



SHOPPING FOR LAW  
IN A COASEAN MARKET

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Introduction

In the twentieth century, two Nobel-Prize winning economists wrote two seemingly unrelated characterizations of the processes constraining human behavior. One, Ronald Coase, wrote a short article entitled *The Nature of the Firm*,<sup>1</sup> in which he reduced all managerial decision-making to a fundamental choice between making the factors of production, or buying them. This article and the idea of the “make or buy” decision for which it has come to be known, have proven to be among the most seminal in the history of financial economics and organizational behavior.

The second economist, Friedrich Hayek, wrote what he thought to be a comprehensive treatment of the approach that ought to be taken to the generation of rules constraining human interaction. This voluminous work, *Law, Legislation and Liberty*, characterized the creation of legal rules as the product of either spontaneous or planned orders. Hayek argued that spontaneous orders like “law” were more efficient mechanisms for governing human behavior than planned orders like “legislation.”<sup>2</sup> This thesis received a lukewarm reception generally, and virtually no reception at all in legal circles.

This Article demonstrates that Coase and Hayek were actually making the same observation, albeit in different contexts. Hayek’s conception of the two sources of order is, in fact, a more abstract application of Coase’s “make or buy” decision. Had Hayek understood his characterization of legal processes to be a

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<sup>1</sup> Ronald H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 385 (1937).

<sup>2</sup> 1 FREDERICK A. HAYEK, *LAW, LEGISLATION AND LIBERTY* 36 (1973).

variant of Coase's "Theory of the Firm," his ideas may have received more traction. Lawyers, judges, and lawmakers may also have understood some of the implications of Hayek's thesis for constraining legal actors, as well as its applications in current debates on the scope of administrative agency authority, tort reform, or the use of legislative history in litigation.

The most important reason for understanding law and legislation in light of the two sources of order and the "make or buy" decision is that this perspective can tell us something about the relative costs, to society in general and individual liberty in particular, of the choices involved. Law, as Hayek referred to common law adjudication, can be shown to involve lower agency and monitoring costs than legislation. This result is a product of two factors. First, common law adjudication is retrospective, while legislation is prospective. This difference permits adjudication to more accurately assess the factual circumstances to which its legal rules will apply than is possible with any planned order, including legislation. It is retrospection that empowers common law adjudication, like other spontaneous orders, to solve the informational barrier that Hayek calls "the knowledge problem."<sup>3</sup>

Second, and in part because of retrospection, the rules generated through common law adjudication are more specific and less general or abstract than legislation can hope to be. The cost of generality can be classified as an agency cost of legislation, since those bound by legislated rules can avail themselves of all of the latitude necessarily associated with generality. This generality, and the distance of legislation from those governed by it, make assurances of compliance more costly to acquire.

In short, common law adjudication generates legal rules at demonstrably lower agency and monitoring costs to liberty and social order than those associated with legislation. This finding is consistent with the central claim of Hayek's *Law, Legislation, and Liberty*, namely, that spontaneous rulemaking through the common law produces better and more efficient rules than can be had through legislation. Legislation, whether produced by legislatures or "from the bench," cannot incorporate as much information about the real lives and circumstances of those to be bound as is embodied in rules generated by common law adjudication.

This Article proceeds in four parts. In Part I, Hayek's taxonomy of ordering mechanisms is examined. His dichotomy between spontaneous order and planned order is explained. This dichotomy is also briefly shown to characterize Coase's "make or buy" decision.

In Part II, Hayek's taxonomy is employed to examine legal rule-making processes. As Hayek suggested in *Law, Legislation and Liberty*, these rule-making processes can be characterized as arising in either of two ways. First, legal rule-making might occur spontaneously, as through common law adjudication. Second, legal rules can be the product of central planning, as typified by legislation. Part II

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<sup>3</sup> By "the Problem of Knowledge," Hayek was referring to the fact that the vast body of knowledge upon which society relies and functions is dispersed, partly tacit, and perpetually evolving. See FRIEDRICH A. HAYEK, *The Use of Knowledge in Society*, in *INDIVIDUALISM AND ECONOMIC ORDER* 77, 77-78 (1948).

then exposes the shortcomings of Hayek's taxonomy by demonstrating that law and legal processes are much more complex than he understood them to be. Here the Article contributes subclasses of spontaneous order to account for these complexities.

Part II concludes by distinguishing common law adjudication from simpler spontaneous orders like the price system and language. The price system is characterized as a recurrent spontaneous order, having little relationship to its past manifestations. Languages, on the other hand, are rooted in the past, and therefore can be thought of as cumulative spontaneous orders. A simple analogy of common law adjudication to either of these spontaneous orders fails, until one realizes that common law adjudication enjoys characteristics of both recurrent and cumulative spontaneous orders. The facts of everyday life and the transactions that bring litigants into court are what give adjudication its recurrent character, while *stare decisis* is the tie that binds common law rule-making to the past. These two characteristics give the common law the information transmitting power that Hayek correctly observed. By bringing facts experienced by litigants, legal training of paid advocates, and a history of litigants, advocates and facts embodied in precedent, the common law performs a feat no planned order can accomplish: it solves Hayek's "problem of knowledge." The common law, in other words, provides a mechanism by which local knowledge can be used to order society, in much the same way that countless unknown individual preferences shape prices.

Part III briefly revisits the Theory of the Firm and the "make or buy" decision facing the manager of any firm. This part also explains the key developments in firm theory, namely, the role of agency and monitoring costs in firms characterized by a separation of ownership and control. Part III then examines the agency costs of both spontaneous and planned ordering mechanisms. This part concludes by acknowledging the principal advantages of managerial accounting, namely, the ability to review profit or loss statements to assess and evaluate the costs associated with a manager's decisions to make or buy.

Part IV applies the more fully developed understanding of spontaneous and planned ordering made possible by Coase's Theory of the Firm to the realm of legal rulemaking. This part begins by identifying the role of central planner within the world of legal rulemaking, and demonstrates that no one party comfortably wears this mantle. Legislatures are presumed to occupy the office of central planner, deciding between legislating over particular areas or issues, or leaving them for the spontaneous rule generation of the court system. Because legislators are incapable of anticipating all human interaction, however, some of the decision-making authority of the central planner is, necessarily, wielded by individual judges.

Part IV then applies the concepts of agency and monitoring costs to both adjudication as a spontaneous process, and legislation as a planned order. Importantly, this part shows that the agency costs associated with the inaccessibility of information to central planners necessarily exceed those of spontaneous ordering through adjudication. It is through the information gathering abilities of common

law processes – discovery and precedent – that localized facts and knowledge are brought to bear upon the social order. This information transmission through precedent and discovery solves the knowledge problem in a way that exceeds the reach of the most sweeping Congressional subpoena.

Part V concludes by summarizing the respective roles of adjudication and legislation in achieving operational efficiency in legal rulemaking.

### I. The Two Sources of Law and Social Order

Since the publication of *The Nature of the Firm*<sup>4</sup> in 1937, the Theory of the Firm has blossomed to find application in a vast array of human organizations. Numerous developments of the basic concepts have extended the application of the theory to multi-owner firms,<sup>5</sup> firms with separation of ownership and control,<sup>6</sup> close corporations,<sup>7</sup> non-profit organizations,<sup>8</sup> and even religious organizations and churches.<sup>9</sup> It is not an exaggeration to say that Coase's short article has been widely recognized as among the most influential contributions to our understanding of the economics of organizations.

Human organizations are only one example of a larger concept that economist Friedrich Hayek referred to as "orders."<sup>10</sup> Coase's Theory of the Firm, as applied to human organizations, may be extended to explain a human order that may only be loosely defined as organized – the law. To understand how the Theory of the Firm might be instructive in the study of the operation of the law, it is necessary to understand the similarities between the concepts common to the law and the firm.

#### A. The Two Sources of Order

While many human organizations and institutions may be characterized as having been born and sustained by human design, this characterization is not true of all human institutions. Some human institutions, such as languages, prices, and many aspects of culture, are not the product of conscious and deliberate planning. Organizations, such as firms, are clearly initiated and sustained by human design and planning. Organization, however, is simply one form of "order."

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<sup>4</sup> Coase, *supra* note 1.

<sup>5</sup> See Eugene F. Fama & Michael C. Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983).

<sup>6</sup> See Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983).

<sup>7</sup> See Frank H. Easterbrook & Daniel R. Fishel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986).

<sup>8</sup> See Dennis R. Young, *Entrepreneurship and the Behavior of Nonprofit Organizations: Elements of a Theory*, in NONPROFIT FIRMS IN A THREE SECTOR ECONOMY 135 (Michelle J. White ed., 1981); Henry B. Hansmann, *The Role of the Non-Profit Enterprise*, 89 YALE L.J. 835 (1980), *reprinted in* THE ECONOMICS OF NONPROFIT INSTITUTIONS 57 (Susan Rose-Ackerman ed., 1986).

<sup>9</sup> See Ira C. Lupu, *Where Rights Begin: The Problem of Burdens on the Free Exercise of Religion*, 102 HARV. L. REV. 933, 954–57 (1989) (criticizing free exercise exemptions for religious institutions because of the existence of agency costs between members and church hierarchy).

<sup>10</sup> HAYEK, *supra* note 2, *passim*.

The concept of “order” was the central preoccupation of volume 1 of Friedrich Hayek’s *Law, Legislation and Liberty*.<sup>11</sup> Order, according to Hayek, describes “a state of affairs in which a multiplicity of elements of various kinds are so related to each other that we may learn from our acquaintance with some spatial or temporal part of the whole to form correct expectations concerning the rest, or at least expectations which have a good chance of proving correct.”<sup>12</sup> This state of affairs may arise from either of two sources: orders may be “made,” or they may arise “spontaneously.”

Made orders may be referred to as “planned,” “centrally planned,” “command,” “authoritarian,” or “exogenous” orders.<sup>13</sup> These orders tend to be relatively simple, or at least only as complex as the maker can survey. Also, made orders tend to be concrete, as they can be intuitively perceived by inspection. Finally, having been deliberately designed, made orders can be associated with an identifiable, particular purpose.<sup>14</sup>

A spontaneous order may be defined as an order that is “grown,” developing without having been deliberately created.<sup>15</sup> Because spontaneous orders are not under the command of any one mind, their complexity is not limited to a level that a human mind can master. In fact, very complex orders, comprising more information than any one brain could possibly access, can only be brought about spontaneously.<sup>16</sup> Also, spontaneous orders need not be perceivable to human senses but may rest on purely abstract relations which we may only be able to mentally reconstruct. Finally, a spontaneous order need not have one discernible purpose but may in fact serve a variety of related or unrelated functions. Much of the study of the social sciences centers on orderly structures that are the product of the actions of many people but are not the result of human design.<sup>17</sup> The concepts of markets, language, money, prices, morals, and customs are all examples of spontaneous or grown orders.<sup>18</sup>

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<sup>11</sup> *Id.*

<sup>12</sup> *Id.* at 36.

<sup>13</sup> Made orders are “exogenous” in that they are created or sustained by forces outside the system. *See id.*

<sup>14</sup> Deliberately made orders are said to have a “purpose” in that they are brought about by the deliberation of a mind or group of minds. The purpose may be one identifiable by even the most casual observer, or could have passed into history beyond the fondest memories of the order’s “high priests.” In this regard, the purpose of a planned order is the one contemplated by the planner upon creation of the structure. *See id.* at 38.

<sup>15</sup> *Id.* at 37.

<sup>16</sup> Thomas Sowell’s conception of the “constrained vision” of human capabilities provides a thorough explanation of these limitations. THOMAS SOWELL, *A CONFLICT OF VISIONS* 19–23 (1987); *see also* Steven G. Calabresi & Gary Lawson, *Foreword: Two Visions of the Nature of Man*, 16 HARV. J.L. & PUB. POL’Y 1, 4 (1993) (“One view . . . seeks to create conditions that will change . . . human nature, while the other takes human nature as a given and seeks to design a political system that, like the free market economy, harnesses ambition and fraction to produce good results.”).

<sup>17</sup> The social sciences have not “cornered the market” on the study of spontaneous orders. The physical and biological sciences are largely concerned with the study of systems and organisms which are not the product of human design. HAYEK, *supra* note 2, at 36–37.

<sup>18</sup> Leoni describes these orders as expressions of “the common will,” in that they emerge from the free participation of members of a community. BRUNO LEONI, *FREEDOM AND THE LAW* 137 (1961).

The Second Law of Thermodynamics, which is often articulated as stating that “[t]he total disorder of a system and its surroundings always increases for a spontaneous process,”<sup>19</sup> would seem to suggest that the concept of “spontaneous order” is an oxymoron. This conclusion, however, is due to a common oversimplification of this empirical rule. The Second Law, more properly understood, asserts that for order to develop, *greater* order must be expended.<sup>20</sup> As one widely-used chemistry text explains:

Order in one place is used to build order in another. Thus a house is built at the expense of order in the food molecules of workers and the substances needed to construct building materials.<sup>21</sup>

The same is true of social processes. Human energies directed toward *individual* purposes and goals expend order to bring about the formation of other orders, the result of many human actors but the intention of no human mind. For example,

An economist thinks of the economic system as being co-ordinated by the price mechanism, and society becomes not an organization but an organism. The economic system “works itself.” This does not mean that there is no planning by individuals. These exercise foresight and choose between alternatives. This is necessarily so if there is to be order in the system.<sup>22</sup>

This distinctive feature of spontaneous orders does not prevent them from sharing similarities with “made” orders or “organizations” like the firm.

## B. Orders in the “Make or Buy” Decision

The theory of the firm has focused on the reasons for the existence of firms and, in particular, the mechanics of the “make or buy” decision confronted by the manager or central planner within the firm.<sup>23</sup> As an organization, the firm has a purpose or set of purposes.<sup>24</sup> To achieve this purpose, the firm assembles “inputs” or “factors” of production. These inputs or factors are used to produce the end product, the sale of which is the purpose or goal of the firm.<sup>25</sup> The acquisition of the inputs or factors of production can be through one of two mechanisms: they

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<sup>19</sup> DARRELL D. EBBING, *GENERAL CHEMISTRY* 684 (1987).

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> Coase, *supra* note 1, at 387 (citing Friedrich A. Hayek, *The Trend of Economic Thinking*, *ECONOMICA* 121 (1933)).

<sup>23</sup> The literature is too extensive to cite in detail. For a small sample, see Coase, *supra* note 1. See also Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 57 *AM. ECON. REV.* 777 (1972); Richard M. Cyert & Charles L. Hendrick, *Theory of the Firm: Past, Present and Future*, 10 *J. ECON. LITERATURE* 398 (1972); Fama & Jensen, *supra* note 5.

<sup>24</sup> Coase defines the firm simply as “an organization which transforms inputs into outputs.” RONALD H. COASE, *THE FIRM, THE MARKET AND THE LAW* 5 (1988).

<sup>25</sup> See Alchian & Demsetz, *supra* note 23, at 778; see also Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 *J. FIN. ECON.* 305, 306-07 (1976).

can be “made” or they can be “bought.”<sup>26</sup> This “make or buy” decision is essentially the question of whether the firm would be better off making a particular factor of its production, or whether the firm might obtain that particular factor at a lower cost on the open market.<sup>27</sup> From the earliest writings by Coase, firm theorists have recognized this choice as one between “command” and “market” structures.<sup>28</sup> In effect, the decision to “make” is one to rely on the internal command structure of the firm to accomplish the desired task. Alternatively, the decision to “buy” is one to resort to the market to accomplish the same task.<sup>29</sup> In other words, *the “make or buy” decision is really a decision of whether to rely on “made” or “spontaneous” orders to accomplish a given task.*

The “make or buy” decision is mirrored in the environment of the law. Law, too, has been described as “purposive,” in that it fulfills a social function.<sup>30</sup> Fulfillment of this “purpose” or function is reliant upon a similar “make or buy” decision. In short, our understanding of the human institution we know of as “the firm” and the “make or buy” decision may help us better understand the order we know of as “the law,” and its “make or buy” dilemma. To facilitate this, the terms “command,” “centrally planned,” “planned,” and “made” will be used interchangeably, to refer to the concept of made or planned orders in both the firm and the law. Similarly, the terms “spontaneous,” “market,” and “grown” will be used to refer to the concept of spontaneous or grown orders as described above. With this terminology in place, we can now attempt to understand law and legal rule-making as a product of both spontaneous and planned ordering mechanisms.

## II. Hayek’s Law: the Purposive Mix of Planned and Spontaneous Orders

### A. Analogizing Law and Legal Rulemaking to the Operation of Markets and the Firm

Law and legal decision-making may be characterized by the same binary “make or buy” dilemma facing the firm. For Hayek, the choice within the realm of legal rulemaking was one between the spontaneous character of the common law process, and the made order of legislative processes.<sup>31</sup> While the dilemma in law may be viewed as similar to that within the firm, the structure of legal institutions disguises the difficulty of using the theory of the firm to evaluate the efficiency of legal decisions with respect to the promotion of social order. Nevertheless, the parallels deserve exploration.

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<sup>26</sup> Coase, *supra* note 1, at 388–89; *see also* OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975).

<sup>27</sup> Coase, *supra* note 1, at 394–97.

<sup>28</sup> *Id.*

<sup>29</sup> *Id.*

<sup>30</sup> *See* Lon L. Fuller, *Human Interaction and the Law*, in *THE PRINCIPLES OF SOCIAL ORDER* 211, 234 (Kenneth I. Winston ed., 1981).

<sup>31</sup> HAYEK, *supra* note 2, at 37.

While some of what we call law can clearly be recognized as deliberately planned by a central planner or planners, much of it can only be described as having grown over time without the direction of any one mind.<sup>32</sup> This development, however, cannot be said to be without purpose or function. In fact, it is the very existence of the need to fulfill the purpose or function that can be shown as having led to the growth of law.<sup>33</sup>

The operation of the common law has been described as a spontaneous order. No one mind or group of minds has designed, or could design, the path, scope, and infinite detail of legal rules necessary to guide and govern the infinitely varied and changing fact patterns of human activity and interaction.<sup>34</sup> As with respect to prices and the allocation of resources, we can think of this obstacle as “the knowledge problem.”<sup>35</sup> The common law has addressed this obstacle by developing principles through dispute resolution that govern similar cases after, and only after, a dispute between human actors arises.<sup>36</sup> Like language, prices, and early forms of money, law has developed to form a purposive order without the design of any one mind or committee of minds.<sup>37</sup>

### 1. Law as a Recurrent Spontaneous Order

Common law precedents make up a lattice of law to which the conduct of all members of society is, to some extent, subject. It cannot be said, however, that the entire body of the common law is the product of the design of any human mind. In fact, the common law can be viewed as the result of many disputes arising from events which may or may not have been foreseen, and were brought by litigants before judges and juries for resolution, all of whom hold specific knowledge and interests necessary to produce the final product.

#### a) Local Knowledge and Recurrent Spontaneous Orders

Spontaneous orders may be characterized as either recurrent or cumulative. Recurrent spontaneous orders are simply those orders that reoccur spontaneously. Prices are an example of such an order. While there may be some relationship of a current price to past prices, the price of a particular good or service is largely a function of localized knowledge about that good’s availability, substitutes, and uses.<sup>38</sup> For example, a carpenter may take an order from a customer for

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<sup>32</sup> *Id.*; see also LEONI, *supra* note 18, at 23.

<sup>33</sup> Fuller, *supra* note 30, at 211; see also LON L. FULLER, *THE MORALITY OF LAW* 95–151 (1964) (arguing that law is a “purposive activity” that cannot be understood merely as a fact). Fuller believed that the essential function of law is the achievement of social “order . . . through subjecting people’s conduct to the guidance of general rules by which they may themselves orient their behavior.” Lon L. Fuller, *A Reply to Professors Cohen and Dworkin*, 10 *VILL. L. REV.* 655, 657 (1965).

<sup>34</sup> See, e.g., Oliver Wendell Holmes, Jr., *Codes, and the Arrangement of the Law*, 5 *AM. L. REV.* 1, 1 (1870), quoted *infra* at note 59.

<sup>35</sup> HAYEK, *supra* note 2, at 14.

<sup>36</sup> See, e.g., Holmes, *supra* note 34, at 1.

<sup>37</sup> See FULLER, *THE MORALITY OF LAW*, *supra* note 33, at 146.

<sup>38</sup> See HAYEK, *supra* note 3, at 86.



chairs.<sup>39</sup> This order causes the carpenter to seek a quantity of wood from his suppliers that exceeds what he would have ordered in the absence of the order. This increase in the quantity of wood demanded would be reflected, *ceteris paribus*, in an increase in the price of wood. Any other carpenter seeking wood for her own customers need not know what use the customer of the first carpenter has for the chairs, or even that the customer ordered chairs. All that she needs to know is that her bid for wood must compete for that wood against our customer's carpenter, and this is reflected in the increased price of wood.

Now, if a large forest from which this wood is drawn is suddenly depleted by forest fire, the wood would become more scarce than it was the day before the fire. This scarcity would be reflected, *ceteris paribus*, in an increase in the price of wood. The increased price would in turn result in an allocation of wood to the use for which it is most needed, since the party that is willing and able to pay the higher price will outbid other parties for the limited quantity available. The carpenters, their customers, and their suppliers need to know nothing directly about the occurrence or the extent of the fire damage to the supply of wood. Nor need they care. All that they really care about is whether the wood they want is available at a price that they are willing and able to pay.<sup>40</sup> Everything about this event that is important to their decision-making is conveyed to the relevant parties in the price of the wood. In this way, the price of wood provides a mechanism by which the significance to decision makers of unlimited numbers of events of varying magnitude which affect the price of wood can be conveyed to those decision makers. The resultant price, and the willingness of parties to pay it, accomplishes an allocation of wood and other resources that could never be achieved by any central planner. The unlimited number of events of varying magnitude that affect the price of each and every resource could never be accounted for by any one mind.<sup>41</sup>

This problem is one which Hayek calls "the problem of knowledge."<sup>42</sup> As the wood example demonstrates, the knowledge problem can only be solved by spontaneous orders like the price system. In the example, the price system takes the local knowledge of each economic actor, and transmits precisely enough information to all other economic actors, without the need for a common language, culture, or even monetary system. Unlike centrally planned orders, spontaneous orders do not require the centralized accumulation of information but rather employ local knowledge at the point of local decision-making.<sup>43</sup> Individual actions are

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<sup>39</sup> This example is an adaptation of one given by Hayek. *See id.* at 85–86.

<sup>40</sup> This is known as the "subjective theory of value," which has its origins in the Austrian School of Economics with which Hayek was associated. Carl Menger, the founder of the Austrian School, is credited with this idea, along with William Stanley Jevons of England and Leon Walras of France. Christopher T. Wonnell, *Contract Law and the Austrian School of Economics*, 54 *FORDHAM L. REV.* 507, 510 n.24 (1986). For a brief but thorough explanation of the subjective theory, see Robert W. McGee, *If Dwarf Tossing is Outlawed, Only Outlaws will Toss Dwarfs: Is Dwarf Tossing a Victimless Crime?*, 38 *AM. J. JURIS.* 335, 358 n.84 (1993).

<sup>41</sup> HAYEK, *supra* note 2, at 13–15; *see also* HAYEK, *supra* note 3, at 87–88.

<sup>42</sup> HAYEK, *supra* note 3, at 77.

<sup>43</sup> HAYEK, *supra* note 2, at 37.

based on the information provided by the system, as well as what the individual knows about her own circumstances, alternatives, and substitutes. No matter how sophisticated computers may become, central planners face an eternal limitation on how much information they can aggregate with respect to preferences, circumstances, motivations, and hopes of each individual.

The operation of the common law may be analogized to the operation of the price system.<sup>44</sup> The common law makes use of socially dispersed knowledge in a manner similar to that employed by the price system. The parties to a lawsuit bring to court particularized knowledge of the facts of the case, both relevant and irrelevant, as well as their preferences with respect to what remedies, if any, might be employed. The jury represents some level of understanding of customs, community values, conceptions of justice and fairness. All of this current, localized knowledge directly impacts the outcome, and therefore the law, of the case. Liti-gants in a contract dispute, for example, each have an idea about what their preferences, expectations, and understandings were at the time of contracting. A judge, in applying the law of contract, attempts to serve these original preferences, expectations, and understandings as they existed at the time of contract.<sup>45</sup> In each case, the law that governs will be shaped by the knowledge that only each individual can have of his own expectations, preferences, and understandings.<sup>46</sup>

Another example of how the common law recognizes the significance of localized knowledge may be found in the rules developed around the use of court appointed counsel for indigent defendants in criminal cases. During the course of a criminal trial, the indigent client has ultimate control over the conduct of the defense case.<sup>47</sup> While the defense counsel may recommend a certain course of action, the courts recognize the right of the defendant to determine how the defense case is to be presented. However, the tables turn on appeal. While the defendant may have some input into the presentation of issues on appeal, the ultimate decision for which issues are to be presented and how they are to be presented rests with defense counsel.<sup>48</sup> This structure may be a reflection of the recognition that localized knowledge should govern the decision making process at each stage of the case. A trial is a “fact-focused” event. The decision making control, it may be argued, is best left in the hands of the person with the best knowledge of the facts — the defendant. On the contrary, an appeal is a “law-focused” event. Accordingly, the

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<sup>44</sup> *Id.*

<sup>45</sup> “[T]he principal purpose of the rules relating to breach [of contract] is to place the injured party in as good a position as he would have been in had the contract been performed.” RESTATEMENT (SECOND) OF CONTRACTS § 16 reporter’s notes (1981).

<sup>46</sup> Wonnell, *supra* note 40, at 516–17.

<sup>47</sup> See, e.g., *Jones v. Barnes*, 463 U.S. 745, 751 (1983) (“[T]he accused has the ultimate authority to make certain fundamental decisions regarding the case, as to whether to plead guilty, waive a jury, testify in his or her own behalf, or take an appeal.”).

<sup>48</sup> *Id.* (“This Court . . . recognized the superior ability of trained counsel in the examination into the record, research of the law, and marshalling of arguments on [the appellant’s] behalf.”) (quoting *Douglas v. California*, 372 U.S. 353, 358 (1963)).

decision making control on appeal is best left in the hands of the person with the better understanding of the law – the attorney.

These examples illustrate only a few of the ways the common law brings localized knowledge to bear on the formation of the law of a particular case. The diffuse, current knowledge that is employed in the formation of the law of a particular case is only one of the ways in which localized knowledge is brought to bear in the law.

b) The Failure of Hayek's Price System Analogy

There is a significant limitation inherent in Hayek's analogy of the common law to the price system. Under the price system, the manager can incorporate otherwise inaccessible local information into her decisions, and can evaluate the correctness of such decisions. The manager may, at the time of the decision or when the profit and loss statements are drawn up, evaluate a particular decision to determine whether a particular price was too high or low, or a particular quantity was sufficient or insufficient. All of the information necessary for making the decisions will be conveyed by the prices the manager confronts in the markets for the factors of production for her product, and the prices that product in turn commands in the marketplace. There are objective tests of the correctness or incorrectness of the manager's decisions. They may be measured by whether the decision results in a marginal profit or loss.

Decisions in law, however, do not enjoy the clarity of the price system. Like decisions in the price system, these decisions require far more knowledge about social functioning than any one individual can possess.<sup>49</sup> Unlike the business manager's decisions, there is no objective test of the correctness or incorrectness of legal decision-making. Judges and lawyers can have knowledge about particular practices, but not about what the effects of those practices are on the larger society. "Without a precise way to measure both the size and the direction of the countervailing costs and benefits, one cannot determine with confidence which rule is preferable, let alone show that the rule finally chosen substantially influences efficiency."<sup>50</sup> There is, in law, nothing like profit or loss signals that tell decision makers, in no uncertain terms, that they are right or wrong.

It may be the case that the best that can be hoped for in law is an approximation of the best decision making process, on the hopeful assumption that a generally good process will, on the whole, lead to generally good decisions. With this view, it would be a mistake in principle to attempt to evaluate a method of legal decision-making directly by reference to outcomes in particular cases. Such an attempt would presuppose what the "right" outcome is. This is precisely the information that is unavailable in the legal decision making process.

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<sup>49</sup> Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353, 382-85 (1978) [hereinafter Fuller, *Forms and Limits*]; see also FULLER, *THE MORALITY OF LAW*, *supra* note 33, at 106.

<sup>50</sup> Richard A. Epstein, *The Social Consequences of Common Law Rules*, 95 HARV. L. REV. 1717, 1721 (1982).

Another view of why the analogy to the price system fails is that the structure of the institutions that produce the common law are monopolistic. The analogy of the common law to a market with prices may only work for common law institutions that mimic those found in markets. With this view, only a polycentric legal system will yield the efficiencies in the employment of socially dispersed knowledge that is characteristic of economic markets.<sup>51</sup>

To illustrate, consider the operation of a monopoly enterprise. The price of the good or service produced by the enterprise can often be characterized as exceeding the price that would result from perfect competition in that good, namely, above the marginal cost of production.<sup>52</sup> The quantity supplied, accordingly, tends to be lower when supplied by a monopoly supplier than would be the case in the presence of competition.<sup>53</sup> As a result, the price of the good or service supplied by the monopoly enterprise may be argued to be incapable of accurately reflecting the vast amounts of dispersed knowledge relevant to decision makers in that market.<sup>54</sup> Only a market with a number of suppliers could accurately convey through a price mechanism the dispersed information necessary to efficient decision-making. Accordingly, any analogy between the common law and the price system can extend only as far as the institutions comprising the common law system correspond to those of markets. Since the institutions of the common law can be characterized as a government monopoly, any analogy to the price system may be said to fail.

This explanation for the failure of the price system analogy is unsatisfactory however. While it is true that the system of courts administering the common law in all common law jurisdictions may be characterized as government monopolies, it cannot be argued that monopoly prices in the price system do not convey significant, dispersed local knowledge. Monopoly prices do in fact reflect the scarcity of the good or service supplied, regardless of how that scarcity came about (*i.e.* monopoly activity).<sup>55</sup> While monopoly prices may not be equivalent to efficient market prices, they appear to be every bit as effective at conveying information.<sup>56</sup>

The failure of Hayek's analogy of the common law to the price system does not undermine the description of the law as a spontaneous order. Instead, the analogy may fail more from incompleteness than inaccuracy. Unlike the price system, which is a relatively simple spontaneous order, the common law may also be seen as sharing the characteristics of a cumulative spontaneous order.

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<sup>51</sup> The term "polycentric" refers to issues or systems having more than one center. See Lon L. Fuller, *Adjudication and the Rule of Law*, 54 AM. SOC'Y INT'L L. PROC. 1, 3 (1960) (citing MICHAEL POLANYI, *THE LOGIC OF LIBERTY* (1951)). For a concrete example of how a polycentric legal system might operate, see Randy E. Barnett, *Pursuing Justice in a Free Society: Part Two - Crime Prevention and the Legal Order*, CRIM. JUST. ETHICS, Winter/Spring 1986, at 30-53.

<sup>52</sup> See Barnett, *supra* note 51, at 30. This is not necessarily true of all monopolies. For an explanation of how output and price may vary depending on the particular goals sought by monopoly managers, see generally DUANE CHAPMAN, *ENERGY RESOURCES AND ENERGY CORPORATIONS* (1983).

<sup>53</sup> See Barnett, *supra* note 51, at 30.

<sup>54</sup> *Id.*

<sup>55</sup> See LUDWIG VON MISES, *HUMAN ACTION* 358 (rev. ed. 1963).

<sup>56</sup> *Id.*

## 2. Law as a Cumulative Spontaneous Order

Spontaneous orders may be cumulative. A cumulative spontaneous order is an order that develops by building upon its own developments over time. These developments may be referred to as accumulated knowledge. Cumulative spontaneous orders employ accumulated knowledge to both perpetuate the order and to shape new developments, which in turn become part of the storehouse of accumulated knowledge.

Examples of cumulative spontaneous orders are language and early forms of money.<sup>57</sup> Languages generally cannot be argued to be the product of any human design. No one person or group of people sat down and charted out the symbols, rules, and structure of the languages by which humans communicate. However, language is clearly characterized by order. An English teacher, for example, can unequivocally evaluate a student's usage or spelling of a word, her sentence structure, and clarity. Certain guidelines or rules have developed over time that inform the teacher's judgment about what is right or wrong. New words, phrases, or even meanings enter languages over time, often as a result of contact with other languages. Simultaneously, other words, phrases, and meanings that have fallen into disuse either become described as archaic or are discarded altogether. In this manner, the cumulative spontaneous order of language incorporates accumulated knowledge over time. The common law may be characterized as operating in a similar fashion.

### a) Accumulated Knowledge, Cumulative Spontaneous Orders, and Law

The common law may be viewed as demonstrating the properties of a cumulative spontaneous order, analogous to the operation of language. The conduct of all members of society may be said to be subject to the law decided by courts, without any articulation of the preferences of those members about what the law ought to be. Common law courts may be seen as applying common law precedents to new fact patterns in the way an English composition student applies the long established rules of grammar and a widely accepted vocabulary to an original theme. The litigants, attorneys, judge, and jury have no more say over the procedural and substantive rules to be applied than the English student has over verb placement. However, each time the common law is applied to a new fact scenario, it alters a common law rule by extending or limiting its sphere of application. In this way, the common law employs what has been learned about the behavior of past parties in situations similar to or distinguishable from current disputes.

Common law precedents, through the rule of *stare decisis*, are the mechanism through which accumulated knowledge may be marshaled to resolve disputes. Without having to know the facts of each and every case that has led up to

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<sup>57</sup> Today's fiat money cannot be characterized as anything other than a planned order. For a discussion of the ways in which fiat money departs from notes that might be issued in a free banking system, see generally GEORGE SELGIN, *THE THEORY OF FREE BANKING* (1993).

the development of the law of the preceding case that governs the facts at hand, a lawyer or judge may make use of that knowledge by applying the common law rule that has developed from it. This accumulated knowledge embodied in a common law precedent allows enormous amounts of information about the interaction of social actors to be used to guide present judgments about such interactions. This is true even though it would be impossible for any one lawyer or judge to know all of the information that led up to the development of the rule: the facts of each case, the procedures followed in each case, the demeanor of the witnesses in each case, the weighing of equities in each case, et cetera. Application of common law precedents leads either to the maintenance, adoption, adaptation, or discarding of law in much the same way that language maintains, adopts, or discards its elements.<sup>58</sup>

The analogy of law to language may be carried even further, to include the modes of operation of the two orders. Just as it necessary for those engaged in the use of language to learn and become facile in those elements of the relevant language necessary to serve the purpose of communication, the actors engaged in utilizing the common law must learn and become facile in those elements of the law relevant to their interests. The rules of English grammar are not commanded by all English-speakers with equal facility. English professors and stevedores have different requirements with respect to their ability to manipulate the English language. Similarly, common law actors may be said to hold differing levels of knowledge about the various elements of the law. Attorneys for parties involved in a dispute become well-versed on practically every possible precedent that may have some bearing on the particular case at hand. The judge, working on several cases at a time, and with limited resources, has some lesser knowledge of the precedents, often largely informed by the attorneys for the parties. The information necessary for the functioning of the order is developed by each actor according to her needs within the system.

Justice Oliver Wendell Holmes acknowledged this characteristic of the common law when he noted:

It is the merit of the common law that it decides the case first and determines the principle afterwards . . . . A well settled legal doctrine embodies the work of many minds, and has been tested in form as well as substance by trained critics whose practical interest it is to resist it at every step. These are advantages the want of which cannot be supplied by any faculty of generalization, however brilliant . . . .<sup>59</sup>

In other words, as better arguments are developed by professional, paid, and well-trained lawyers about why the law should favor their party, the law changes to accommodate the new understanding of the possible fact patterns which it might govern. Likewise, as new fact patterns expose the frailties of established

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<sup>58</sup> The maxims of equity show a striking resemblance to those found in the English language. For example, the rule that "a party may not benefit from his own wrong" carries force similar to that borne by the rule "i before e, except after c." Both have their exceptions, and appear to be of unknown origin.

<sup>59</sup> Holmes, *supra* note 34, at 1.

law, the precedents may crumble under the weight of reason. However, it is this very failure of precedents to stand without exception that causes the analogy of the common law to language to fall short of explaining the operation of the common law as a spontaneous order.

b) The Failure of the Language Analogy

The fact that *stare decisis* is not an absolute rule provides the difficulty that arises when the common law is analogized to language. Unlike the rules of language, common law rules are often discarded and replaced when confronted by current circumstances that demand new treatment.<sup>60</sup> As a result, established common law precedents cannot be said to fully inform the judgment of legal decision makers. It may be the case that law is a complex spontaneous order, consisting of a web of both recurrent and cumulative ordering elements. Fact-focused elements may reflect the recurrent order of the law, while law-focused elements represent its cumulative nature. The failure of attempts to measure the correctness or incorrectness of common law decisions may lie in the fact that such attempts have previously been one-dimensional. The theory of the firm, with its two-dimensional approach to the decision making process, may provide a more complete instrument for effective evaluation of legal decisions.

### 3. The Planned Order of Legislative Processes

Quite unlike common law adjudication, legislation and codification can only be described as “made” orders.<sup>61</sup> Legislation arises only upon the design of one or a few minds.<sup>62</sup> It should be clear at this point in the discussion that when considering centrally planned ordering within the context of the law, we are generally referring to legislation or “legislation-like” enactments. This would include regulations, codes, edicts, executive orders, and even written constitutions. Such enactments are designed with a particular purpose in mind, and are even evaluated on their ability to achieve stated or implicit purposes. Legislation, in all of its various forms, has two distinguishing characteristics. First, it tends to be general enough to govern a variety of fact scenarios. Second, it tends to be prospective. These characteristics move legislative enactments away from the realm of spontaneous orders, placing them squarely within the definition of made orders.

Legislation tends to be much more general than, say, the case law generated by common law adjudication. The amount of time, energy, and political inertia necessary to set legislation in motion seems to require that once it is in motion, it should cover as many cases as possible. Often, this is as many cases as the central planner or planners could envision. This “envisioning” of cases is important to leg-

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<sup>60</sup> Of course, any secondary school pupil who has wrestled with Macbeth or Beowulf is aware that the rules of language are not static. The argument here is, instead, that they are relatively static when compared with those of substantive and procedural law.

<sup>61</sup> HAYEK, *supra* note 2, at 72.

<sup>62</sup> *Id.* at 124–25.

islation because, where legislation attempts to be “backward-looking,” it takes on an air of adjudication.

For this reason, legislation tends to be prospective. This is true even when it appears that certain rules are being created to cover cases retrospectively. Bills of attainder, for example, which were passed by parliaments to outlaw individuals, cannot truly be called legislation. They were specific to the case of one individual, and were much more like adjudication of specific facts found in common law courts.

This illustrates a central point: it must be understood that both types of legal order, namely, legislation and adjudication, may be effected by just about anyone. Adjudication may be the done by courts, legislatures, administrative agencies, executives, street gangs, and even the Irish Republican Army.<sup>63</sup> Nor does it matter whether the judge derives her power from government or the consent of the parties.<sup>64</sup> Likewise, judges can legislate from the bench. What is important about the ordering mechanism, for purposes of the present discussion, is the process, not the vehicle or institution through which it moves.

### III. A Brief Review of the Theory of the Firm

The theory of the firm is based on the observation that firms do not rely exclusively on either command (made) or spontaneous orders for the satisfaction of the demands of the enterprise. Firms may be viewed as islands of economic central planning in a sea of spontaneous exchange-based order. The manager of the firm must decide when it is more advantageous to employ the command structure of the firm to accomplish a particular task than it is to resort to market exchanges.

#### A. The Dilemma Facing the Manager: The Basic “Make or Buy” Decision

Economists generally think of the economic system as being coordinated by the price mechanism. This view of economic exchange pictures society as an organism rather than an organization. Organisms function without the direction of any one mind or committee of minds. However, this description of economic coordination does not fit very well within the framework of the firm. Within the firm, coordination of economic activity is a function of commands rather than spot market prices.

For example, price theory suggests that the allocation of a factor of production between two different uses is determined by the difference in the price of that factor in each of the two uses. If the price of factor A becomes higher in use X than in use Y, then A will move from use Y to use X until the difference between the prices in X and Y disappears. This does not apply when discussing the functioning

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<sup>63</sup> Recall the “trial” scene from the Oscar-winning film, *THE INFORMER* (RKO 1936), in which the hapless and unemployed Jiffo, after informing the Dublin police of the whereabouts of an IRA fugitive in exchange for money, submits himself (involuntarily?) to the “jurisdiction” of an underground IRA “court,” which “sentences” him to death.

<sup>64</sup> Fuller, *Forms and Limits*, *supra* note 49, at 392–93.



of the firm. When a worker moves from department Y to department X, it is not because of relative prices but rather because she was commanded to do so. This method of coordination may be referred to as command or centrally planned ordering because it operates through a command from a central planner or planners. Outside the firm, the price system directs resources through a series of exchange transactions. Exchange transactions may be referred to as spontaneous or market mechanisms, because they take place as the result of spontaneous ordering. The price, place, and time of a transaction is not the product of any one planner's deliberate decisions, but rather the spontaneous coming together of supply and demand in the marketplace. Within the firm, these exchange transactions are replaced by the decisions of an "entrepreneur-coordinator," central planner, or manager. Often, the same function may be performed by either method of coordination. The dilemma of the central planner, entrepreneur, or manager is, "*When is it advantageous to select one method of coordination over the other?*"

The choice of whether to resort to exchange/spontaneous ordering or command/planned ordering in the operation of the firm is one of the central concerns facing the manager. The reason for the existence of this choice is that there are costs associated with both reliance on the spontaneous ordering of the price mechanism, and with using the command approach of the organization. The relative advantage of resort to one coordinating mechanism over the other rests, *ceteris paribus*, in the comparative disadvantages of these costs.

## **B. Ordering Costs Within the Context of the Firm**

### **1. The Costs of Spontaneous Ordering**

There are several costs associated with the resort to the spontaneous ordering of market exchanges. First, there are costs involved with gaining information on the relevant prices. The existence of specialized markets and specialists may reduce these costs, but could never eliminate them.<sup>65</sup> Second, there are transaction costs of identifying the relevant potential transactors within a given market.<sup>66</sup> Again, specialized markets may reduce but can never eliminate these costs.<sup>67</sup> Third, the costs of negotiating and concluding a separate contract for each exchange

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<sup>65</sup> A "specialized market," as the term is used here, is one that consists of transactions concerning only one type of good or service.

<sup>66</sup> "Transaction Costs" are those costs involved in carrying out market transactions, namely, the costs incurred when "it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a bargain, to draw up the contract, to undertake the inspection needed to make sure that the terms of the contract are being observed, and so on." Ronald H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 15 (1960).

<sup>67</sup> Even if one knows whom to call for a particular commodity or service, for example, that particular supplier may or may not have the quantities or delivery capabilities necessary to fill a particular order or need at the time he is called.

transaction must be considered. Techniques such as form contracts and spot market exchanges may, again, reduce but not eliminate these.<sup>68</sup>

The costs of each exchange transaction within the price mechanism may be reduced by resort to long-term contracts. As long-term arrangements are made, the costs involved with each discrete transaction are reduced. Long-term contracts, however, may lock in the positions of the transactors, leaving them vulnerable to changes in their respective environments. This increased risk of variance in possible future events may lead some to contract for the long term while leaving the details of the contract open. One party may accept a premium for the uncertainty involved in a contract that allows the other party flexibility. It is this type of arrangement that characterizes the internal relationships of the firm. In other words, it appears that firms would develop where the costs of exchange transactions may be effectively reduced by long-term contracts that allow a manager discretion over the terms of the contract within certain limits. Employment relationships are, in essence, such contracts. For a fixed or variable salary or wage, employees cede to their employers the right to exercise discretion over the ways in which employees engage their productive efforts.<sup>69</sup> The manager, in other words, orders the productive resources and efforts within the firm through commands.

## 2. The Costs of Command Ordering

The coordination provided by the firm is not without costs itself. First, firms of any size appear to be subject to “agency costs.” Agency costs are the costs inherent in the fact that the interests of the commander and the commanded differ, and that the commanded may utilize any opportunity given her to pursue her own, rather than her commander's, interests.<sup>70</sup> The loss associated with this misdirection of resources may be described as the cost to a principal of engaging an agent to accomplish a task that is in the principal's interest rather than that of the agent. These costs may be reduced by the coincidence of the interests of the principal and agent, but unless identical, they cannot be eliminated entirely. As firms get larger, these agency costs increase.

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<sup>68</sup> Form contracts reduce the costs of transactions in several ways. First, and most obviously, they reduce the costs associated with negotiations over each and every term. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 102 (3d ed. 1986). Second, they shape potential bargains into a “bundle” which might then be measured against other alternative such bundles, thereby reducing the costs associated with identifying possible transactors. See *id.* Finally, and much less obviously, they provide a “channel” through which businesspeople can fit their actions in a way which assures them that they have achieved an enforceable bargain. This reduction in uncertainty is a reduction in the cost of the transaction—a reduction in risk. See Lon L. Fuller, *Consideration and Form*, 41 COLUM. L. REV. 799, 800 n.4, 801-02 (1941).

<sup>69</sup> Coase, *supra* note 1, at 403-04.

<sup>70</sup> Jensen and Meckling define agency costs as “the sum of (1) the monitoring expenditures by the principal [owner], (2) the bonding expenditures by the agent, [and] (3) the residual loss.” Jensen & Meckling, *supra* note 25, at 308. In turn, monitoring costs are defined as the costs of measuring and observing the behavior of the agent, as well as “efforts on the part of the principal to ‘control’ the behavior of the agent.” *Id.* at 308 n.9. Bonding expenditures are simply the costs borne by the agent in an attempt to gain the trust of the principal. *Id.* at 325-26.

Second, as the costs of organizing the firm rise with increasing size of the firm, there comes a point at which the costs of organizing a transaction within the firm are equal to the costs of carrying out the transaction through an open market exchange. Finally, as the numbers of transactions organized within the firm increase, they begin to reach or exceed the capacity of the manager to organize them effectively. Resources may not be allocated to their best uses. There comes a point in time at which the costs represented by this waste of resources equals the costs that would be experienced by resorting to the price mechanism for allocating these resources. These costs have been referred to as the “diminishing returns to management.”<sup>71</sup>

Agency costs are inherent in the choice of command ordering mechanisms. It is important to keep in mind that “most organizations are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals.”<sup>72</sup> The firm is simply a nexus of those contracts that provide one party (the manager) with flexibility while another party (the subordinate) receives a premium for the uncertainty associated with the first party’s flexibility.<sup>73</sup> Viewed in this way, the firm is simply “a team whose members act from self-interest but realize that their destinies depend to some extent on the survival of the team in its competitions with other teams.”<sup>74</sup> It is natural to expect that the members of the organization will, in pursuit of this self-interest, attempt to secure the maximum benefits possible within their contract while giving the least allowable under their contract in return. In other words, the interests of the agents within a firm do not coincide exactly with those of the central planner or manager and in fact may often be at odds with these.

This problem is further compounded by the fact that as a separation of ownership and control takes place, agency costs of the manager or key decision-maker increase proportionately. In other words, as the manager's fraction of the equity falls, her fractional claim on the outcomes of her decisions also falls, and this will encourage her to appropriate more of the firm’s resources in the pursuit of her self-interests.<sup>75</sup> The agency costs of the subordinate's pursuit of self-interest through deviation from the interests of the manager are, therefore, further compounded by the agency costs of the manager's pursuit of self-interest at the expense of that of the owners of the firm. With all of these deviations from the desires of the stakeholders, it has caused some commentators to wonder why firms exist at all, particularly in the common form where ownership and control are separate.<sup>76</sup>

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<sup>71</sup> Coase, *supra* note 1, at 394.

<sup>72</sup> Jensen & Meckling, *supra* note 25, at 310.

<sup>73</sup> See Alchian & Demsetz, *supra* note 23, at 781.

<sup>74</sup> Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980).

<sup>75</sup> Jensen & Meckling, *supra* note 25, at 313.

<sup>76</sup> See, e.g., Fama & Jensen, *supra* note 5, at 301.

### 3. Factors Limiting the Impact of Agency Costs (Why Firms Even Exist)

“Absent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs.”<sup>77</sup> There are a number of reasons why firms or, more importantly for this paper, command orders can operate without being replaced by spontaneous orders. First, agency costs may be limited by the separation of decision monitoring from initiation and implementation. Second, this separation allows for diffusion of decision functions throughout the formal hierarchy of the organization, thereby taking advantage of diffuse, specific knowledge among various agents. This diffusion of decision making functions operates to allow for mutual monitoring by competing agents within the hierarchy of the firm. Finally, external market forces exert an external monitoring pressure on agents to orient their decision making process in the direction of the interests of the owners of the firm.

It may be observed that, rather than having one central planner or decision maker, many firms or organizations have a formal hierarchy of decision-making. The firm may be characterized as having decision makers at various levels, with those managers or planners at the highest levels allowing some discretion to those managers or decision makers below them. While this discretion may allow for an increase in self-interested activity at all levels, it actually places controls on the variance from the commands issued at the highest rank. This hierarchy allows for a separation of decision making functions. Managers at the top of the hierarchy may delegate decision making authority to those beneath them. Lower level managers may initiate decisions that must be ratified or approved by higher ranking managers.<sup>78</sup> Through this ratification process, higher level managers may reduce agency costs between themselves and lower level managers through their ability to monitor the actions of subordinates. The agents that initiate and implement decisions are evaluated by the managers above them on how their decisions conform to the commands of the managers higher up in the hierarchy. This is a form of internal monitoring that directly limits agency costs.

This hierarchy of decision-making, in turn, places decision making power in the hands of lower level managers who may have specific knowledge important to operations. Lower level managers, therefore, may be better suited to make certain decisions than “higher ups” without the capacity to access the vast array of information held by the larger number of managers at the lower levels. The access to this specific knowledge, in turn, gives lower level managers a competitive advantage over higher level managers in the competition for managerial positions within the organization. In this way, managers on the same level, and on disparate levels, monitor each other's decisions in order to gain advantages over each other. This mutual monitoring places an internal pressure on agents to conform as closely

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<sup>77</sup> *Id.* at 301.

<sup>78</sup> *See id.* at 308.

as possible to the interests represented by their “marching orders.” This is another form of internal monitoring, again limiting agency costs under a command system.

Finally, external forces of the market place pressures on agents within the firm to conform their activities to the wishes of the firm’s central commander. Capital markets reflect the knowledge of the investment community about the activities of the firm or organization.<sup>79</sup> Stock prices reflect beliefs concerning the future cash flows of the firm.<sup>80</sup> Prices may be a collective judgment of the performance of management and its decisions. This performance includes management’s internal monitoring and evaluation of its agents and their decisions. Similarly, the market for takeovers provides incentives for managers to conform their decisions to those that would be in the interest of the stakeholders of the organization.<sup>81</sup> These market forces act as a form of external monitoring of agent behavior, and place limits on agency costs. These constraints on agency costs will prove significant in the context of law.

### C. Profit and Loss Information of the Price System: The “Correctness” of the Make or Buy Decision

The choice before the manager rests on her ability to discern when the costs of market exchanges are more profitable or, where revenue is fixed, less costly than commanded transactions. Within the environment of the firm, this choice is informed by the use of profit and loss statements. The discipline of management accounting has established clearly defined procedures for determining the profitability of any particular transaction within or without the firm.<sup>82</sup> Transactions occurring outside the firm are easily accounted for by the actual values of the goods or services exchanged. Accountants duplicate this mechanism for internal transactions by assigning each internal transaction costs attributable to it, and by dividing unattributable costs among various transactions in some reasoned fashion. A manager can, by resort to this system, determine with a great deal of precision the relative costs of performing tasks through either command or exchange transactions.

Access to the information of the profit and loss statement may be argued as a trait that distinguishes the position of the manager from any comparable position

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<sup>79</sup> See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 83 (6th ed. 2000) (if investors believed a particular firm’s stock to be overpriced or underpriced, “investors would rush to buy or sell it”).

<sup>80</sup> See *id.* at 63 (defining the present value of a firm’s stock as the present value of cash flows from the firm).

<sup>81</sup> See Jonathan Macey, *Private Trusts for the Provision of Public Goods*, 37 *EMORY L.J.* 295, 303–06, 315 (1988) (arguing that “[c]ompetition in capital markets, product markets, and the market for corporate control all induce managers and directors of public corporations to act in ways consonant with shareholder welfare”); see also RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 14.8, at 453–57 (5th ed. 1998).

<sup>82</sup> Cost accounting, focusing on “profit centers” within a firm, allow a manager to determine which internal departments and agents are adding value to the objectives of the firm, and which are detracting from the firm’s efforts. For a detailed description of the function of managerial accounting, see, for example, RAY H. GARRISON & ERIC W. NOREEN, *MANAGERIAL ACCOUNTING* 6–10 (3d ed. 2003) (discussing the differences between financial accounting and managerial accounting).

enjoyed by any actor within the environment of law. This information affords the manager a reasonably accurate method for evaluating the correctness or incorrectness of economic decisions, including the choice, in any given instance, between the price mechanism and the command mechanism. However, what makes this evaluation process even more difficult for decision makers within the environment of law is the absence of both a profit and loss balance sheet, and a manager to review it.

#### IV. Applying the Theory of the Firm to Law

As mentioned above, the environment of the law may be viewed as analogous to that of the firm in that its elements are comprised of a combination of command and spontaneous orders. Legislation and execution, whether done by legislatures, an executive, or even judges, may be described as the command component of the law. Adjudication, including the common law method of dispute resolution and administrative proceedings, may be viewed as the spontaneously ordered component of the law. While the analogy of the law to the operation of the firm is strong, law proves to be much more complex for two reasons. First, while the organizing function of the manager is conserved across the analogy, the law operates without a manager whose role it is to fulfill that function. Second, as has already been demonstrated, while the firm operates upon locally dispersed current information provided through the working of a recurrent spontaneous order (the price system), the law relies upon both past and current locally dispersed knowledge provided through both recurrent and cumulative spontaneous orders. Where the profit and loss statement available to the manager of the firm, made possible by the one dimensional recurrent spontaneous order of the price system, allows the manager to know whether her decisions are generally correct, no such system has been developed for the two dimensional spontaneous order of the law.

##### A. The Central Planner's Function: Choosing Between Common-Law (Spontaneous) and Planned (Legislative) Responses to Legal Questions

The point that the analogy of the law to the theory of the firm makes clear is that *the role of choosing between the made and spontaneous ordering processes of legislation and adjudication is one of a central planner*. In evaluating the propriety of legal decisions, it is the function of the central planner, in a fashion similar to that of the manager in the firm, to choose between the two mechanisms for maintaining social order. The two questions remaining to be answered are: (1) Who fills the role of the central planner within the environment of the law and (2) What does the theory of the firm tell us about how that person should choose between the two mechanisms?

To arrive at the answer to the first question, it may be useful to look at what the role of the central planner entails. Toward this end, it might be useful to resort once again to the theory of the firm for simplicity's sake. Within the firm, the manager has a choice between two branches of suppliers: an internal branch and an

external one. To marshal resources through the internal branch, the manager need only command the relevant department head to set about the job. As noted earlier, as the firm grows in size and complexity, it becomes much more costly for the department head to accomplish the task. At some point, the cost of accomplishing the task would become so great that the department head must either find cheaper ways of accomplishing the task, or risk losing the mission to the producer in the marketplace. The department head may have an incentive to react to this cost pressure, particularly if it is relevant to his evaluation or progress within the hierarchy of the firm.

Should the manager resort to the marketplace for the desired resources, she is confronted by the information, transaction, and contracting costs inherent in such exchanges. To gain competitive advantages, each supplier within each market will seek to reduce these costs with respect to doing business with their respective firm. To accomplish this, each engages in the sales function, by employing a salesperson or acting as one. The role of the salesperson would be to persuade or lobby the manager to choose his particular supplier, by providing relevant information on prices, the identity of the particular supplier, and form contracts or other cost cutting mechanisms. It is the function of the salesperson to gather some of the localized knowledge relevant to the manager's decision. Because there are so many different kinds of markets, and so many different firms within each market, all subject to the decision of the central planner within each customer-firm, no one salesperson can pick or choose his transactions. However, when a salesperson can influence the decision of the central planner, it is typically in his interest to persuade her to choose, first, the exchange transaction and second, his particular supplier. This is similar to the incentives of the internal department head, who is competing for the same business albeit for different reasons.

In law, both judges and legislatures perform functions analogous to both that of the salesperson of a supplier to the firm, and that of the internal command structure of the firm. The judge performs a function analogous to that of the sales representative of a supplier to the firm, while the legislature and executive form a unit which might be viewed as analogous to that of the internal command structure of the firm. The judge is "selling" a process for the production of legal rules, the common law. The "internal" command structure, comprised of the legislature and the executive, promises rule production through a quite different process. The central planner is confronted with the choice between these two processes for production of rules for the promotion of social coordination.

However, within the environment of the law, *there exists no one central planner, coordinator, or manager* whose function it is to choose between the spontaneous problem solving order of the common law, or the command problem solving order of legislation. The "constitution-maker" does not and cannot fulfill this role. Constitutions are generally broad, sweeping statements of general principle. The "constitution-maker," therefore, is much more like a member of a policy-setting board of directors. However, "constitution-makers" are not often afforded the "decision monitoring" power of a corporate board. They may set parameters for decision

making in the same fashion as many boards, but in the environment of the law, they are often not around to police the decision making of the actors exercising the power of the central planner.

In a democracy, it may be presumed that the electorate holds the office of central planner. While notions of popular sovereignty might suggest otherwise, the fact is that the citizenry, or electorate cannot be construed as acting as a central planner or manager with respect to the choice of legal ordering systems. While they may be likened to shareholders or stakeholders within the context of the firm, "the people themselves" in fact exercise much less managerial power than the common shareholder in the typical firm characterized by a separation of ownership and control.<sup>83</sup> Voter participation is not proportional to their interest in the outcome, and their interest in the outcome cannot be increased or decreased by purchasing or selling shares in their position.<sup>84</sup>

Citizen participation is not limited, however, to the polling place. It must be remembered that litigants' choice of the courts as the forum for dispute resolution sets the adjudication process in motion. This "choice," however, is less like the choice of the central planner and much more like the choice of potential buyers and sellers in the market place. Litigants may participate if they choose, but the courts may be busy with disputes of those who chose to "bring their wares to market," and the law may be impacted only as much as the price of wood with one more or less supplier or consumer. In short, while sovereignty may rest in the hands of the people, the "make or buy" decision regarding legal rules does not.

With the constitution-maker and populace discredited as potential central planners, only the executive, legislator, and judge remain as candidates. If the role of the executive is defined narrowly, it is clear that executives do not function as central planners in the law. Narrowly defined, executives execute the law, entering the picture far after the central planner has made the ordering decision. When defined more broadly, executives take on the functions of both legislatures and judges, and may act as central planners in much the same way the holders of these offices. To understand how this might work, we must now consider how judges and legislators usurp the role of the central planner in the law.

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<sup>83</sup> LARRY D. KRAMER, *THE PEOPLE THEMSELVES* 233-34 (2004).

<sup>84</sup> This is the common explanation for the concept of "rational voter ignorance" advanced by public choice theorists. The argument is that it does not profit a voter to gain additional information to make a more informed choice in the voting booth since the cost of accruing additional information is not met by an additional gain in position at the ballot box (votes). Furthermore, the opportunity costs of gaining additional information is that the voter could have profited by engaging in information gathering with respect to issues (such as those found in the marketplace) which would yield a return on the time and energy invested. EDGAR K. BROWNING & JACQUELINE M. BROWNING, *PUBLIC FINANCE AND THE PRICE SYSTEM* 259 (1979).



## B. Judges, Legislators, and the Responsibilities of a Central Planner in the Legal System

Within the law, both judges and legislators are frequently confronted with the dilemma of the central planner. That the legislature exercises the power of a central planner within the legal system is simply inescapable, and therefore merits only brief discussion. Legislatures often bear broad powers over the jurisdiction of courts. They may decide not only which cases courts may hear, but also dictate how (through procedure and evidence codes as well as substantive rules of law) they might hear them. Courts, in turn, may limit the exercise of the legislature's power to choose between ordering mechanisms through judicial review. Accordingly, legislative bodies exercise the powers of the central planner when they choose to direct legal questions through their chambers rather than to allow the "private" spontaneous ordering mechanism of the courts to address conflicts as they arise. Because of this authority, legislatures may be thought of as the ultimate central planners of law.

The judge's role as a central planner is a subtler one. The judge does not have the power to determine the specific problems or disputes she will resolve.<sup>85</sup> But when presented with a dispute, she can choose between three alternatives. She can: 1) accept the dispute and allow for its resolution within the framework of the law; 2) accept the dispute and depart from the framework of the law while legislating from the bench; or 3) refrain from accepting the issue, deferring instead to the legislature to develop a legislated solution.

The fact remains that no central planner tells a judge, particularly one with life tenure, whether or not to apply the law, or to defer to the legislative process. Judges, while only granted the authority to make this choice for those limited number of cases which happen to come before them, must make this determination on their own. The only constraints upon a judge's discretion in this choice are that she cannot pick and choose her cases, the threat to her legitimacy of seemingly arbitrary decisions, and the time constraints imposed on her by her caseload. In this way the judge takes on the limited role of "central-planner-for-a-day."

The analogy of the judge to a salesperson for her court is limited by any discussion of incentives. While it is to the salesperson's advantage to grab as much business and control as possible, this may not be entirely true for judges. Like few sales people, judges can only exercise control over the pieces of business that come their way. They cannot go out and "drum up business" with a "sandwich sign."<sup>86</sup>

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<sup>85</sup> Fuller cites an unnamed German socialist for the idea that "courts are like defective clocks; they have to be shaken to set them going." Fuller, *Forms and Limits*, *supra* note 49, at 385.

<sup>86</sup> At least a few judges, however, have been accused of actually "drumming up" business. The Chancellors of the Delaware Court of Chancery, as well as the federal bankruptcy judges sitting in the United States Bankruptcy Court for the District of Delaware, have been characterized as "soliciting" the business of corporate charter and bankruptcy filings. See G. Marcus Cole, *Delaware is Not a State: Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 VAND. L. REV. 1845, 1874-75 (2002). In a polycentric legal system, as well as in private dispute resolution, judges reliant upon the patronage of litigants will solicit business by developing reputations for fairness and sophistication. See RANDY E. BARNETT,

Instead, their discretion over the choice of ordering mechanisms begins only once the dispute has landed in their respective fora. In this way, judges act *collectively* as “central planners” of the law.

Judges are also limited by their desire to maintain their authority to decide future cases. Much of this authority depends upon the ability of each judge to maintain a belief of litigants and potential litigants that they are fair, impartial, and not arbitrary. This legitimacy or authority is jeopardized by decisions that appear arbitrary. As with any of their decisions, judges must bear in mind the impact on their legitimacy of their exercise of discretion over the choice of mechanism.

Additionally, workload serves as a constraint on the judge's exercise of discretion over the choice of coordinating mechanism. A judge's ability to effectively make use of the localized knowledge brought by litigants and common law precedents is limited, like any other coordinator, by the capacity of her mind to juggle the relevant relationships. This capacity is not unlimited. Therefore, any judge's desire to accept a case which should be deferred is limited by the judge's ability to squeeze the case into her docket. While these parameters reveal some constraints on the exercise of the choice between ordering mechanisms, they leave unanswered the issue of how a judge can decide when it is appropriate to decide or defer.

Finally, courts and legislatures may act in concert, or in opposition, to make the choice of ordering mechanisms. Legislation may stimulate new and possibly unforeseen spontaneous dispute resolution and common law rulemaking. Like a firm making an input acquisition decision, which in turn requires (previously unrequired) additional input purchases, courts may attach requirements to legislation brought before them.<sup>87</sup> Likewise, legislatures may produce legislation which, in

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THE STRUCTURE OF LIBERTY: JUSTICE AND THE RULE OF LAW 238–97 (1998); see also Tom W. Bell, *Polycentric Law*, HUMANE STUD. REV., Winter 1991–92, at 1; Randy E. Barnett, *supra* note 51, at 37–47.

<sup>87</sup> An example of this may be found in *In re Windsor on the River Assocs., Ltd.*, 7 F.3d 127 (8th Cir. 1993). In that case, a single asset limited partnership filed for reorganization under Chapter 11 of the bankruptcy code. Under the plan proposed by the debtor, the mortgage lender was to receive very small payments on the nearly \$10 million loan balance initially, while having the term of the loan increased from four years to thirty years! The other two classes of creditors consisted of unsecured trade debts totaling roughly \$13,000 and a disputed unsecured claim for about \$59,000. *Id.* at 129–30. The plan postponed payment to the trade creditors for sixty days after the plan's effective date, thereby creating an “impairment” of those claims. *Id.* at 129. The debtor's attorneys arranged the plan in this way because they wryly observed that the straightforward language of the statute provided that a Chapter 11 plan can be confirmed over the objections of a class of creditors: “If a class of claims is impaired under the plan [and] at least one class of claims that is impaired under the plan has accepted the plan . . . .” 11 U.S.C. § 1129(a)(10). The bankruptcy court confirmed the plan over the objections of the mortgage lender, and the district court affirmed. *Windsor*, 7 F.3d at 130.

The Court of Appeals reversed, holding that while the plan complied with the technical requirements of the bankruptcy code to the letter, the impairment of the trade claims was “manufactured at the will of the debtor ‘just to stave off the evil day of liquidation.’” *Id.* (quoting POSNER, *supra* note 68). The court reasoned that “[t]o allow manipulation of claims in a reorganization . . . would be contrary to the purpose of the provisions of the bankruptcy code. *Id.* at 131. The court, in other words, refused to allow a party to use the “letter” of the statute to circumvent the “spirit” of the statute.

turn, spurs adjudication.<sup>88</sup> It may even be observed that this process can devolve into endless spirals of legislation, litigation, legislation and more litigation.<sup>89</sup>

It is critical to emphasize again that, while both legislators and judges may act as central planners, they may each execute either prong of the “make or buy” decision. In other words, the decision is bifurcated: legal actors may choose first which ordering mechanism to employ, and then whether they may themselves execute the choice. Legislators may (and often do) adjudicate disputes, while judges commonly legislate from the bench. What is important about the choice of the central planner is not who performs the function but rather which ordering mechanism is chosen. *The distinguishing characteristic between spontaneous and planned ordering mechanisms is the process by which they are employed.*<sup>90</sup>

### C. The Agency Costs of the “Central Planner” in Legal Rulemaking

As with the central planner in the firm, there are agency costs associated with decision-making in the law. Just as the manager of the firm must be concerned with the agency costs associated with resort to command ordering within the firm, the central planner in the operation of the law must be concerned with the agency costs of resort to planned ordering within the law. Additionally, the central planner must be concerned with the various mechanisms for containing these costs in order to make planned ordering “cost-effective.”

#### 1. The Agency Costs of Legislation

Like the command structures within the firm, legislation entails agency costs. First, the agency costs inherent in firms characterized by the separation of ownership and control are also built in to the “cost” of legislation. Second, legislation, as “commands” from a “commander,” involves agency costs in implementation and execution.<sup>91</sup> These agency costs are very much like those experienced in the firm.

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<sup>88</sup> Title VII of the Civil Rights Act of 1964, for example, has generated thousands of suits that could not have been maintained prior to its enactment. See RICHARD A. EPSTEIN, FORBIDDEN GROUNDS: THE CASE AGAINST EMPLOYMENT DISCRIMINATION LAWS 160-61 (1992).

<sup>89</sup> This process is evident within the evolution of civil rights law. For example, in *Wards Cove Packing Co. v. Atonio*, 490 U.S. 642 (1989), the Supreme Court reversed precedent established eighteen years earlier in *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971), which held that once a plaintiff established by statistical evidence that a facially neutral employment policy was discriminatory, the burden of proof shifted to the employer to demonstrate a business justification for the policy. *Wards Cove*, 490 U.S. at 659. In *Wards Cove*, the court held that “[t]he burden of persuasion . . . remains with the disparate-impact plaintiff.” *Id.*

Congress responded to this holding by enacting the Civil Rights Act of 1991, the stated purpose of which was to “respond to recent decisions of the Supreme Court by expanding the scope of relevant civil rights statutes in order to provide adequate protection for victims of discrimination.” Civil Rights Act of 1991, 42 U.S.C. § 1981a (3)(4); see *Landgraf v. USI Film Prods.*, 511 U.S. 244, 250 (1994). The Court has subsequently determined that the new statute cannot be applied retroactively. *Id.*

<sup>90</sup> HAYEK, *supra* note 2, at 38-39.

<sup>91</sup> To John Austin, the father of legal positivism, the definition of “law” was the command of the commander to the commanded. See JOHN AUSTIN, THE PROVINCE OF JURISPRUDENCE DETERMINED 18-22, 133-34 (Hackett Publ’g Co. 1998) (1832).

Legislatures are prototypical disinterested agents. By “disinterested” we mean the type of agent that makes decisions in a firm characterized by the separation of ownership and control. In other words, agents whose decisions are with regard to the interests of others. While their members are frequently subject to their own enactments, legislatures are much like professional managers whose commands impact far greater interests than their own.

As disinterested agents, legislators come with agency costs. These costs are measured by the deviation of their personal interests from those of their many constituencies. The broader and more disparate the constituencies, the larger the total deviation.<sup>92</sup> These costs are analogous to those suffered by the residual claimants in the firm with separation of ownership and control.

Legislation is the archetype of a command, and bears agency costs similar to those associated with commands within the structure of the firm. As the commands are issued, the subordinate decision makers whose task it is to implement or execute the legislation as enacted have their own individual interests and agendas. As these interests deviate from the purported purpose of each statute or ordinance, agency costs are again incurred. These agency costs are, again, like the costs incurred by the firm when managers issue commands to subordinates. However, these are not the only agency costs confronting the central planner.

## 2. The Agency Costs of Common Law Adjudication

Much of the literature on the Theory of the Firm focuses on the agency costs of internal command ordering. This is natural, since the existence of these costs make it difficult to understand why firms exist at all. However, these costs are also inherent in spontaneous ordering mechanisms as well, albeit at much smaller levels, and a complete description of the order of the law would be impossible without recognizing the agency costs of common law adjudication.

Once common law courts employ their forums in rule generation, certain agency costs inhere from the viewpoint of the “role” of the central planner. First, there are agency costs generated by the directives of the court to the parties directed. Second, there are agency costs inherent in the enforcement mechanisms employed by common law courts to ensure that their directives are obeyed by the parties. Finally, agency costs arise with respect to whether similarly situated parties follow the rules generated through the common law process.

When discussing agency costs within the context of the law, and in particular the common law, it is important to distinguish the reference point from which these costs are incurred. Like in the firm, agency costs in the law are measured by the deviation of agents from the objectives of the manager or central planner. As already noted above, however, there exists no one manager or central planner within the environment of the law whose sole function it is to choose between or-

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<sup>92</sup> JAMES BUCHANAN & GORDON TULLOCK, *THE CALCULUS OF CONSENT* 68 (1971).

dering mechanisms.<sup>93</sup> Legislatures can choose to occupy this role, but once a legislature grants any jurisdiction to a court, it has ceded some of its “central plannerhood.” Despite the absence of an actual central planner, agency costs within the law still must be measured from the perspective a central planner might occupy. If we adhere to the Fullerian belief that the purpose of law is social coordination, then agency costs may be measured as deviations from commands directed to promote this end.<sup>94</sup>

First, common law courts seeking to settle disputes, and perhaps oblivious to any overall purpose of law, issue commands to specific parties. These parties are then confronted by three alternative choices. They may each: (1) obey the command exactly in the full spirit in which it was issued, (2) obey the command only in as much as will forestall enforced obedience, or (3) refuse to obey the command in as much as will forestall “enforcement.” Unless the objectives of the command are in complete agreement with the objectives of the party commanded, that party will choose alternatives (2) or (3), each of which represent agency costs of common law adjudication. If the particular party deviates from the exact objectives of the command to a degree small enough to escape enforcement measures by the court, the amount of this deviation constitutes an agency cost. These agency costs are further compounded by enforcement costs represented by the action of sheriffs, bailiffs, or marshals should a party choose to withhold obedience sufficient to avoid enforcement. Regardless of the choice of the party concerned, these costs are also compounded by the monitoring costs courts must incur, represented, in part, by the very employment of the enforcement agents (sheriffs, bailiffs, and marshals) as deterrents to withheld obedience.

Second, there are obvious and subtle agency costs involved with enforcement of court decisions. Sheriffs, bailiffs, or marshals must be engaged to enforce court orders through the “legitimized use of physical force” should any party refuse to obey particular commands. These agents of the court are like all other agents; they each have individual interests that may diverge from the objectives of the court issuing the order. While this divergence may not appear to be significant at all times, it is conceivable that this divergence may prevent enforcement entirely if the interests of enforcement agents were diametrically opposed to those of the court.<sup>95</sup> Nevertheless, these agency costs are real, albeit insignificant, when they are incurred from time to time.

Finally, the most significant agency costs involved in the use of common law ordering processes occur with respect to the general reach of common law rules. Persons similarly situated to the parties before a court may expect to be held to standards settled in the case before the court. And then they may not. Similarly

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<sup>93</sup> See *supra* Part IV.A.

<sup>94</sup> FULLER, *THE MORALITY OF LAW*, *supra* note 33, at 106.

<sup>95</sup> Consider, for example, a case where agents are directed by a court to accomplish a task that placed the agents' lives at risk. It is conceivable that courts might go through considerable numbers of agents before finding a number sufficient to carry out the order with disregard for their own lives.

situated persons are confronted with three possibilities when confronted with the reach of common law rules. First, they may believe that the rule reaches their conduct perfectly, and therefore consider themselves governed by the rule. Second, they may believe that their particular situation is distinguishable from that which generated the rule, and therefore consider themselves to not be governed by the rule. In this case they will engage in conduct in contravention to the objectives thought to be furthered by the rule. Finally, they may believe that the rule reaches their conduct, but that enforcement of the rule is unlikely or that the rule is wrong. In these cases, they will again engage in conduct in direct contravention to the objectives thought to be furthered by the rule, in the hope that either their conduct will not be challenged, or that it will be challenged so as to present them with an opportunity for reversing or altering the rule.

Accordingly, it must be recognized that all rule generation in the law entails agency costs. These costs are analogous to those shown to exist in factor production or purchase within the context of the firm. However, while these costs are analogous to those experienced by the firm, agency costs in the law occur in an environment that differs from the firm in a few, but critical, respects.

### 3. Internal and External Monitoring Mechanisms and the Law

By now it has been established that law mirrors firms and other organizations in that it can be characterized as involving a choice between made and spontaneous orders. It is also clear that while the order of the law does not enjoy one central planner whose function it is to make the choice between ordering mechanisms, the function of the central planner is preserved, and may be performed by various legal actors. And, as it has just been demonstrated, the exercise of this function involves agency costs similar to those experienced in the manager's decision making process in the context of the firm. The remaining question is whether the monitoring controls that limit agency costs within the firm are also present in the law.

As mentioned above, firms with separation of ownership and control are able to exist, in part, because internal and external monitoring mechanisms operate to restrict the agency costs inherent in the separation of the decision-making power from the residual interest holders. These monitoring mechanisms allow firms to employ command ordering systems without these systems becoming excessively costly. Unfortunately, not all of these mechanisms exist in the law. While command systems in the law enjoy separation of the decision monitoring from the decision initiation and implementation decisions much like the firm, the benefits of internal, mutual monitoring and "market-like" external monitoring are conspicuously absent.

Like commands within the firm, legislation may be characterized as enjoying a separation of decision monitoring from decision initiation and implementation. Decision initiation rests with the legislature. Implementation is generally the province of an executive. Monitoring of legislation is often shared between the legislators, courts, executives, special interest groups, and the electorate at large. If

this separation arrangement appears to be strikingly different than the firm, it is for good reason. Unlike the separation within the command structure of the firm, this separation does not create internal mutual monitoring mechanisms to keep agency costs in check.

We may recall that within the firm, separation of decision monitoring from initiation and implementation allows the use of the hierarchy of the firm to employ the diffuse, specific knowledge of lower level managers. This allows lower level managers to take advantage of their localized knowledge as they engage in competition with each other and their superiors. This competition ensures that decision making does not stray far from the interests of the commander, thereby acting as an internal monitoring device to keep agency costs in check. This cannot be said to be true for the world of legislation.

Commands in the form of legislation are not necessarily protected by the internal monitoring device afforded by collegial competition. First, commands are initiated at the highest level, rather than the lowest. This means that the localized knowledge that provides performance advantages is not available to the decision-makers. Second, there is no advantage for anyone within the command hierarchy to compete with each other to conform their interests to those of the commander. From administrators to legislators, there exists little incentive to compete with colleagues. Rewards for performance within the command hierarchy of legislation are often independent of the performance of others within the system.

This absence of competitive pressure is mirrored outside the legislature. All firms, even monopolies, experience some external monitoring pressures. Commanders within firms in a competitive environment must be wary of reduced stock prices, potential takeover bids, and the external market for managers. Monopoly firms must also fend off complete or partial takeovers of entire markets through takeover bids or regulation. As a result, decisions of agents within the firm are made with the caution that is warranted by these external pressures.

These external pressures are not experienced by legislatures. Unlike the internal command mechanism of the firm, legislatures enjoy a monopoly protected by the "legitimized use of force."<sup>96</sup> There exists no present or potential competition for the power of the body to command.<sup>97</sup> As a result, legislatures are immune from the competitive pressures experienced by most firms, and the external monitoring of agency costs provided by such pressures.

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<sup>96</sup> M. WEBER, THE THEORY OF SOCIAL AND ECONOMIC ORGANIZATION 154 (1964). The legitimate use of physical force is central to Weber's definition of the state:

A compulsory political organization with a continuous organization (*politischer Anstaltsbetrieb*) will be called a "state" if and insofar as its administrative staff successfully upholds a claim to the *monopoly* of the *legitimate* use of physical force in the enforcement of its order.

*Id.*, and as it appears in Randy Barnett, *Pursuing Justice in a Free Society: Part One - Power vs. Liberty*, CRIM. JUST. ETHICS, Summer/Fall 1985, at 50, 67 n.1 (emphasis in original).

<sup>97</sup> This argument is made with the recognition that this may not be entirely true for legislatures in federal systems, where there may be some competition between legislatures. Corporations law in the United States is a good example of such competition between states for more "attractive" codes. See William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 665-66 (1974).

Common law adjudication does not suffer the same agency cost infirmities inherent in legislative processes. Agency costs of common law processes are controlled in several ways. First, the agency costs arising from party disobedience is minimized by the simplicity of monitoring. Second, the agency costs of divergent interests of court agents is limited by unlikelihood of divergence. Finally, and perhaps most importantly, the agency costs of rule generality and prospectivity are reduced by moving the perspective of the central planner closer to a position discouraging generality and prospectivity in the first instance.

Agency costs from party disobedience to court generated rules are reduced by the very simplicity of monitoring. This is for two reasons. First, a large share of the monitoring responsibilities, and therefore the costs, are borne by the adversary to the party in question. Civil disputes, for example, involve adversaries whose direct and significant interest it is to make certain that the opposing party adhere as closely as possible to the rules resulting from the resolution of their dispute. Should a party deviate from a court command, this deviation is likely to be perceived and reported by the deviant's adversary. This holds particularly true for "relational" disputes, where the parties are likely to maintain close contact for extended periods after resolution of the particular dispute in question.<sup>98</sup> Second, the simplicity of monitoring agency costs with respect to parties results from the limited number of "agents" "commanded." When common law courts issue commands, there are simply a limited number of parties whose activities the court must survey. It is not beyond the capacity of any one judge to monitor the activities of a discrete, limited number of parties within its jurisdiction. This is to be contrasted with the monitoring required of a legislature following the promulgation of legislation. Note also that the ability of a common law court to survey the activities of parties following resolution of a dispute is inversely proportional to the number of parties to a case. Class actions, therefore, do not enjoy the reduced agency costs of other forms of adjudication.

Second, the agency costs of enforcement agents tend to be insignificant for two reasons. First, enforcement agents need only be engaged to follow commands when commands to parties are substantially disobeyed. If this disobedience were a common occurrence, parties would be unlikely to bring their dispute to the forum for resolution in the first place. The court would be viewed as an ineffective means of rights enforcement. In reality, few of the commands issued to parties by courts are substantially disobeyed. As a result, sheriffs, bailiffs, and marshals need only stand around and "look intimidating." This is part of the second reason enforcement agency costs are minimal. Sheriffs, bailiffs, and marshals have very little expected of them in the way of their enforcement duties, and what is expected involves very little discretion. When required to enforce a command, enforcement agents' range of actions are typically well defined as, say, placing a lock on a door, removing furniture or equipment, or arresting the offending party. There is very

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<sup>98</sup> See Ian McNeil, *The Many Futures of Contract*, 47 S. CAL. L. REV. 691, 694-95 (1974).



little discretion for enforcement agents to act, when they are required to act at all, in a fashion inconsistent with their respective mandates.

Finally, the most important and perhaps profound control on agency costs in the common law is inherent in the fundamental nature of common law rulemaking itself. As noted above, agency costs may be defined as the deviance from the command by the commanded. This deviance may be measured from the position of the central planner, even if no central planner exists. Common law rules may be viewed as involving huge agency costs if they are designed to be general and prospective. However, the very point of resorting to common law adjudication for generation of rules for social coordination is to avoid the generality and prospectivity of legislation. In other words, *agency costs of common law adjudication are reduced by the simple fact that the number of parties and circumstances they are designed to govern are very limited themselves.* The broader a rule is designed to be, the more deviation (and, as a result, agency costs) it will necessarily involve. Common law rules are only clearly law for the parties to the dispute. "Deviation" by parties who are not similarly situated to those involved in the case generating the rule are not engaged in "costly" behavior.

Furthermore, it would be undesirable for common law rules to apply generally and prospectively. If they did, they would be indistinguishable from legislation, and would suffer the same uncontrollable agency costs inherent in legislative processes. Judges engaged in this type of "adjudication" are more properly characterized as "legislating from the bench." In sum, the agency costs of deviance by persons other than those who are parties to a case can be minimized, and in fact are minimized, by simply not having obedience by such persons an "interest" of the central planner. By having common law judges decide "the case first and . . . the principle afterwards . . .," deviations from the interests of the central planner and, concomitantly, agency costs are avoided.<sup>99</sup>

#### D. The Divergence of Law from the Model of the Firm

The limited applicability of common law rules reveals the fundamental distinction between the law and the firm. The firm, because it is initially a "made" order, that may from time to time resort to spontaneous ordering mechanisms for the accomplishment of certain tasks, has a discernable purpose, towards which progress may be measured through "profit and loss" statements facilitated by the price system. Any particular decision by the manager of the firm may be evaluated by reviewing its distinct and discernable impact on the balance sheet. And even though it may not be possible to determine whether in the infinite set of possible decisions the one in question was the best, it is in fact possible to measure whether the decision in question was profitable or unprofitable, good or bad, negative or positive. The price system makes this all possible.

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<sup>99</sup> Holmes, *supra* note 34, at 1.

As already demonstrated, the law does not enjoy a perfect analogy to the price system.<sup>100</sup> Law, because it was initially a spontaneous order,<sup>101</sup> is not truly “purposive” in the sense that it fulfills some particular design. Nevertheless, law may be viewed as “purposive” in the sense that it fulfills a crucial function, that of social coordination.<sup>102</sup> Legal rules, whether developed through made or spontaneous ordering mechanisms, fulfill their function when they promote social order.<sup>103</sup> This is the point, however, at which the analogy to the firm ends. Where the manager in the firm can discern the purpose of the firm, can independently direct the resources of the firm toward that purpose, and can evaluate the efficacy of this resource allocation through a profit and loss statement, none of these things are possible in the law.

First, law has no independent central planner whose function it is to direct resources. Those fulfilling the function of the central planner may or may not discern the “purpose” of the law, that of social coordination. If the purpose should be discerned by those acting as the central planners of the law, there is no way of knowing which “allocation of resources” (legal rules) will result in advancing the purpose of social coordination. This is particularly true where numerous legal actors impact the system constantly. No one mind within the system, however brilliant, can know what combination of the constantly changing legal rules returns a “profit” in terms of social coordination. In other words, *the manager of the firm has more knowledge, and knowledge of a different type, than that with which law planners must work.* The knowledge of the manager is simple, measurable, and relatively complete. To the contrary, actors usurping the role of central planner in the law must work with knowledge that is complex, immeasurable, and only a fraction of what is relevant to the achievement of the overall goal.

### V. Conclusion: The Operational “Efficiency” of Law

It appears that the theory of the firm can be expanded to explain the functioning of the purposive order we know as law. Law may be characterized as an order that functions in much the same way as an organization. Furthermore, law appears to involve the same choice of “make or buy” confronted by the firm. The spontaneous order of common law adjudication mirrors the resort to market production of inputs to the firm. Similarly, legislation appears to be analogous to made or command orders within the firm.

Finally, the “make or buy” decision is one for a central planner. While this function is conserved across the analogy to law, there is no one person within the operation of the law that fills this function exclusively. In fact, it appears that a

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<sup>100</sup> See *supra* Part II.A.1.b.

<sup>101</sup> “Although man never existed without laws that he obeyed, he did, of course, exist for hundreds of thousands of years without laws he ‘knew’ in the sense that he was able to articulate them.” HAYEK, *supra* note 2, at 43.

<sup>102</sup> FULLER, THE MORALITY OF LAW, *supra* note 33, at 106.

<sup>103</sup> *Id.*

myriad of legal actors, either in the role of legislators or judges, performs this function.

Legislatures are not shielded from the agency costs inherent in the command structure of complex organizations. However, while most organizations experience internal and external pressures that monitor and reduce these agency costs to manageable levels, the command structure that produces legislation is not as fortunate. Legislatures and their agents are immune from these pressures. As a result, there are costs for resorting to the command/planned order of legislation that are not present in the spontaneous order of the common law.

What the theory of the firm seems to suggest about the choice between ordering mechanisms is that centrally planned or command ordering may not be as “efficient” within the environment of law as it is within the firm. Adam Smith appears to have recognized this very fact over two hundred years ago:

The man of system . . . seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges pieces upon the chessboard. He does not consider that the pieces upon the chessboard have no other principle of motion besides that which the hand impresses upon them; but that in the great chessboard of human society, every single piece has a principle of motion of its own, altogether different from that which the legislature might choose to impress upon it. If those two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously, and is very likely to be happy and successful. If they are opposite or different, the game will go on miserably and the society must be at all times on the highest degree of disorder.<sup>104</sup>

The spontaneous ordering mechanism of the common law appears to, therefore, have advantages over legislation in the pursuit of social order. Where legal actors perform the role of central planner, the analysis presented appears to advise a conservative presumption in favor of resort to common law solutions to legal questions. It is for this reason that those usurping the role of central planner in the law must step gingerly when adding straws to the back of the social order.

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<sup>104</sup> ADAM SMITH, *THE THEORY OF MORAL SENTIMENTS* 233-34 (D.D. Raphael & A.L. Macfie eds., Liberty Classics 1982) (1759).

