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Posner, Hayek the economic analysis of
Law**

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The Evolution of Common Law: Revisiting Posner, Hayek & the Economic Analysis of Law

ABSTRACT

This paper is aimed at highlighting how common law has evolved over the centuries, namely through the flexibility accorded to judicial precedents, as well as through the evolutionary nature evidenced in the processes and rules applied in statutory interpretation. In addition to illustrating how informational asymmetries can be mitigated through decentralisation, the paper also illustrates how a particular case, *Pepper v Hart* has revolutionised the scope and permissibility of aids to statutory interpretation. Whilst the decision in the case has been criticised as having facilitated a transfer of powers from the executive and legislature, to the judiciary, it is also evident that any form of aid to statutory interpretation - which would greatly assist judges in arriving at reasonable outcomes - in terms of legitimate expectations and efficient allocation of economic resources, should be permitted in judicial proceedings.

Whilst financial markets and changes in the environment impact legislators, and whilst it is widely accepted that legislation constitutes the supreme form of law, the necessity for judges to introduce a certain level of flexibility will also contribute towards ensuring that legitimate expectations of involved parties are achieved - particularly where the construction of the words within a statute gives rise to considerable ambiguity.

Key words: legitimate expectations, certainty, flexibility, judicial precedents, statutory interpretation, allocative efficiency, *Pepper v Hart*, Posner, Hayek. common law, regulatory capture, regulation

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The Evolution of Common Law: Revisiting Posner, Hayek & the Economic Analysis of Law

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A Introduction

To Be or Not to Be Regulated: Purposive Rules and the Centralisation of Information

Posner's conception of law as "a series of disparate rules, and as purposive"²

The development of judicial precedents and the role of judges in the interpretation of statutes and legislation - to better align with the original intent of the legislator, has been evidenced over the past centuries. Certain cases, however, have reflected possibilities whereby judicial development may generate outcomes which are contrary to legislative intent. This can be illustrated by section 10 (b) and Rule 10b-5 of the Securities Exchange Act of 1934, which has been highlighted as having been interpreted "to require corporate insiders and tippees to either disclose material inside information or refrain from trading."³

Carlton and Fischel argue that such judicial development is contrary to legislative intent and that no evidence exists to support the fact that Congress intended to prohibit insider trading.⁴

Further, whereas Hayek is considered to view the common law as a "spontaneous order which regulates society better than a person could", Posner is considered to view the law as "an order consciously made through the efforts of judges and legislators."⁵

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² TJ Zywicki and AB Sanders, "Posner, Hayek & the Economic Analysis of Law" Iowa Law Review Volume 93 No 2, pp 559-603 February 2008, George Mason University Law and Economics Research Paper Series, see particularly abstract

³ SEC v Texas Gulf Sulphur Co, 401 F.2d 833 (2d Cir 1968) (en banc), cert denied, 404 U.S 1005 (1971). See D Carlton and D Fischel, "The Regulation of Insider Trading" Stanford Law Review Volume 35 No 5 (May 1983) pp 857-895 at page 884,

⁴ see *ibid*

⁵ see TJ Zywicki and AB Sanders, "Posner, Hayek & the Economic Analysis of Law" Iowa Law Review Volume 93 No 2, pp 559-603 February 2008, George Mason University Law and Economics Research Paper Series, see particularly abstract

Such above differing views about levels of control of the law and perceptions of being regulated and the ability to regulate, can be attributed as influential factors in the opinions also shared by Posner and Hayek on the roles of judges, as well as their support for decentralisation (Hayek) and centralisation (Posner) of information. The question revolving around why firms might want to allocate “property rights in valuable information”⁶ to managers, rather than to shareholders, is not merely based on the premises that managers may value such information more than shareholders, but also attributed to the ability of such agents to better monitor, supervise and account for the distribution and dissipation of such information in a manner and timing (which shareholders are less better equipped and specialised to handle).

From this perspective, it could be argued that whilst information regulates those who are less specialised and equipped to handle such information, the delegation and centralisation of such information to those who are better specialised and equipped to handle such priceless resources and privileged public utilities, generates an outcome whereby such information is better regulated, as well as maximised.

In like manner, whilst law, and in particular the common law, could regulate those who are less specialised to handle such rules, they are regulated by more capable individuals and authorities. Hence the question does not necessarily and merely relate to whether law is being regulated or regulates, but rather, why it should be regulated and the agents through which such regulation should take place.

In their article, Carlton and Fischel, also argue that “even if Federal regulation is justified on the basis of law enforcement cost, firms should have the opportunity to opt out of the regulation in the absence of any showing of third party effects, and that such firms are best judges of how to structure the terms of their employment contracts.”⁷

Therein lies the argument for enforced self regulation. Whilst individual firms may be the best judges to decide on the design of their contracts, in order for those contracts to be tailor made to adjust better to their firm’s needs, self regulation through these firms, may be better enforced by the State and through the courts. Even with its advantages, certain disadvantages can also be attributed to self-regulation⁸. As well as being consequential of a lack of transparency in a regulatory and supervisory regime, regulatory capture is also more likely to occur where a system of self regulation exists.

⁶ See See D Carlton and D Fischel, “The Regulation of Insider Trading” Stanford Law Review Volume 35 No 5 (May 1983 at page 866

⁷ see *ibid* at page 895

⁸ For further information on the advantages and disadvantages of Self Regulation, Enforced Self Regulation see M Ojo, “Co-operative and Competitive Enforced Self Regulation: The Role of Governments, Private Actors and Banks in Corporate Responsibility http://mpr.ub.uni-muenchen.de/27850/1/MPRA_paper_27850.pdf; also see I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* Oxford University Press at page 102

Posner and Theories of Economic Regulation

The theory of regulatory capture was introduced by Richard Posner who argued that „regulation is not about the public interest at all, but is a process, by which interest groups seek to promote their private interest..”⁹

- The economic theory of regulation as proposed by Stigler admits the possibility of “capture” by interest groups other than the regulated firms. Furthermore, exceptions to the general rule that regulatory agencies are captured by the regulated firms are explained by references to the personality of the legislators, public opinion, ignorance, folk wisdom etc.¹⁰

Posner also provides criticisms of both the traditional public interest theory of regulation and “the newer economic theory” which regards regulation as “a service supplied to effective political interest groups.”¹¹

Which leads us back to the question of why firms might want to allocate “property rights in valuable information” to managers, rather than to shareholders.

The independence of the regulator from the industry which is being regulated is vital to ensuring that regulatory capture does not occur. Regulatory capture is less likely to occur where more actors are involved in the regulatory process and is more likely to occur where there is regular contact between the regulator and the regulated (firms). Whilst these actors may have their interests, and whilst despite such interests, it may be optimal allocating these resources to certain agents, the intervention of courts serves in many respects as a check in dealing with the available resources - in such a way whereby a greater level of maximisation of utilities is achieved.

Flexibility is also certainly a crucial and vital element in all evolutionary processes, and has been a feature of common law - within the context of judicial precedents - particularly when contrasted with the principle of *stare decisis*.

As highlighted by Zywicki and Sanders:

⁹ See R Posner “Theories of Economic Regulation” (1974) 5 Bell Journal of Economics and Management Science at pages 335-358

¹⁰ See *ibid* at pages 343 and 344.

¹¹ *Ibid* at page 356

“Preservation of legitimate expectations often will be best furthered, not by adherence to precedence, but by a prudent and thoughtful updating of rules to adapt to changing needs and expectations. In particular, because legal rules are just one element of the set of rules and practices that guide individual behavior in society, changes in non-legal rules may also affect legal rules such that in order to best preserve expectations and predictability about others’ actions, it will become necessary to amend some legal rules to better cohere with changing legal and non-legal rules. The objective is to increase social coordination such that individuals will have maximum freedom to act on local information as it arises. Interpersonal coordination, not aggregate economic efficiency, should be the overarching goal of the legal system.”¹²

Hence the need for a reasonable balance between certainty and flexibility in the judicial process is also evident. To what extent should certainty and rigidity in the process be sustained in order to preserve the legitimate expectations of those parties involved? Moreover, it is also reflected that “the thoughtful updating of rules” as a means of adapting to changing needs and expectations is necessary in the goals of preserving legitimate expectations.

The aim of the ensuing section is to highlight the importance of the purposive application of rules in the “updating” process. Such a goal will be facilitated by way of reference to the rules of statutory interpretation.

B “The Thoughtful Updating of Rules”: Rules of Statutory Interpretation

The purposive intent of rules and the legislator constitutes a fundamental characteristic of the common law system. In illustrating the increased role of judges, by not only adhering to the legislator or legislation, and the growing importance of interpreting rules with intent, the application of rules of statutory interpretation and the evolution of such rules will be elaborated on:

The Literal Rule of Statutory Interpretation

This usually constitutes the basic, starting point in construing a piece of legislation. Under this rule, judges are required to interpret statutes and legislation according to their ordinary, natural and dictionary meaning even if the outcome of such an interpretation may generate absurd or ridiculous results. Judges’ roles are considerably limited and restricted under this rule and may be regarded as being more passive

¹² TJ Zywicki and AB Sanders, “Posner, Hayek & the Economic Analysis of Law” Iowa Law Review Volume 93 No 2, pp 559-603 February 2008 at page 577

when compared to their roles under the other methods of statutory interpretation. Whilst certainty appears to be an advantage of complying with this rule, such advantageous attributes must be weighed against the results which are obtained where absurd outcomes are generated and the legitimate expectations of parties involved are effectively not met.

For this purpose, the golden rule constitutes the next resort where absurd results need to be mitigated.

The Golden Rule of Statutory Interpretation

Under this rule, judges are not only required to give effect to the literal meaning and application of the rule, but should also do so with the aim and purpose of avoiding an absurd result. The golden rule is namely, thus:

“The golden rule is that the words of a statute must prima facie be given their ordinary meaning.”

- Viscount Simon (*Nokes v Doncaster Amalgamated Collieries*)¹³

The Mischief Rule of Statutory Interpretation

The mischief rule represents a much narrower application of the golden rule - narrower in the sense of its greater focus on the intent of the legislator. Its application is considered necessary where a statute is considered to have been introduced as a means of remedying or rectifying a defect or problem (the mischief) in the common law.

An extension of the application of the mischief rule is embodied in the fourth and final rule of statutory interpretation being considered under this heading: namely, the purposive rule or the Rule in Heydon's Case.

¹³ [1940] A.C 1014 at page 1022

The Purposive Rule or The Rule in Heydon's Case

The purposive rule or the rule in Heydon's case, has at its core purpose, the discovery of the intent of Parliament or the legislator, namely,

What purpose was the statute enacted to rectify - for which the common law had a defect or needed to be rectified?

From the above-mentioned rules an evolution of the role of judges is demonstrated - both in respect of a greater role given to judges to interpret according to the intent of the legislator, and also in respect of analytic reasoning and balancing.

It is quite understandable as regards why Hayek and Posner's backgrounds have considerably impacted their perspectives of the role of judges.

According to Zywicki and Sanders,¹⁴

"Posner conceives law to be a series of disparate rules and as purposive. He believes that a judge should examine an individual rule and come to a conclusion about whether the rule is the most efficient available," whilst Hayek is considered to "conceive law as a purpose independent set of legal rules bound within a large social order."

These views will now be examined to a broader context under a landmark ruling which has not only contributed to judges' abilities to introduce aids as a means of interpreting statutes to a more effective extent, but also demonstrates the interdependency of rules - from one social order to the next.

¹⁴ TJ Zywicki and AB Sanders, "Posner, Hayek & the Economic Analysis of Law" Iowa Law Review Volume 93 No 2, page 559

C Pepper v Hart : The Mischief Rule and the Inclusion of Aids (Parliamentary Privileged Information) as a Means to Statutory Interpretation

Pepper v Hart¹⁵ represented a landmark ruling in the sense that it was the first time whereby the use of privileged parliamentary debates, information and records (Hansard) were permitted as admissible aids to statutory interpretation. The case involved the valuation of employee benefits for income tax purposes - given the ambiguous wordings of the statute involved.

The following issues were raised in the case:

- 1) Should existing rule prohibiting any reference to Parliamentary material (Hansard) in construing legislation be relaxed, and if so, to what extent?
- 2) If so, does the case fall within the category of cases where reference to Parliamentary proceedings should be permitted?
- 3) If reference to Parliamentary proceedings is permissible, what is the true construction of the statutory provisions?
- 4) If reference to Parliamentary proceedings is not permissible, what is the true construction of the statutory provisions?

As per Lord Browne-Wilkinson:

“Reference to Parliamentary material should be permitted as an aid to the construction of legislation which is ambiguous or obscure, or the literal meaning of which leads to an absurdity. Even in such cases, references in court to Parliamentary material should only be permitted where such material clearly discloses the mischief aimed at or the legislative intention lying behind the ambiguous or obscure words.”

¹⁶

Section 63 of the 1976 Finance Act constituted the central piece of legislation in the case. It is obvious that in such cases - not just those cases involving contentious attributions to the construction of the piece of legislation, but those whose scope may lie beyond the scope and principal expertise of the judge, aids

¹⁵ [1992] 3 WLR 1032, [1993] 1 All ER 42, HL (E)

¹⁶ See *ibid*, also see S C Styles, “The Rule of Parliament: Statutory Interpretation After Pepper v Hart” Oxford Journal of Legal Studies Vol 14 No 1 (Spring 1994) pp 151-158 Oxford University Press

to statutory interpretation may be justified where such aids are vital to efficient allocation of resources, as well as generating outcomes which could be considered to be reasonably efficient within the ambit of legitimate expectations of the parties involved.

Should judicial decisions be criticised for generating more efficient and purposive outcomes - particularly where the legislative source being referred to (regardless of whether such a source is privileged information), has not been altered in any sense, but has simply served as a means of shedding more light, providing more information, and giving purpose and meaning (or more meaning) to the legislation at hand?

D Conclusion

“If we can agree that the economic problem of society is mainly one of rapid adaptation to changes in the particular circumstances of time and place, it would seem to follow that the ultimate decisions must be left to the people who are familiar with these circumstances, who know directly of the relevant changes and of the resources immediately available to meet them.

We need decentralization because only thus can we ensure that the knowledge of the particular circumstances of time and place will be promptly used.”¹⁷

In very interesting fashion, decentralization is also essential towards ensuring that possibilities for regulatory capture are minimised.

Why firms might want to allocate “property rights in valuable information” to managers, rather than to shareholders? Because centralisation of information in the ambit of those better equipped and specialised to handle such information warrants such a move.

Centralisation and decentralisation should thus be viewed from relative (as opposed to absolute) perspectives. Support for centralisation of information is justified where such information resides within capable and more equipped ambits who will transform such information for the purposes of maximisation of wealth or utilities. Given such merits, there still exists the need for checks and balances to ensure that such powers are not abused. In like manner, decentralisation of information may still be facilitated optimally taking into account timing, manner of the dissipation, and agents involved in the distribution of such information.

Judges should certainly not make and unmake the law in certain cases - the supremacy of Parliament should be adhered to. Judge made law, namely common law, however constitutes an exception where the principle of *stare decisis* cannot hold in a world which is constantly changing and where those changes need to be incorporated into decisions if such decisions are to generate meaningful results.

Prices, for example, constitute examples of vital information which need to be updated constantly if wages which were earned centuries ago, are to have meaningful and reasonable importance and values in modern day valuation and measurements. The rise of macroeconomics has certainly played a part in impacting and interpreting the values attributed to information and macro indicators. Markets will definitely evolve and adequate rules are needed to regulate the markets. This is very evident given the

¹⁷ F A Hayek, “The Use of Knowledge in Society” *The American Economic Review*, Vol. 35, No. 4. (Sep., 1945), pp. 519-530
<http://www.jstor.org/discover/10.2307/1809376?uid=3739920&uid=2&uid=4&uid=3739256&sid=21104299293711>

fact that market failures, namely information asymmetries exist, and also the fact that the Efficient Markets Hypothesis does not hold in its entirety. Decentralization, hence constitutes a means of not only mitigating information asymmetries, but also ensuring that efficient maximisation of resource utilisation and allocation, takes place.

Hence the decentralisation of powers and information, in this case, from the executive and legislature to the judiciary, should be viewed positively as a means of addressing and mitigating informational asymmetries resulting from ambiguous, confusing and misleading words within a statute and also resulting in more efficient allocation of resources, and awarding of damages to the parties involved.

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