A FREE-MARKET VIEW ON ACCIDENTS AND TORTS

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I
INTRODUCTION

Since the early 1960s, the activity of legislators has attracted increasing attention from the economics profession. In particular, many economists of the modern law-and-economics tradition have taken a consequentialist approach, focusing on how to utilize lawmaking and judicial rulings to efficiently obtain social goals.[1] Under the neoclassical-law-and-economics approach, for example, the politician should select the social goals and the economist should identify those instruments—including taxation, regulation, and other encroachments on private-property rights—most appropriate for obtaining these predefined social goals.[2]

The neoclassical-law-and-economics literature has not aroused great enthusiasm among free-market supporters.[3] Free-market advocates hold that all

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1. *See* Charles Rowley, *An Intellectual History of Law and Economics: 1793-2003*, *in* THE ORIGINS OF LAW AND ECONOMICS: ESSAYS BY THE FOUNDING FATHERS 3, 7 (Francesco Parisi & Charles K. Rowley eds., 2007) (noting that references to efficiency to justify and assess policy making date back to Adam Smith). In recent times, the consequentialist approach to property rights has been made explicit by many authors. *See generally, e.g.*, RICHARD EPSTEIN, SIMPLE RULES FOR A COMPLEX WORLD (1995); Harold Demsetz, *Toward a Theory of Property Rights*, 57 AM. ECON. REV. 347 (1967); Louis Kaplow & Steven Shavell, *Property Rules Versus Liability Rules: An Economic Analysis*, 109 HARV. L. REV. 713 (1996); Richard Posner, *The Economic Approach to Law*, 53 TEX. L. REV. 757 (1975). Of course, not all economists engage in consequentialist inquiry. Thus, economists of the public-choice school have studied how individuals make use of politics to create and exploit privileges. *See generally, e.g.*, JAMES M. BUCHANAN & GORDON TULLOCK, THE CALCULUS OF CONSENT: LOGICAL FOUNDATIONS OF CONSTITUTIONAL DEMOCRACY (1962); DENNIS C. MUELLER, PUBLIC CHOICE III (2003) (standard textbook on public-choice theory); MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS (1965); Benoît Le Maux, *Governmental Behavior in Representative Democracy: A Synthesis of the Theoretical Literature*, 141 PUB. CHOICE 447 (2009) (providing the briefest account of public-choice theory out of the cited sources). (In a word, the school of public choice makes use of the traditional tools of neoclassical economics in order to analyze the world of politics (including policies, decision-making mechanisms, the behavior of politicians, bureaucrats and voters).)

2. *See, e.g.*, Richard Posner, *What Do Judges and Justices Maximize? (The Same Things as Everybody Else Does)*, 3 SUP. CT. ECON. REV. 1 (1994).

3. Yet free-market advocates have not been absent from the law-and-economics agenda. Henry Manne, s*ee generally* THE COLLECTED WORKS OF HENRY G. MANNE (Fred McChesney ed., 2009),

individuals have a right to be free from coercion and have a duty to not violate the liberty and property rights of others. In this light, the role of government is to protect individuals from violence, while the role of the judiciary is to enforce contracts and to adjudicate the use of violence. The state cannot force individuals to consume public goods, and the judiciary must abstain from introducing regulation and assigning property rights.[4] Thus, free-market supporters feel uneasy about tampering with private-property rights and engaging in extended policy making, even if such policy making would aid in the efficient achievement of social goals.

Guido Calabresi is often associated with the neoclassical-law-and-economics tradition. His 1961 article, *Some Thoughts on Risk Distribution and the Law of Torts*, was one of the seminal works that gave rise to the modern law-and-economics research program.[5] Yet Calabresi—as he expresses his view on accidents and torts in that article—offers key methodological insights that keep him distanced from the mainstream neoclassical tradition and that should in fact be appreciated by free-market supporters. In particular, Calabresi is wary of rule making and rule overhauling that is driven only by efficiency concerns.[6] He is also reluctant to accept technocratic planning even in the presence of uncertain costs. In a word, Calabresi's contribution is an interesting still-neoclassical alternative to the traditional Chicago view.[7] Embedded in Calabresi's view is a better understanding not only of the distinctive features of the free-market approach to liability, but also of other issues currently debated, such as the consequences of the Lockean view of property rights and the role and limits of institutional analysis.[8]

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and, from a broader perspective, Bruno Leoni, *see generally* Bruno Leoni, FREEDOM AND THE LAW (1961), have actually made pathbreaking contributions to this literature. *See also* MARIO RIZZO, AUSTRIAN LAW AND ECONOMICS (2011) (offering a comprehensive view on the connection between the Austrian free-market approach and the law).

4. *See* MURRAY ROTHBARD, THE ETHICS OF LIBERTY (1982); MURRAY ROTHBARD, THE LOGIC OF ACTION TWO 286–87 (1987). For the purpose of this article, "free-market view" is defined as the school of thought that originated from the Scottish Enlightenment, evolved into classical liberalism, *see* WILHELM HUMBOLDT, THE LIMITS OF STATE ACTION 137–38 (1852), and later became what is now known as the Austrian school of economics, *see* CARL MENGER, PRINCIPLES OF ECONOMICS (1871) ; LUDWIG VON MISES, HUMAN ACTION 492–93 (1949); MURRAY ROTHBARD, MAN, ECONOMY AND STATE 304 (1962).

5. 70 YALE L.J. 499 (1961).

6. Moreover, when Calabresi does consider efficiency—that is, cost minimization—his calculus diverges from the neoclassical tradition. Unlike the neoclassical school, Calabresi defines the term "cost" to mean "social cost" and takes into account social justice, which legitimizes redistribution regardless of (allocative) efficiency. *See* Roger Van den Bergh, *Introduction: The Impact of Guido Calabresi on Law and Economics Scholarship*, 1 ERASMUS L. REV., no. 4, 2008, at 1, 2 (Neth.).

7. Although members of the Chicago school are generally wary of government intervention, they are not necessarily supportive of the free-market view. As mentioned earlier, the linchpin of the Chicago view is efficiency (wealth maximization), rather than individual freedom. This has consequences. For example, in the aftermath of the recent financial and public-debt crises, free-market advocates have been arguing for outright deregulation, while Chicago scholars have generally been in favor of better regulation. *See, e.g.*, Luigi Zingales, *The Future of Securities Regulation* 34–35 (Chicago Booth Sch. Bus., Paper No. 08-27, 2009), *available at* http://ssrn.com/abstract=1319648.

8. *See, e.g.*, HARDY BOUILLON, BUSINESS ETHICS AND THE AUSTRIAN TRADITION IN

To illustrate this claim, in the next subparts I briefly clarify the nature of the costs to which liability applies—the focus of Calabresi's 1961 article.[9] I also review Calabresi's arguments on how to legislate for efficient cost allocation in the realm of accidents and torts. I then proceed in parts II and III to investigate the free-market perspective regarding two sets of situations in which uncertain costs play a role—*respondeat superior* and limited liability—and assess the difference between the free-market perspective and Calabresi's approach. I conclude in part IV by drawing attention to key issues for the future of institutional economics broadly understood.

A. On the Nature of Uncertain Costs

Uncertainty plays a crucial role in the free-market context, because it creates opportunities for entrepreneurial endeavors, which in turn are the handmaiden of growth. Free-market supporters particularly draw on Frank Knight's *Risk, Uncertainty and Profit* to classify uncertain costs in three categories.[10] The first are "risky costs": costs the nature and probability of which is known. For example, most drivers know there is chance their car will be stolen during the next six months and that, as a consequence, the cost of using that car might suddenly increase, because when the theft occurs the residual value of the vehicle drops to zero. Drivers can easily acquire information about the likelihood of theft and buy insurance.

Another kind of uncertain costs is "potential costs": Their nature is known, but their probability distribution is not. A typical example is an earthquake: People know it might come one day, but most have vague or no ideas about when and how extensive the damage will be. In most cases people can buy insurance, although the price of the policy is necessarily erratic.

Finally, a third source of uncertain costs can be defined as "accidents," the very nature of which is unknown. For example, a builder completes the construction of a house with materials that years later turn out to have unhealthy features that had been previously ignored or severely underestimated.[11] Under these circumstances, of course, insurance is not

ECONOMICS (2011); Tom Palmer, *Are Patents and Copyrights Morally Justified? The Philosophy of Property Rights and Ideal Objects*, HARV. J.L. & PUB. POL'Y 817 (1990); R.N. Langlois, *What is Wrong with the Old Institutional Economics (and What is Still Wrong with the New)*, 1 REV. POL. ECON. 270 (1989).

9. Calabresi, *supra* note 5.

10. *See* MISES, *supra* note 4, at 289 (citing FRANK KNIGHT, RISK, UNCERTAINTY AND PROFIT 211–13 (1921)); Armen Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 212–14 (1950).

11. Admittedly, the notion of "unknown" suggests that the difference between potential costs and accidents could be faint. For example, Strabo and Pliny the Elder had noticed that something was wrong with asbestos, but their concerns were not taken very seriously. Roberta C. Barbalace, *A Brief History of Asbestos Use and Associated Health Risks* (Dec. 11, 2013, 11:37 AM), http://environmentalchemistry.com/yogi/environmental/asbestoshistory2004.html. When and why did asbestos cease to be a source of accidental costs and turned into certain harm? Surely, at the time, sellers of asbestos-intensive products were not considered criminals.

For the purpose of my discussion, an accident is a situation in which there is no strong evidence available, unless it is included in very comprehensive policies against all kinds of illness.

Although in the law-and-economics literature the word "accident" usually means "unintentional injury,"[12] it is important to underscore the unknown nature of the accidental event (as opposed to its unintentional component). The issue I analyze is not whether Calabresi or a free marketeer would say that one can insure against unintentional injury, but rather what Calabresi or a free marketeer would say ought to be done in the presence of unexpected damage, and whether either would say that an individual can still be held liable if he has no possibility of taking action against accidental harm. Moreover, dealing with the unknown nature of accidents widens the debate from the realm of allocative efficiency to that of ethics and distributive justice, which seems to be particularly appropriate in the context proposed by Calabresi.

B. Calabresi and the Resource-Allocation Approach

What is the role of uncertain costs in Calabresi's and the free-market advocate's frameworks? Since the marginalist revolution, the normative view argued by the economics profession has been the resource-allocation approach. Put simply, this approach maintains that individual behavior in the marketplace produces efficient outcomes as long as prices are a good measure of scarcity. Both free-market supporters and Calabresi[13] accept this argument and add that the buyer and the seller should bear the full cost of their decisions, because the buyer and seller are in the best position to know whether the value of one unit of good X is greater or smaller than the value of what they could buy with P_X.[14] In the view of Calabresi and free-market supporters, forcing the seller to accept a price that does not compensate him for the sacrifice of giving away X would unjustifiably violate his preferences.[15] Further, there is no reason to ask third parties (society) to subsidize the purchase of goods and services that they are unwilling to buy.[16]

In contrast with the free-market view, however, Calabresi warns that efficiency and cost minimization are not the only factors involved and thus, he argues, rule making should mimic the resource-allocation approach only when the nature of property rights is ambiguous.[17] Because uncertain costs generate

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about the chain of causality leading to an adverse event or about the harmful content of a transaction; moreover, I let the judge decide when withholding relevant information is fraudulent.

12. *See, e.g.*, Alan Sykes, *The Boundaries of Vicarious Liability: An Economic Analysis of the Scope of Employment Rule and Related Legal Doctrines*, 101 HARV. L. REV. 563, 567 (1988).

13. *See* Calabresi, *supra* note 5, at 505.

14. *See, e.g.*, FRIEDRICH HAYEK, THE CONSTITUTION OF LIBERTY 71 (1960) (asserting that all individuals should bear the costs of their decisions); Calabresi, *supra* note 5, at 513.

15. *See* sources cited *supra* note 14.

16. *See* sources cited *supra* note 14.

17. *See* Calabresi, *supra* note 5, at 503–04. For example, Calabresi mentions a situation in which a worker is injured on duty and the injury is caused partly by his own negligence and partly by the hazardous facilities of the location where he operates. Calabresi, *supra* note 5, at 505.

ambiguity, one may assign liability to reduce deadweight losses (allocative inefficiencies), to promote the purchase of insurance at the lowest price, or to share the burden.[18] Calabresi concludes that when damages are not exceedingly high, monopolistic enterprises should be held liable, because paying the costs of accidents would merely erode the enterprises' monopolistic rents with no further consequences, such as a drop in output.[19]

Calabresi further argues that, in competitive environments, even default liability for uncertain costs should be assigned to the seller–producer, although for different reasons than other sorts of liability should be so assigned: The seller–producer is presumably in a better position to evaluate the nature and probability distribution of risky events, to contract away at least part of the cost to third parties, or to do both.[20] However, Calabresi also finds that in some contexts, the burden of uncertain costs could be absorbed or spread by introducing a state insurance program financed by taxpayers at large[21] or by levying a lump-sum tax on all producers subject to uncertain costs.[22] In his view, this solution (taxation) is more appealing (1) in the presence of accidents and substantial judicial costs, (2) when enterprise liability might drive some companies out of business, leading to significant secondary effects, such as lower output and more unemployment, or (3) when the activities involved are extrahazardous.[23] In short, consistent with the Chicago school but in contrast with the free-market vision, Calabresi admits that there are situations in which

18. *See* Calabresi, *supra* note 5.

19. *See* Calabresi, *supra* note 5, at 524–27. Calabresi's argument includes two implicit assumptions. First, rents are undeserved and, therefore, no social harm is produced when they are reduced. Second, because no marginal firm would be hit, production would not fall, which is desirable because in monopolized industries production is already suboptimal.

20. Calabresi, *supra* note 5, at 506–07.

21. *See* Calabresi, *supra* note 5, at 529. A similar argument was already put forward in Young B. Smith, *Frolic and Detour*, 23 COLUM. L. REV. 444 (1923). Yet this author did not engage in any utilitarian accounting, merely claiming that it would be socially more expedient to frame the law to encourage the master to buy insurance. *Id.* at 460–61.

Calabresi is rather wary of the loss-spreading mechanism provided by private-insurance schemes. In his view, whenever a producer buys insurance, the producer still generates a significant loss to other parties: either consumers, who would be charged higher prices, or producers, who would be offered lower wages and prices. Calabresi, *supra* note 5, at 519. These secondary effects would be magnified in a stagnant or declining economy, but would be relatively modest in monopolistic industries, in which the monopolistic firm would be more likely to translate higher costs into lower profits, rather than into lower output and lower demand for inputs. Calabresi, *supra* note 5, at 524–25. Under such circumstances, of course, the cost of accidents would be spread among the company shareholders.

22. *See* Calabresi, *supra* note 5, at 517–24. A lump-sum tax on producers would not affect marginal costs. Thus, prices and quantities would remain constant in the short run. In the long run, however, some marginal producers would leave the market, or new (marginal) producers would abstain from entering. *See id.* Therefore, the difference between producer liability and state liability with a tax on production raises two issues. One relates to efficiency, because in the long run the incentive to avoid accidental costs would be smaller. *See id.* The other relates to the desirability of redistribution among the sellers. In particular, a lump-sum tax would favor large, innovative firms, which would be required to pay a proportionally smaller tax and which would be more vulnerable to (unpredictable) accidents. *See id.*

23. *See* Calabresi, *supra* note 5, at 541–42.

rule making can encroach upon individual freedom for the sake of efficiency, accepts that a victim has a right to compensation even in the absence of an identified tort feasor, and is open to the idea that property rights can be created and managed by government.

In the rest of this article, Calabresi's vision is examined by considering two different areas in which the law-and-economics literature has produced important contributions. One is the analysis of accidents within the doctrine of *respondeat superior*, the very area examined in Calabresi's 1961 article[24] and to which Guido Calabresi devoted considerable attention throughout his scholarly career. The other area regards limited-liability firms, a field in which, rather than following the general principle that the actor should be held liable for mishaps, most scholars have agreed to let the actor off the hook and pass at least part of the harm created by accidents to the victim. Thus, the case of limited-liability firms presents a perspective on default liability opposed to that of *respondeat superior*. The contrast shows how both Calabresi and free-market advocates can challenge the prevailing efficiency-based view of members of the Chicago school.

II
DIFFERENT PERSPECTIVES ON *RESPONDEAT SUPERIOR*

How far is Calabresi's position from the free-market vision? As mentioned above, I try to shed light on this issue by looking at two areas: *respondeat superior* and firms' limited liability. *Respondeat superior* refers to the legal doctrine that assigns liability to the principal for the damages provoked by agents who operate on his behalf. *Respondeat superior* illustrates that although the free-market perspective requires neither mandatory risk spreading nor state insurance, that perspective generates conclusions similar to those put forward by Calabresi. Likewise, a closer look at limited liability shows that efficiency is not necessarily compromised by the free-market rule that the owner–aggressor is always liable, regardless of intentionality. In contrast with Calabresi's position, however, the presence of accidents strengthens the case for compliance with free-market guidelines, and the economic argument in favor of transforming accidental losses into a social burden at the expense of the taxpayer is vulnerable to criticism.

A. *Respondeat Superior*: The Free-Market Perspective

The free-market view emphasizes individual responsibility (the tort feasor is always liable)[25] and explicit contractual commitment. By contrast, all kinds of

24. *See* Calabresi, *supra* note 5, at 543.

25. *See generally* JAMES M. BUCHANAN, *General Implications of Subjectivism in Economics*, *in* WHAT SHOULD ECONOMISTS DO? 81 (1979); HAYEK, *supra* note 14; MISES, *supra* note 4; James M. Buchanan, *Individual Choice in Voting and the Market*, 62 J. POL. ECON. 334 (1954). On the difference between responsibility and liability, see, for example, Joel Feinberg, *Collective Responsibility*, 65 J. PHIL. 674, 674 (1968) (distinguishing between responsibility, defined as the obligation running to the

implicit agreements are regarded with skepticism,[26] even when the acceptance of these agreements might legitimize efficiency-enhancing regulation. Put differently, free-market advocates argue that unless somebody else explicitly accepts liability in the owner's stead, the owner is always responsible (and liable) for the damage provoked by his actions or by objects that are his property. In particular, within the context of exchange, the seller is the owner until the transaction is completed; the buyer becomes the owner only after completion of the transaction. Identifying the principal and the agent, therefore, boils down to finding out whom the owner is and—in the case of a contractual transaction—who has signed the contract (or on behalf of whom the contract has been signed). Thus, by definition the agent is never liable unless he operates outside the contract with the principal, thereby becoming a principal himself.

In a word, the *respondeat superior* problem vanishes altogether from a free-market perspective. Compliance with the principles and implications of property ownership suffices. Certainly, tradition and habit could shape judicially enforced default rules that apply to incomplete contracts. Yet opting out of a default rule should always be permitted.

B. Normative Consequences

The free-market vision outlined above generates two normative consequences, depending on whether damage takes place during or after transaction. If damage occurs during the transaction—for example, if a company carries out maintenance works in a building and its employees (unintentionally) break a pipe or harm a resident—this event is equivalent to an encroachment on the residents' private property or on their physical safety and health. In this case, the contractual counterparty is always the tort feasor, regardless of who is physical executor. Hence, if maintenance services are sold by the tort feasor's agent, the agent is liable, because in this case the agent is in fact the principal, even if he pretends otherwise. On the other hand, if services are sold by the principal who then relies on the agent, the principal is liable.

Of course, the above is true independent of the accidental nature of the event. The presence or absence of criminal intent also makes no difference, because in both cases the offender remains the owner and principal. However, when damage is accompanied by criminal intent, the eventual contractual transfer of liability from the seller to the buyer becomes void, and both the principal and his agent are liable. To illustrate this last point, consider a situation in which the seller (1) knowingly conceals risky or potential costs, so

author of the damage (the aggressor, in our case) and liability, defined as the obligation to compensate the victim). According to the traditional vision, responsibility does not necessarily imply liability: "Liability requires the capacity to act, predictability of the consequences, and the possession of control. In the case of groups, their degree of unitary character is an added factor that must be considered." Sven-Olof Collin, *Bad Losers: An Investigation of the Morality of the Limited Liability of Shareholders in a Joint Stock Company*, 30 J. ECON. ISSUES 283, 286 (1996).

26. *See, e.g.*, John Simmons, *Locke's State of Nature*, 17 POL. THEORY 449, 463–65 (1989) (emphasizing that Locke should be read to require explicit consent to form a social contract).

as to increase the chances of closing a profitable deal, (2) induces the buyer to accept liability for all accidents, should they materialize, and (3) subsequently tries to persuade the buyer that the observed risky or potential costs were unpredictable and therefore accidental. For example, a builder might not mention that maintenance could involve damage to a pipe, thus leading to an extra charge to the residents. Under these circumstances, if both the agent and the principal knew about this possibility and kept silent, then both the agent and the principal are liable, because their behavior is equivalent to that of two accomplices who collude to induce the buyer to enter a contract he would not have signed if he had known the full story.

A different conclusion applies when damages emerge after the transaction has been completed. For example, suppose that an individual buys a car that, though produced by a manufacturer, is sold by a dealer who is employed by the manufacturer and acting on its behalf. After a few months the car breaks down, possibly harming a fourth person as a consequence of the malfunction. How would the free-market liability principle work in this case? Of course, if the malfunction was possible or even likely (and therefore not accidental), and if this possibility was known to the manufacturer and the dealer but not the buyer, then under the free-market approach the buyer is liable to the fourth person, and the dealer and the manufacturer are accomplices and fully liable to the buyer, who fell victim to fraudulent behavior.[27] By contrast, if the damage is completely unpredictable and therefore accidental, then neither the dealer nor the manufacturer can be held liable to the buyer, unless they explicitly accepted liability when signing the contract.[28] In other words, because the accidental event took place after the buyer acquired full property rights, the driver cannot claim he has been harmed by the manufacturer or the dealer, and the seller should be discharged from all obligations.

Therefore, from a free-market perspective, liability for nonaccidental damages is assigned according to the contractual agreement. Absent an explicit accord between the parties, the default rule prescribes that one should identify the victim, because there cannot be a tort feasor without a victim, and then identify the tort feasor (if there is one). In a contractual transaction, the tort feasor is always the owner of the good to be sold or the contractor that vows to perform given services. He is the principal, and by signing the contract, he takes responsibility and thus necessarily accepts liability. An employee selling or delivering a faulty car on behalf of his principal is indeed responsible and liable if he knows about the fraud. He becomes the principal's accomplice, even if he

27. However, if the dealer explicitly requested the buyer to bring in the car for periodic checkups and the buyer did not comply, then the buyer would be in breach of contract and the dealer off the hook.

28. The driver would still be liable to the fourth person, though, because there is no doubt that the driver is the aggressor and that the victim never agreed to waive the driver's liability. This contrasts with Calabresi, who refers to a car hitting a pedestrian and seems open to the idea of making the pedestrian liable if he happens to obtain lower insurance prices and thus enhance efficiency. Calabresi, *supra* note 5, at 506.

is a mere agent. But if he does not know, then only the principal is liable: the buyer's counterparty is the principal, while the agent is the instrument used by the principal to fulfill the principal's contractual obligation. By definition, however, the presence of an accident rules out fraud. Thus, the seller is liable until the transaction is completed, and unless a different agreement intervenes, the buyer must bear liability for accidents that occur after he has acquired full ownership. That there is a victim, but not an offender, is not enough to make the seller responsible for damages, because the seller can no longer be an offender after full ownership has been transferred.

C. *Respondeat Superior*: Is Calabresi's Position Really Different?

The alternative to the free-market view on *respondeat superior* rests on two sets of arguments, both of which Calabresi articulated. One is based on cost minimization. Consistent with the line of theorizing dear to the neoclassical tradition, Calabresi maintains that the principal has better control than the agent over the economic activity at issue and has access to a wider range of remedies to contain the cost of the accident.[29] Thus, because the principal is in a better position to contain the cost of the accident, he should be held liable. The second argument, on which I focus my attention, claims that the cost of the accident should fall on the rich, because the rich have deeper pockets and fairness requires that they bear the burden.[30] (This is known as the ability-to-pay principle.) In particular, this line of thinking assumes that no buyer would ever do business with a counterpart who has little incentive to keep his word and who might not be able to compensate the buyer upon failure to deliver or exposure to damage or accident. The lawmaker (or judge) can thus infer that the principal's pockets are necessarily deep and, therefore, the principal must be considered liable.[31]

Clearly, the argument that the rich should pay implicates questions of the role and meaning of the principle of social justice (or fairness), which in turn is contingent on the existence and nature of the social contract. Regrettably, however, the debate on the social contract—and therefore the meaning of social justice—is far from settled. Some authors follow Thomas Hobbes in believing that the social contract exists and that it is implicit.[32] Others support an

29. *See* Calabresi, *supra* note 5, at 500–01.

30. *Id.* at 527.

31. As mentioned in Smith, *supra* note 21, almost a century ago Thomas Baty listed nine reasons that could explain the *respondeat superior* doctrine and concluded that there is only one real motivation, which boils down to deep pockets. THOMAS BATY, VICARIOUS LIABILITY 196 (1916). A similar argument has also been made by Roscoe Pound, who referred to the "exigencies of social justice." Roscoe Pound, *The End of Law as Developed in Legal Rules and Doctrines*, 27 HARV. L. REV. 195, 233 (1914).

32. *See* MICHAEL OTSUKA, LIBERTARIANISM WITHOUT INEQUALITY 115–16 (2003). An implicit social contract is also put forward in JAMES M. BUCHANAN & ROGER D. CONGLETON, POLITICS BY PRINCIPLE, NOT INTEREST: TOWARD NONDISCRIMINATORY DEMOCRACY (2006), in which the authors argue that when government intervention clearly makes everybody better off, it cannot be illegitimate.

interpretation of John Locke's view, according to which the social contract exists only if it is explicit.[33] And a third group of theorists follows John Rawls's view that the social contract is legitimized regardless of people's opinion as long as it derives from a shared set of hypotheses.[34] By contrast, the free-market camp flatly denies the existence of any social contract.[35] Because the terms "social justice" and "social responsibility" are based on the constitutive elements of the social contract, the free-market supporter, by denying that contract's existence, rejects the notions of social justice and social responsibility. Consequently, the free-market supporter also rejects the notion that liability should fall on the rich because of their deeper pockets. Without a social contract that creates social responsibility, this liability would unjustifiably infringe upon the individual liberty of the rich.

Thus, it appears that both the free-market supporter and Calabresi reject neoclassical efficiency and the Chicago school's emphasis on material wealth as the only relevant standard for imposing liability. Rather, they underscore—the free-market advocate more so than Calabresi—that the allocation of liability should also take into account a metaprinciple of justice. Of course, the notion of justice is not the same: the free-market supporter maintains that justice consists in the preservation of freedom from coercion and in the protection of (uninfringeable) property rights.[36] By contrast, Calabresi seems more inclined towards the ability-to-pay criterion.

In other words, the free-market view chooses the Lockean–Rothbardian approach to property rights.[37] The very nature of accidents rules out the existence of responsible tort feasors. The victim of an accident has no right to hold anybody liable or to ask for compensation. In fact, the whole *respondeat superior* doctrine becomes a moot issue. Regardless of who falls victim to the accident before the transaction is completed—the principal or the agent—the

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33. *See, e.g.*, MICHAEL HUEMER, THE PROBLEM OF POLITICAL AUTHORITY: AN EXAMINATION OF THE RIGHT TO COERCE AND THE DUTY TO OBEY 21–22 (2012); ANTHONY DE JASAY, THE STATE 40–41 (1985); David Hume, *Of Civil Liberty*, *in* ESSAYS: MORAL, POLITICAL, AND LITERARY 156 (T.H. Green & T.H. Gross eds., Longmans Green & Co. 1889) (1742).

34. *See* JOHN RAWLS, A THEORY OF JUSTICE (1972).

35. *See* MICHAEL HUEMER, THE PROBLEM OF POLITICAL AUTHORITY 58 (2013).

36. *See supra* text accompanying note 4.

37. To simplify, the Lockean property rule claims that an individual can appropriate a good in two ways. The first is voluntary transactions: Individual *A* receives the good from rightful owner *B*, either as a gift or in exchange for something else (such as money). The second way originates from the first user–first owner principle: An individual can rightfully appropriate a resource as long as that resource has not been previously appropriated by somebody else. According to Locke's *Second Treatise on Civil Governments*, the act of appropriation is effective when the individual makes use of that resource: "Whatsoever then he removes out of the state of nature hath provided, and left it in, he hath mixed his labour with, and joined to it something that is his own, and thereby makes it his property." JOHN LOCKE, SECOND TREATISE ON CIVIL GOVERNMENTS 26 (Lester DeKoster ed., 1978) (1690).

The Rothbardian view reproduces the Lockean structure, with an important addition: Once an individual has mixed his labor with the previously unappropriated resource (such as a piece of land), his property right to the resource is established for good, even if the mixing no longer takes place. *See* Rothbard, *supra* note 4.

buyer's rights regarding the principal remain unaltered. If the accident occurs during the transaction, the buyer may hold the principal liable. On the other hand, if the accident hits the buyer after the transaction is completed, he can blame neither the principal nor the agent.[38]

By contrast, Calabresi puts forward solutions that are both efficient and consistent with the expectations of public opinion (and are therefore just, one is tempted to add). Access to information and market power matter, and liability should be assigned to those allegedly better situated to tackle risky situations, buy cheap insurance, or both (typically principals, rather than agents). Moreover, when the deep-pocket or the asymmetric-information argument does not apply, the ultimate risk-spreading device—tax-financed subsidies covering accidental costs—becomes tempting. From Calabresi's perspective, the underlying assumption is that because an accident is nobody's fault, the lack of an offender makes society liable; and because the logic of collective action suggests that resistance to socializing losses is usually weak, forced solidarity obtains consensus and becomes morally acceptable.[39]

Despite the differences with respect to the notion of social justice, however, Calabresi and the free-market supporter would agree on two important points. First, the allocation of liability should follow a default rule, according to which the principal is liable until the transaction is completed. Calabresi and the free-market supporter also agree that default rules can be waived through a contractual agreement. Second, Calabresi's argument for risk spreading when accidents occur and nobody is at fault is based not on efficiency, but on the existence of a hypothetical social contract. According to that social contract, when nobody is at fault, the whole community—rather than an individual—should be considered a victim and thus suffer the consequences. Efficiency might play a role, of course, but it is not critical. The free-market supporter would also agree that efficiency is not critical, and would accept that risk spreading depends on the existence of a social contract. Yet, while Calabresi is happy with an implicit or hypothetical social contract, the free-market view would require that it be explicit.[40]

38. Once again, from a free-market vantage point, the default rules are straightforward and depend on whether the cost is provoked by truly accidental circumstances. For example, there is no accident if the worker is negligent. Thus, the worker is responsible for his negligence and liable to his employer. By contrast, if the employer requires the employee to perform certain duties and the employee gets injured because, for example, the machine he is operating breaks down or the scaffolding collapses, then the employer is liable, insofar as he is the owner of the machine or scaffolding.

This also applies in the absence of a buyer. If an employee is struck by lightning while performing on behalf of his employer, the employer is not responsible. But suppose that an agent drives a truck owned by the principal and the driver is blinded by a sudden flash of light, loses control, and hits another vehicle. Then, unless the employer and his agent had previously agreed otherwise, the principal is liable, because he is the owner of the vehicle and (temporarily) of the labor input provided by the driver.

39. *See* Calabresi, *supra* note 5, at 529–30.

40. According to Locke, in the absence of an explicit social contract, the role of the state consists in protecting and enforcing individuals' natural rights (physical integrity and property). *See* John

III
LIMITED-LIABILITY COMPANIES

The case of limited-liability firms offers an interesting opportunity to analyze the law and economics of accidents from a different perspective. In contrast with the general principle typical of the *respondeat superior* doctrine, limited liability makes individuals external to firms—for instance, suppliers—vulnerable to uncertainty regarding their own liability, especially when extrahazardous activities are involved. Under limited-liability rules, therefore, the firm's owners become the beneficiaries of a kind of subsidy, which increases with the size of the uncertain costs and with the value of the shares in their possession.

The traditional justification for limited liability relates to the alleged dynamic efficiency of limited-liability companies, as well as to the lower transaction costs that limited liability implies.[41] Put simply, supporters of limited liability usually argue that limited liability makes it easier for entrepreneurs to raise the amount of capital necessary to attain optimal size.[42] They assert that investors would not engage in activities characterized by substantial uncertain costs (including those provoked by bad managers) if they ran the risk of losing all their wealth. And they argue that by instead letting shareholders off scot-free, a community avoids squandering the resources necessary to find shareholders and close legal loopholes.

A. Limited Liability: The Free-Market View

The free-market advocate is probably ready to acknowledge that the limited-liability regime is simpler. Yet, in his view, simplicity, allegedly optimal company size, or subsidies to risk taking are not enough to justify making the victim pay "the consequences that belong to the worst of all in the set of possible outcomes of an action."[43] Therefore, the principle of individual responsibility would induce the free-market supporter to consider the owner

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Simmons, *Locke's State of Nature*, 17 POL. THEORY 449, 456 (1989). Put differently, the state should not give substance to the notion of social justice, let alone carry out redistribution. In this vein, therefore, the rights of an individual correspond to his natural rights (liberty and property), and his obligations are his duties to respect the natural rights of the other members of the community and to comply with the terms of the social contract when it exists.

41. *See, e.g.*, EPSTEIN, *supra* note 1, at 270–71; Joseph Grundfest, *The Limited Future of Unlimited Liability: A Capital Markets Perspective*, 102 YALE L.J. 387, 424–25 (1992).

42. *See generally* Frank H. Easterbrook & Daniel R. Fischel, *Limited Liability and the Corporation*, 52 U. CHI. L. REV. 89 (1985).

43. Collin, *supra* note 25, at 286; *see also* Henry Hansmann & Reinier Kraakman, *Toward Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1933–34 (1991) (advocating (proportional) liability). This triggered an intense scholarly debate. In fact, full liability would not prevent large corporations from coming to the surface. There is also evidence suggesting that the pool of shareholders would not necessarily be small (concentrated ownership) or that "the shares would be perceived to be particularly risky." Peter Grossman, *The Market for Shares of Companies with Unlimited Liability: The Case of American Express*, 24 J. LEGAL STUD. 63, 78 (1995). By contrast, it is doubtful that gate-keeping legislation and regulation under a limited-liability regime lead to "optimal" behavior by the managers, who might still fool shareholders and third parties.

liable by default in this context as well. In particular, liability is imposed for both the owner's and his employees' misdeeds, as long as his employees operate within an agency agreement. Whether the owner is an individual or a company makes no difference. Certainly, there may be situations in which a counterparty voluntarily agrees to deal with a limited-liability business partner. This would raise no problem to a free-market advocate, as long as full liability is waived explicitly and the waiver also includes accidents.

In practice, a company can become an offender within two different settings: when it enters a contractual agreement and fails to complete the job, and when it experiments with innovative activities in its laboratories and causes accidental damage. The former case presents no particular problem, because liability in the presence of breach of contract is not disputed. But unless the victims have waived their rights, the offender is clearly responsible in the latter scenario as well, because one can hardly decline liability unilaterally and let the victim deal with the consequences. That damages are provoked by accidents makes little difference in assigning liability.[44] Furthermore, the involvement of a government authority does not alter the essence of the argument. For example, it might happen that the local authorities allow a producer to carry out experiments with potentially harmful materials and agree that the tort feasor will bear only limited liability for the damages he might produce. Under these circumstances, however, either the local authorities have an explicit mandate and are empowered to ignore the residents' initial right to give permission and claim compensation,[45] or the local authorities overstep their mandate and become the producer's accomplices, with whom they will thus share liability.

B. Against Risk Spreading

Calabresi's emphasis on risk spreading suggests that accidents should be treated differently than the other categories of costs. In particular, he argues that society should be liable for involuntary and unpredictable torts, possibly for the sake of dynamic efficiency.[46]

The free-market camp would object on two grounds, both of which are manifestations of the principle of individual responsibility mentioned earlier. The first ground draws on the conviction that costs are a function of knowledge and that the "discovery of knowledge" should develop free of artificial impediments. When applied to uncertain costs (including accidents), this means that the importance of damages also depends on the extent to which individuals can devise products and processes that reduce their impact. The free-market advocate knows neither the optimal speed of the discovery process nor the

44. Of course, this does not imply that unlimited-liability companies are vulnerable to all uncertain costs. In fact, companies frequently buy insurance against risky or potential costs, so that insurance companies end up with the cost of uncertainty.

45. It is assumed that the residents homesteaded the area before the company started operating and causing damages.

46. *See* Calabresi, *supra* note 5, at 520–21.

identity of the potential discoverers. But he posits that the discovery process is analogous to entrepreneurship: It is driven by a mix of intellectual curiosity, complacency, vanity, and greed (profit seeking), and can be best performed by individuals who respond to those stimuli and react accordingly. And because legislators have rather tenuous notions about which way and how fast discovery should go, they should not be allowed to force its direction.[47]

The second ground relates to the principle of social responsibility as a whole, regardless of the accidental nature of the event. Proponents of the free-market view do not object to the existence of instruments providing broad coverage against catastrophic events. Unless this coverage involves protection against violations of one's natural rights, however, it should be the object of voluntary, cooperative agreements and exchange, rather than of government action.[48] Put differently, and in accord with the Humboldtian vision of social rights and obligations,[49] the state should not engage in insuring against accidents, let alone by taxing the population at large.

To summarize, when uncertain costs do not lead to bankruptcy, the liability question actually vanishes and, if insurance is indeed preferable, unlimited-liability companies will buy insurance anyway, with no need for social risk sharing. For both Calabresi and the free-market adherent, then, the crucial question is how to treat catastrophic accidents, which cannot be neutralized through insurance and the cost of which cannot be covered by the firm's net capital. Should these costs be borne by the shareholders (unlimited-liability companies), or by the other stakeholders and society at large (limited-liability companies)? Who is right: the free-market champion or Calabresi?

Unfortunately, the answer will hardly come from the economics profession. Social scientists will have to look elsewhere. Most notably, they will have to look toward political philosophy: the nature of the social covenant, the meaning of social responsibility, and the source of legitimacy of government coercion, which define the extent to which private property can be violated. To define the default liability rule in the presence of catastrophic accidents, one should identify the victim at the moment that the accident hits a member of society. Is the victim society, of which the individual is just a component? Or is the victim the individual per se?

In the former case, there is no doubt that society as a whole should pay. For example, suppose that a new source of energy unexpectedly becomes available. As a consequence of this accident, companies operating in the traditional mining and oil industries suddenly go broke and create significant secondary problems: Contracts with workers and suppliers are no longer honored.

47. RANDALL HOLCOMBE, ENTREPRENEURSHIP AND ECONOMIC PROGRESS 37–38 (2007).

48. *See, e.g.*, ENRICO COLOMBATTO, MARKETS, MORALS AND POLICY-MAKING 62 (2011); ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 73–74 (1974).

49. *See* HUMBOLDT, *supra* note 4. In a word, the state's sphere is confined to the "preservation of security . . . . Political activity can only extend its influence to such actions as imply a direct trespass on the rights of others; to the task of deciding in cases of disputed rights; to redressing the wronged, and pursuing the wrong-doers." *Id.* at 82.

Following from this first scenario—society is the victim—the taxpayer will compensate the stakeholders by paying the debts of the failed companies and guaranteeing unemployment benefits to those who lost their jobs. In such a case, the only open issue regards the features of taxation.

If the victim of the accident turns out to be the individual, however, one has to evaluate the nature of the covenant between the individual and society. This evaluation is the essence of the second metaissue. If one believes that the covenant between the individual and society only includes protection against violence by other human beings, then the individual cannot ask society to pay for the damages caused by the accident. In fact, two explicit contracts are required: one between the potential victim and a government authority, and one between the government authority and the taxpayers who should provide the resources to pay compensation. By contrast, if one believes that the covenant between the individual and society also includes some kind of tacit collective insurance that materializes at the very moment one becomes a member of society, then risk spreading might be justified, and the stakeholders might well ask the some or all taxpayers to replace the debtor after an accident has struck.

The analysis of the social covenant is well beyond the scope of this paper and we shall not pursue the matter further. Yet both Calabresi and free-market supporters would agree that the evaluation of the existence and nature of the social covenant is crucial, even if it pertains to the domain of political philosophy rather than to that of law and economics. By contrast, the proponents of the Chicago school are more likely to take the opposite view and maintain that the notion of justice is ultimately driven by efficiency, either because it is the only objective criterion upon which individuals might agree, or because this criterion would eventually prevail as a result of an evolutionary process in which the most efficient societies succeed at the expense of the others.[50]

IV
CONCLUSION

Although Calabresi's concerns for fair redistribution are well known, he refrains from advocating violations of freedom of contract for the sake of wealth creation, let alone suggesting that judges become technocrats involved in cost-benefit simulations. Thus, Calabresi rejects much of the Chicago vision, which develops from the two Coasean principles of reciprocity and wealth creation.[51] The same also applies to uncertainty. The Chicago approach borrows

50. *See* Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457 (1897); Richard Posner, *Wealth Maximization Revisited*, 2 NOTRE DAME J.L. ETHICS & PUB. POL'Y 85 (1985).

51. According to the former, the identities of the victim and of the aggressor cannot be established a priori, but only after the policy maker has reached his verdict on the matter. R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 2 (1960). According to the latter, property rights should be assigned so as to reproduce the situation that would have emerged if the agents had been able to

on the neoclassical tradition and deals with uncertainty by resorting to regulation or judicial intervention. Calabresi, by contrast, sides with the free-market perspective and considers uncertainty inevitable.

In the end, the only significant gap between Calabresi and the free-market approach in the realm of liability regards the connection between accidental events and social responsibility. From the free-market vantage point, the treatment of an accident relates to the existence of an injurer. If there is no aggressor, the victim has no right to compensation and the long-standing debate about negligence and strict liability becomes less relevant, because no precaution is possible in the presence of an accident.[52] Put differently, bad luck creates no rights and, therefore, the attribution of liability is a political decision that has little to do with efficiency or with natural law.[53] By contrast, Calabresi's perspective takes for granted the intrinsic justice of a social arrangement that ultimately redistributes wealth from the rich to the poor.[54] However, the nature of this debate pertains to political philosophy, rather than to economics: Social responsibility ultimately depends on one's notion of social justice and, therefore, of society. These are crucial questions, of course, but beyond the scope of this article.

Do the above conclusions have consequences for the relevance of institutional economics, which is so deeply indebted to the law-and-economics approach? By and large, economists justify policy making by referring to the presence of market failures, defined as undesirable outcomes originated by unfettered interaction among individuals. Therefore, economists argue that policy makers should be responsible for creating and implementing the suitable social architecture and for enforcing desirable cooperation agreements that would hardly see the light of day spontaneously.

Speculation about the features of the appropriate social architecture has inspired a substantial literature. Yet it is undeniable that the bottom line remains unclear and that such speculation often boils down to a set of tautologies. For example, economists tend to define good institutions as arrangements that lead to satisfactory economic performance and are accepted

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transfer property rights in an ideal world characterized by zero transaction costs. *See id.* at 16–17, 19, 34; GEORGE STIGLER, THE THEORY OF PRICE 114 (3d ed. 1966).

52. The reader might recall my definition of accident, which does not refer to unintentional injuries, but rather to unpredictable events. *See supra* Part I.A.

53. Natural law refers to the individual's right to protection and private property. In this context, an individual cannot be held liable if he has not done violence to the victim, and the victim has no right to ask for state intervention. Moreover, one may observe that the free-market view on accidents and liability described here is also efficient. One could hardly imagine the magnitude of the transaction costs involved in assigning liability for the unpredictable damages provoked by a good that has been previously owned by several different actors and the producer of which is no longer in business.

54. From Calabresi's perspective, therefore, the issue consists of deciding whether the damage originates from an accident or from another category of uncertain costs: Society is in charge of the burden in the case of accident, and the victim suffers the loss otherwise. *See* Calabresi, *supra* note 5, at 527, 534. The free-market perspective is simpler: The owner always shoulders the burden. *See, e.g.*, HAYEK, *supra* note 14; MISES, *supra* note 4.

by the community to which they apply. That is, of course, equivalent to "theorizing" that good formal institutions should always comply with the common interest: It is reasonable, but operationally unsatisfactory. Indeed, it is not surprising that the static explanatory power of today's institutional economics is limited to underscoring the presence of transaction costs. Efforts to shape institutional dynamics are also rather disappointing, because path dependence is not really a theory about change, but about inertia until a shock occurs. And of course, not much can be put forward normatively, because the prescriptions for optimal institutional design follow one's beliefs about the range of policy maker actions and the possibility of restraining policy maker discretion (such that these prescriptions thus fall under the purview of political philosophy, public-choice theory, and constitutionalism).

To conclude, by neglecting the political–philosophical side of institutional analysis, the original Coasean insights have offered neither satisfactory explanations of the dynamic of the rules of the game nor credible normative prescriptions. At best, they have offered empirical investigations to prove the obvious: Growth suffers when entrepreneurial skills are stifled through regulation, expropriation, and ideological intolerance. Luckily, Calabresi seems to take a different and more promising route. He does not discard neoclassical efficiency reasoning altogether, but he is well aware of the problematic aspects raised by the notion of responsibility, both as the source of desirable incentives and as the essence of moral behavior. To be fair, Calabresi is inclined to believe that social responsibility might eventually be a reasonable solution to the thorniest situations and, therefore, he runs counter to the free-market emphasis on individual responsibility. Yet even the most rigid free-market advocate must acknowledge that Calabresi's way of framing the law-and-economics debate is more fruitful than the standard neoclassical version, and that it leaves the door open to much-needed contributions by moral and political philosophers. The interaction between these disciplines and the economic way of thinking is indeed where institutional economics should be heading in the future.