate inefficiencies tend to dominate

over, and have a higher survival value than, the less efficient outcomes do. This is obviously true in the private sector, but the same forces are present in the public sector, even if the implementation costs in that sector are higher.

9. Concluding Remarks

At any point in time, rights delineation is incomplete: contractors' costs of delineating some of the rights involved in their transactions exceed the gains, and such rights are left in the public domain. Disputes occur when the net value of properties that lie in the public domain increase, inducing individuals to compete for them. Competition here consists of spending resources in order to capture the rights to these properties. The courts contribute to the resolution of disputes and to the delineation of previously inadequately delineated rights.

In this paper it is argued that the common law of contracts is a self-regulating mechanism for rights delineation. Like Smith's "invisible hand," it relies on individuals' self-interest rather than on their public-spiritedness or joint action. The main force behind the self-regulating mechanism is selectivity in litigation coupled with the precedential nature of the common law. The greater the expected gain from better rights delineation, the higher the probability of litigation. The rulings clarify the legal constraints in the particular cases and in all similar cases.

References

Barzel, Yoram. 1997. *Economic Analysis of Property Rights*. Cambridge: Cambridge University Press.

Cheung, Steven N.S. 1974. "A Theory of Price Control," 17 *Journal of Law and Economics* 53–72.

Coase, Ronald H. 1960. "The Problem of Social Cost," 3 *Journal of Law and Economics* 1–44.

Cooter, Robert. 1996. "Decentralized Law for a Complex Economy: The Structure Approach to Adjudicating the New Law Merchant," 144 *University of Pennsylvania Law Review* 1643–96.

Cooter, Robert, and Lewis Kornhauser. 1980. 9 "Can Litigation Improve the Law Without the Help of Judges?" *Journal of Legal Studies* 139–63.

Goodman, John C. 1978. "An Economic Theory of the Evolution of Common Law," 8 *Journal of Legal Studies* 393–406.

Gould, John P. 1973. "The Economics of Legal Conflicts," 2 *Journal of Legal Studies* 279–300.

Hadfield, Gillian K. 1992. "Bias in the Evolution of Legal Rules," 80 *Georgetown Law Journal* 583–616.

Landes, William M. 1971. "An Economic Analysis of the Courts," *Journal of Law and Economics* (April) 61–108.

Landes, William M., and Richard A. Posner. 1979. "Adjudication as a Public Good," 8 *Journal of Legal Studies* 235–84.

Posner, Richard A. 1977. *Economic Analysis of Law*, 2nd ed., Boston: Little, Brown.

Priest, George L. 1977. "The Common Law Process and the Selection of Efficient Rules," 6 *Journal of Legal Studies* 65–82.

———. 1980. "Selective Characteristics of Litigation," 9 *Journal of Legal Studies* 399–422.

Priest, George L., and Benjamin Klein. 1984. "The Selection of Disputes for Litigation," 8 *Journal of Legal Studies* 1–56.

Roe, Mark J. 1996. "Chaos and Evolution in Law and Economics," 109 *Harvard Law Review* 641–68.

Rubin, Paul H. 1977. "Why is the Common Law Efficient?" 6 *Journal of Legal Studies* 51–64.