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THE EVOLUTION OF A LEGAL RULE

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ABSTRACT

The efficiency of common law rules is central to achieving efficient resource allocation in a market economy. While many theories suggest reasons why judge-made law should tend toward efficient rules, the question whether the common law actually does converge in commercial areas has remained empirically untested. We create a dataset of 465 state-court appellate decisions involving the application of the Economic Loss Rule in construction disputes and track the evolution of law in this area from 1970 to 2005. We find that over this period the law did not converge to any stable resting point and evolved differently in different states. We find that legal evolution is influenced by plaintiffs' claims, the relative economic power of the parties, and nonbinding federal precedent.

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I. Introduction.

We investigate the evolution of a particular common law rule pertaining to the construction industry, as developed by state appellate courts in the United States over the last 35 or so years. Although the topic might at first glance appear esoteric, the evolution and efficiency of legal rules are central to understanding any market economy. The simplest way to see this is by going back to the Coase Theorem (Coase 1960). The Theorem holds that, as long as initial property rights are well defined and private parties whose behavior affects each other can freely negotiate and contract over their conduct, they will agree to act efficiently. Such efficient behavior maximizes total surplus, which parties can agree to divide via contract among themselves.

But what if the parties cannot negotiate and contract (perhaps because of high transaction costs), or have failed to do so? In those cases, efficient resource allocation requires that underlying legal rules, such as the rules of liability, provide parties with incentives to act efficiently. Such rules would steer parties to outcomes that mimic those that the market would produce if transaction costs were low. In a common law system, which prevails in most English-speaking nations, including the United States, legal rules in a number of important fields, including torts, are created mainly by appellate judges as a byproduct of deciding cases. Such rules are modified, and sometimes even reversed, in subsequent decisions, so they evolve over time. If the rules are predictable and efficient, but not otherwise, parties will act in an efficient manner even without contracting. For this reason, the efficiency of common law rules is necessary for attaining efficient resource allocation in a market economy.

Scholars in law and economics have sought to understand why common law rules might be efficient. Posner (1973) recognized the importance of this question, and argued that appellate judges have personal incentives to maximize efficiency. Rubin (1977) and Priest (1977) showed that because inefficient legal rules lead to inefficient economic outcomes, they are more likely to be challenged in court. Such litigation is likely to drive them out in favor of efficient rules, even when judges do not pursue efficiency.¹

These arguments for efficiency do not come to grips with the legal realist and critical legal studies criticism that judges have policy preferences other than social welfare or disagree about what serves social welfare. Indeed, a considerable empirical literature concludes that judges pursue political objectives (see, e.g., George and Epstein (1992), Brenner and Spaeth (1995), Songer and Lindquist (1996), Hansford and Spriggs (2006), and Landes and Posner (2007)). When judges follow personal policy preferences, the case for the efficiency of common law is harder to make. Nevertheless, one can still argue, in the spirit of Cardozo (1921), that the law evolves toward better rules through sequential decisions of judges with diverse preferences (see also: Holmes (1897), Frank (1930), Llewellyn (1951), Stone (1985), and Posner (2005)).²

Yet much of the discussion of the efficiency of legal rules remains theoretical, with no empirical studies of how the law evolves in commercial fields that matter for the efficiency of resource allocation. That is the gap we try to fill. The doctrine we have chosen for our study is an important common law tort doctrine known as the “economic

¹ See also: Cooter, Kornhauser, and Lane (1979).

² Gennaioli and Shleifer (2007) show, for example, that because appellate courts tend to distinguish prior cases from current ones on the basis of information generated by the latter, rather than overruling the prior cases and thus losing the knowledge generated by them, sequential decision making leads to the refinement of the law over time, and thereby improves its efficiency on average even when full efficiency is not attained.

loss rule” (ELR). We study the application of the ELR to construction disputes. We ask whether the courts have adhered to the ELR (with some standard exceptions that might be necessary to make the rule efficient) in the construction industry, and, if not, how the pattern of adherence and non-adherence has evolved.

Stated at its broadest, the ELR holds that one cannot sue in tort for “economic loss” unless that loss is accompanied by personal injury or property damage. (“Economic loss” thus just means a loss that is not a personal injury or property damage.) So if the builder of your house installs windows negligently with the result that they do not keep out the rain, you cannot sue the builder in tort for the cost of re-installing the windows carefully, because your loss is purely economic.³ In contrast, if the water that seeps into the house because of the badly installed windows damages your furniture (i.e., causes damage to *other* property), then you can sue the builder in tort.

The antecedents of ELR are very old, but the doctrine was first clearly articulated in the 1960s and applied to disputes in the construction industry in the 1970s.⁴ Most construction activity is governed by contract, so the vast majority of construction disputes are contract disputes. There are two principal types of case in which tort claims and therefore the ELR become relevant in construction. In the first, a plaintiff property owner sues in tort for economic loss when contracts or warranties have expired or are unavailable, or when he simply wants to make additional claims. In the second scenario, a builder sues other builders, architects, engineers, inspectors, or manufacturers for damages resulting from the defendant’s alleged negligence. We investigate how state

³ But you may be able to recover the cost of repairing or replacing the windows in a suit for breach of warranty.

⁴ See Barrett (1989) for a discussion of early ELR cases in the construction industry. An important early statement of the rule was Holmes’s opinion for the Supreme Court in *Robins Dry Dock & Repair Co. v. Flint*, 275 U.S. 303, 308–310 (1927), an admiralty case.

appellate courts, whose decisions constitute the precedents that shape common law, have dealt with such cases.

We have decided to examine the application of the ELR in the construction industry for four reasons. First, construction disputes arise out of commercial relations, and legal evolution in commercial law is our principal interest. Second, the industry is mature. Any changes we observe in the ELR between its first clear articulation and the present day cannot be attributed to changes in the underlying economic activity, but only to changes internal to the legal system⁵. Third, there do not appear to be differences across states in construction that might dictate different legal regimes. (This is important because the common law of torts is for the most part a state prerogative. One state is not required to decide construction cases the same way as any other state is—for that matter, no state is required to make ELR a part of its law.) Thus both time-series and cross-sectional analysis of ELR should be unaffected by variance in construction methods and practices. Fourth, the doctrine is sufficiently recent to enable us to trace its evolution under modern conditions, but old enough, and construction disputes common enough, to have generated enough appellate cases⁶ to allow an empirical analysis of its evolution. Our sample contains 465 appellate decisions over 35 years: enough to reach some tentative conclusions on how the law evolves but not so many as to make the project unmanageable.

To understand how the application of the ELR has evolved in construction disputes, we examine three principal issues. First, we consider both the bright-line ELR

⁵ In section V, we discuss some evidence that differences in state growth rates or state construction activity cannot account for the differences in the application of the ELR that we document.

⁶ Cases at the trial level are rarely decided in judicial opinions that explain the factual and legal issues fully. And the opinions of trial judges have only very limited impact on the evolution of legal doctrine, because trial-court opinions are not considered precedents, i.e., authorities, binding courts in subsequent decisions.

and the ELR with generally recognized exceptions as candidates for the efficient rule, and ask whether the law achieves or moves toward either of them. Second, we ask more generally whether the law converges over time to any resting point. If it does not, in an environment that is basically stationary, it becomes harder to argue that the law tends toward efficiency – whatever one’s view of efficiency is. The absence of a resting point is not conclusive evidence of inefficiency. Although the environment may be stable, disputes may still involve different facts, creating a process of continuous judicial learning that generates a continuous adjustment of the rules. If the law is efficient and the facts do not change, however, *some* tendency toward stability can be expected as a legal doctrine matures. Third, we look at the evolution of the law in different jurisdictions. Under the assumption that legal rules in the field of construction should not efficiently vary across jurisdictions, large differences in the patterns of legal evolution across jurisdictions would argue against an inference of efficient judicial rulemaking.

To summarize the results, over our sample period the law did not converge to the bright-line ELR, to the bright-line ELR with generally recognized exceptions (such as fraud), or to any other resting point. While there is some tendency to convergence in the first 25 years of the sample, in the last decade courts increasingly have limited the ELR in construction by creating idiosyncratic exceptions to it – exceptions adopted in only a few jurisdictions and rejected in others. Moreover, while adherence to the ELR in some form grows in some states over time, in others it diminishes. These results are inconsistent with simple theories of efficient judicial lawmaking.

It might seem that judicial disagreement about the proper scope of the ELR makes the doctrine unrepresentative as an object of study of legal efficiency by marking it as

controversial. In cases governed by less controversial doctrines, courts would find it easier to agree on what would be efficient outcomes, and so there would be faster and more complete convergence. But no one doubts that efficiency has some domain in law; the interesting question is whether courts can converge to stable rules in the numerous areas of law where there is room for disagreement about efficiency or equity. The ELR is one such area.

In the next section we spell out in more detail the ELR, its application to construction, and the exceptions to the rule. Section III describes the data. In Section IV, we present basic trends in state appellate courts regarding recovery for economic losses in tort, as well as trends in the exceptions to these recoveries. We also discuss the predictability of the law. Section V looks behind the trends to ask whether they reflect changes in plaintiffs' claims, the presence of explicit contracts, the economic power of the parties, or leadership by the U.S. Supreme Court. We also check how much variation there is across states. Section VI concludes.

II. The Economic Loss Rule in Construction Disputes.

Although the term "Economic Loss Rule" is recent, the idea of barring recovery in tort for a pure economic loss is not.⁷ The immediate antecedent of the application of the ELR in construction cases was its application in products liability cases. In the 1960s,

⁷ An early U.S. case is *Anthony v Slaid*, 52 Mass. 290 (1846). The most famous case announcing the fundamental principle is *Ultramares Corp. v Touche*, 255 N.Y. 170 (1931), in which Cardozo held that an accountant owes no duty to third parties, such as lenders, to refrain from negligently causing economic injury (from reliance on accountant's reports). See also the *Robins* case, note 3 above, decided four years before *Ultramares*. Feldthusen (2000) provides a detailed historical analysis of tort recovery for economic losses in various common law countries. The arguments for limiting recovery in tort for economic loss are analyzed in Bishop (1982), Rabin (1985), Goldberg (1994), and Posner (2006). The economic loss rule exists in approximately its American form in England, but has much less purchase in Continental European law. See Bussani and Palmer (2003).

when the California Supreme Court was making groundbreaking decisions on the liability of manufacturers for defective products, the question of liability in cases in which the loss was purely economic, with no accompanying personal injury or property damage (other than to the defective product itself), was bound to arise, and did. In *Seely v White Motor Co.*,⁸ the court ruled on this issue. The plaintiff had purchased a truck with defective brakes. The truck overturned, but the plaintiff was not hurt (nor did the accident damage any other property). He sued in contract as well as in tort to recover repair costs and lost profits. The court held that strict liability was not available and the plaintiff was limited to warranty remedies.⁹ In later rulings, the ELR was extended to negligence (as distinct from strict liability) claims in product cases.

The theoretical case for the efficiency of the ELR in situations similar to *Seely*, including construction disputes,¹⁰ rests on the possibility of anticipating problems through contracts. Applied in situations of low transaction costs, the ELR encourages parties to solve their potential problems through contracts. As Posner (1973) pointed out, courts prefer parties to govern their relationships through privately negotiated contracts rather than through tort suits whenever transaction costs are low enough, because the parties know their business better than the judges can. He reiterated this logic as a judge in upholding a bright-line ELR in *Miller v United States Steel Corp.*: “tort law is a superfluous and inapt tool for resolving purely commercial disputes. We have a body of

⁸ 63 Cal. 2d 9 (1965).

⁹ *Seely* actually recovered for both the repairs of the truck and lost profits under his warranty, but the case is famous because the court established the legal rule with respect to recovery for economic loss in tort. We discuss the role of contracts in the application of the ELR in Section V.

¹⁰ In cases such as *Ultramares*, a crucial efficiency justification for the ELR is that it protects parties engaged in normal business conduct from unpredictable tort claims from strangers if an accident occurs. In construction disputes, the plaintiffs and the defendants are not strangers, so this argument does not apply.

law designed for such disputes. It is called contract law.”¹¹ Thus the buyer of a house who worries that it is poorly built should demand a warranty rather than repress his concern and seek a remedy in tort should his fears materialize.

This logic behind the ELR implies denial of monetary recovery to some persons harmed by wrongful acts, and this troubles some courts. An example is the 1965 New Jersey case of *Santor v. A & M Karagheusian, Inc.*,¹² in which a consumer recovered tort damages from a carpet manufacturer when he discovered that the carpet had a defect. The dealer from whom he had bought the carpet had gone out of business before the consumer realized that the defect could not be fixed, so the dealer’s warranty was of no value to him; and there was no manufacturer’s warranty. We do not know whether the New Jersey court was moved by an alternative view of efficiency or by sympathy for the plaintiff, but it rejected the ELR.

Even those convinced by the basic efficiency logic of the ELR recognize the need for some exceptions. One generally recognized exception is fraud (the deliberate infliction of an economic loss). Another is economic loss that accompanies a personal injury or physical damage, as in a case in which a defectively installed window lets in rain that damages furniture. These situations are difficult to anticipate and make provision for by contract. In our empirical analysis, we keep track of such generally recognized exceptions, bearing in mind that they may be efficient. The bright-line ELR is one candidate for an efficient legal rule; the ELR with generally recognized exceptions is another. And of course, some courts might not be persuaded by the economic logic of the ELR, or might find the outcomes it yields repugnant, and in the latter case might create

¹¹ 902 F.2d 573, 574 (7th Cir. 1990).

¹² 44 N.J. 52 (1965).

“idiosyncratic” exceptions. Idiosyncratic exceptions are applied inconsistently across jurisdictions and sometimes overruled within the same jurisdiction.

The application of the ELR to construction offers an interesting setting for analyzing the behavior of appellate courts. We have a rule that is well-known and can be justified using good efficiency arguments, but may leave some courts dissatisfied. We have an environment unlikely to be changing over time and from state to state. We can ask: what do courts do with this rule over time and space? Do their decisions converge to, or at least move toward, an efficient resting point, which might be the bright-line ELR or the ELR with generally recognized exceptions? Do their decisions converge over time at all? Is the evolution of decisions in this area similar across states? Answers to these questions would bear on the central questions regarding the efficiency of common law. In the next few sections, we attempt to obtain these answers.

III. Data.

Overview of the Database

We gathered data on 465 state-court appellate decisions in tort cases involving the ELR (see Appendix for details). We have read all these cases and extracted our variables from the judicial decisions. We coded the state in which the decision was rendered, the date of the decision, and the level of the court (whether the state’s highest court or a lower appellate court). We did not include information about individual judges. We recorded the type of plaintiff and defendant. We divide parties into one of five general categories: (1) property owner; (2) builder (such as general contractors and subcontractors); (3) architect, engineer, or inspector; (4) manufacturer; and (5) other (real

estate agent, insurance company, or bank). We noted whether the plaintiff and the defendant were parties to a contract and whether any contractual claims were made by the plaintiff (breach of contract, breach of express warranty, or breach of implied warranty), as well as the outcomes of such claims on trial and on appeal. Our primary interest, however, is in the resolution of tort claims.

Our data collection was motivated in part by the ambiguity of what should be considered “efficient” in this context. One possible view is that efficiency calls for applying the ELR with no exceptions at all (call this the strict view). Another is that efficiency requires applying the ELR with the exceptions that are generally recognized by most courts (call this the middle view). A third view holds that courts have vastly more information about cases than the researchers do, and so the application of the ELR and its exceptions is highly nuanced and contingent on specific facts of the case (call this the broad view). Our data allow us to test both the strict and the middle view, but the broad view is untestable by the methods that we use.

We use data about the specifics of tort claims, and whether they are allowed, to create *tortwin*, which denotes the plaintiff’s winning at the appellate level. It is a dummy variable that takes a value of “0” if the plaintiff’s claim in tort is barred by the ELR and “1” if it is not. We use *tortwin* to test the strict view of the ELR, under which *tortwin* should be “0” on average. A value of “1” for *tortwin* does not necessarily mean that the plaintiff actually recovered damages. The appellate court may decide that recovery is not barred by the ELR but remand the case to a lower court for considering other defenses, assessing damages, or resolving other issues material to a final resolution of the dispute.

Coding the Reasons for Not Applying the ELR

We also document the reasons courts give when they do not apply the ELR. There are relatively few such reasons, summarized in Table 3.1. In coding the data, we recorded the primary exception to the ELR applied by the court. Other exceptions that the court mentioned along the way (*dicta* rather than the holding of the case) we ignore.

<p>Generally recognized exceptions</p>	<ul style="list-style-type: none"> • <i>Other property</i> • <i>Independent torts</i> • <i>Generally recognized independent duties</i> <ul style="list-style-type: none"> ○ Statutory independent duties ○ Architect’s independent duty to a general contractor under the <i>Restatement on Torts</i>
<p>Idiosyncratic exceptions</p>	<ul style="list-style-type: none"> • <i>Idiosyncratic independent duties</i> <ul style="list-style-type: none"> ○ Builders owing an independent duty to property owners ○ Builders owing an independent duty to other builders ○ Architects owing an independent duty to property owners ○ Architects owing an independent duty to subcontractors ○ Manufacturers owing a independent duty to property owners • <i>Other reasons</i> <ul style="list-style-type: none"> ○ The plaintiff does not have a contractual remedy ○ The economic loss rule applies only to commercial plaintiffs ○ The economic loss rule does not apply to negligence claims ○ Sudden and calamitous event poses unreasonable risk of injury

Table 3.1: Distinction between generally recognized exceptions and exceptions that are idiosyncratic.

We distinguish between two categories of reasons given by a court for its decision: (1) generally recognized exceptions to ELR; and (2) idiosyncratic exceptions. Under the middle view of efficiency, *tortwin* should be “0” other than when courts apply generally recognized exceptions. There are three kinds of generally recognized exceptions:

Independent Torts: Pure economic loss can occur as a result of either intentional or unintentional wrongdoing. Intentional wrongdoing is a standard exception to the ELR.

For example, when the defendant fraudulently induces the plaintiff to sign a contract, the ELR does not bar him from suing the defendant in tort for fraud.

Other Property: Plaintiffs are permitted to recover tort damages for personal injury or property damage. In products liability cases, this includes damage caused by a defective product to other property belonging to the plaintiff, as well as to property belonging to a third party. Damage to the defective product itself is treated as economic loss, but if other property of the plaintiff is damaged, the ELR does not preclude recovery. State courts vary in their application of this exception. For simplicity, we classify all applications of the other property exception as generally recognized.

Generally recognized Independent Duty: Courts have recognized exceptions in which defendants owe a duty to the plaintiff that is independent of any contract. Many of these exceptions are idiosyncratic, but two are generally recognized. First, as noted in section 552 of the *Restatement (Second) of Torts*, architects have an independent duty to a general contractor. This seems an efficient way of avoiding making architects contract separately with builders when both have already contracted with the owner. Second, several states have enacted statutory duties in this area. For example, Florida has imposed a number of statutory duties upon builders, architects, and inspectors. Section 553.84 of Florida Statutes (1995) provides a cause of action for economic loss when a builder has injured a property owner as a result of violating the building code or doing construction without required permits. This duty operates independently of any other available ground for a remedy.

The coding of exceptions as “generally recognized” does not necessarily mean that all cases from all jurisdictions have accepted the exception. For example, we have

coded fraudulent inducement as a “generally recognized exception” even though in two cases in our dataset fraudulent inducement was held not to constitute an exception. One was overruled a year later; the other was based on a statutory interpretation.¹³

Courts have carved out a number of additional exceptions, which we refer to as idiosyncratic (see Table 3.1). These are exceptions that are peculiar to a few states or not uniformly recognized even within the same state. The label “idiosyncratic” does not refer to innovations made by courts in situations that have not previously arisen (as in Gennaioli-Shleifer 2007). Rather, idiosyncratic exceptions are exceptions rejected by other courts either explicitly or implicitly. For each case that we classify as having been decided on the basis of an idiosyncratic exception, there is a factually very similar case decided in favor of applying the ELR.

Most of the idiosyncratic exceptions are independent duties created by courts. A few courts subject builders or architects to a tort duty to property owners or subcontractors. For example, Colorado and Georgia hold that builders owe property owners a tort duty independent of the ELR, but most courts do not. Sometimes an idiosyncratic exception is inconsistent with other cases in the same state. In an early Illinois case, an architect was held to owe an independent duty to purchasers of residential property, but most cases from Illinois apply the ELR in such cases.¹⁴

¹³ In *Woodson v. Martin*, 663 So. 2d 1327 (Fla. 1995), the Florida court held that any misrepresentations of the defects in the house caused only economic losses. This was overruled in *Wassall v. W H Payne* 682 So. 2d 678 (Fla. 1996) and has been disapproved in a number of other Florida cases. In *Flagg Energy Development Corp. v General Motors Corp.*, 244 Conn. 126, 151–55 (1998), the Connecticut court dismissed the claim for fraudulent misrepresentation, but while mentioning the ELR the court actually based its decision on an interpretation of the Uniform Commercial Code. While the case has been distinguished in Connecticut, it has not been overruled or disapproved.

¹⁴ *Ferentchak v Frankfort*, 121 Ill. App. 3d 599 (1984), was the early architect case. The similar cases from Illinois that upheld the ELR are *Illinois Housing Development Authority v. M-Z Construction Corp.*, 110 Ill. App. 3d 129 (1982); *2314 Lincoln Park West Condominium Association v. Mann, Gil, Ebel & Frazier, Ltd.*, 136 Ill. 2d 302 (1990); and *Martusciello v. JDS Homes, Inc*, 361 Ill. App. 3d 568 (2005).

Some courts recognize an exception in cases in which the plaintiff has no contractual remedy, or confine the ELR to commercial, but not to residential, property owners. These “other reasons,” which seem motivated by sympathy for wronged plaintiffs seemingly barred by the ELR, are rejected by other courts and we code them as idiosyncratic exceptions.

Brief Summary of the Data

Cases are not distributed uniformly across the years 1970-2005 covered by the dataset. In some years we have no observations, while the maximum number of cases in one year is 28 (in 1998 and 2005). Figure 3.1 plots the number of cases each year, and reveals a clear upward trend in appeals cases in which ELR is mentioned.

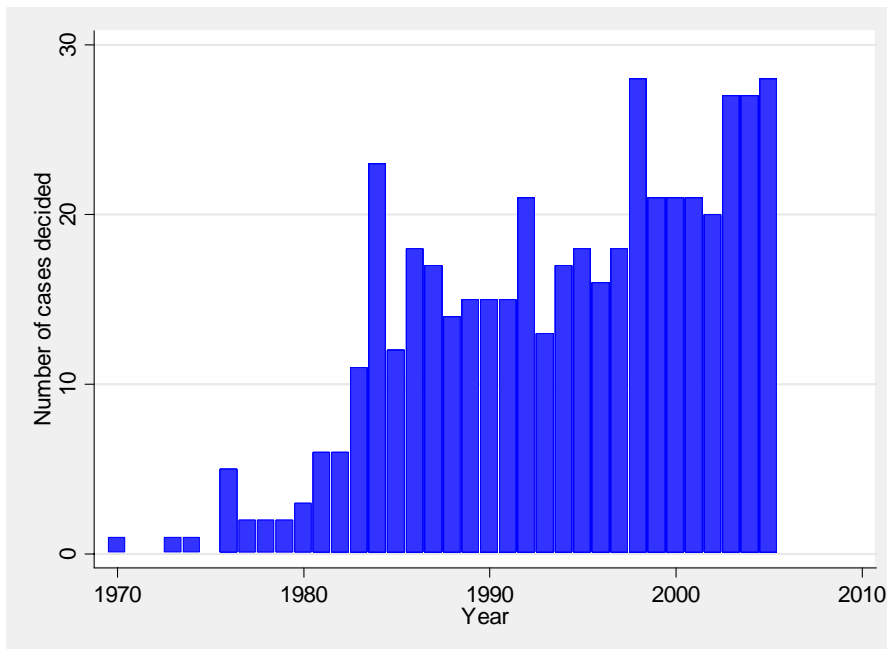


Figure 3.1: Number of cases in each year in our dataset.

The growth in the number of ELR cases is affected by our search strategy in constructing the dataset. Many construction cases from the 1970s and 1980s do not refer to the ELR explicitly and hence are not included. The result is to bias the plaintiffs’

success rate downward in the early years of our sample. A plaintiff is more likely to have recovered economic damages in a case in which the ELR is not mentioned than in one in which it was.

In the majority of our cases, a plaintiff property owner is suing a builder, architect, engineer, inspector, or manufacturer. In 331 cases (71.18%), the plaintiff is a property owner. Builders are the only other significant plaintiff category (involved in 25.81% of the cases). The most frequent defendants are builders (involved in 34.84% of all cases), followed by manufacturers (27.10%), architects, engineers, and inspectors (20.86%), and property owners (14.62%). Table 3.2 summarizes these data.

PLAINTIFF	DEFENDANT					Total
	Property Owner	Builder	Architect, Engineer, Inspector	Manufacturer	Other	
Property Owner	48	132	44	98	9	331 (71.18%)
Builder	18	21	53	25	3	120 (25.81%)
Architect, Engineer, Inspector	1	7	0	1	0	9 (1.94%)
Manufacturer	1	1	0	2	0	4 (0.86%)
Other	0	1	0	0	0	1 (0.22%)
Total	68 (14.62%)	162 (34.84%)	97 (20.86%)	126 (27.10%)	12 (2.58%)	465

Table 3.2 Breakdown of the parties to the 465 disputes.

Table 3.3 summarizes the outcomes in our 465 cases. Plaintiffs won 170 cases (36.56%). The most frequent exceptions to the ELR found in our sample are other property (25.88% of all cases that plaintiffs win); idiosyncratic independent duties (22.94%); and independent torts (21.76%). Courts invoke generally recognized

exceptions to the ELR in 113 of the 170 *tortwin* cases (66.47%) and idiosyncratic exceptions in the remaining 57 cases (33.53%).

The data on means begin to tell the story of how the ELR has been applied in the construction industry. More than 63% of the cases apply the ELR and deny plaintiffs recovery in tort. In nearly 25% of the cases the decision is for the plaintiff based on a generally recognized exception to the ELR. Only about 12% of the cases apply idiosyncratic exceptions. On average, then, the ELR plus its generally recognized exceptions is widely, but not universally, accepted by state appellate courts. The question arises whether, over time, this acceptance has grown, suggesting convergence. If it has, what kinds of decision have withered away? If acceptance has not grown, what kinds of exception are responsible? We address these questions in the following sections.

	Observations
Generally recognized exceptions	
Other property	44
Independent torts	39
Generally recognized independent duties	32
<i>Total Generally recognized exceptions</i>	<i>113</i>
Idiosyncratic exceptions	
Idiosyncratic independent duties	39
Other reasons	18
<i>Total Idiosyncratic exceptions</i>	<i>57</i>
Total <i>tortwin</i>	170

Table 3.3: Outcomes of cases and frequency of exceptions

IV. Aggregate Outcomes.

Figure 4.1 presents the fraction of cases each year in which plaintiffs won (*tortwin*). It reveals a U-shaped pattern: *tortwin* declines steadily over the first 20 years of the data but rises in the last decade. The frequency with which claims are rejected based on the ELR rises in the 1970s and 1980s but falls after the mid-1990s.

There are various ways to establish the U shape more formally. One strategy is to use Locally Weighted Least Squares (Lowess) to fit the curve (Figure 4.2). We fit the Lowess curve over the 465 binary observations of *tortwin*. The trend curve is an amalgam of 465 linear regressions around each local point using a localized subset of the data. This smoothes the data and generates a trend curve.¹⁵

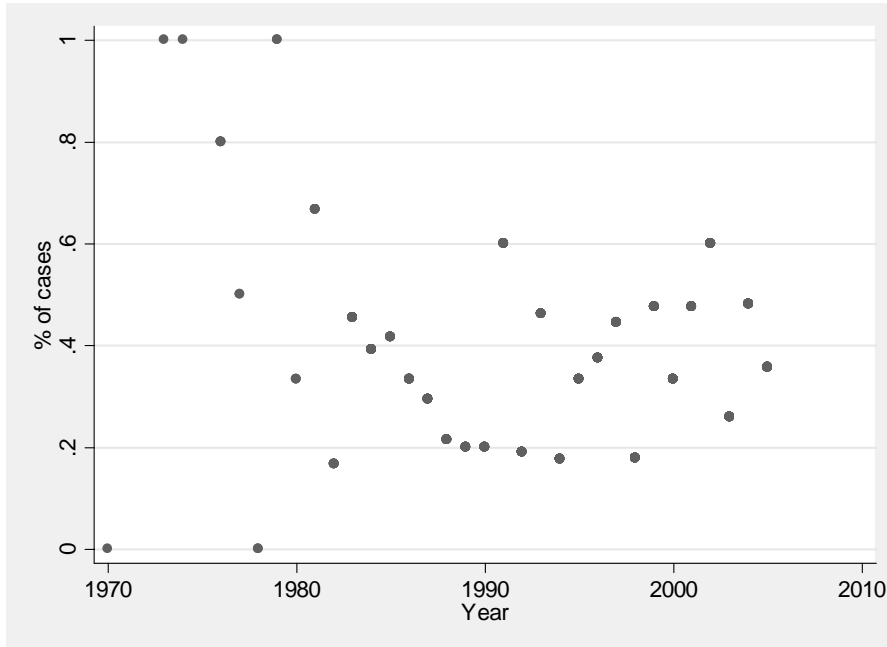


Figure 4.1: Percentage of plaintiff tort victories each year

The Lowess curve suggests that outcomes in our sample indeed follow a U-shaped curve over time, with the bottom *tortwin* rate of about 30% reached in the early 1990s. Thus, there has never been convergence on what we call the “strict” view of ELR—the view that it always bars the recovery of economic loss in tort.

One can obtain the same U shape with more restrictive models. A simple quadratic model fitting case outcomes over *time* and *time*² yields strongly significant

¹⁵ The smoothing parameter (referred to as bandwidth) is the proportion of all observations that each regression uses. The smaller the bandwidth, the coarser the trend line appears, since individual regressions are more localized. The default bandwidth for Lowess curves in STATA is 0.8 (meaning that each of the 465 regressions uses 372 observations), which we use throughout. The picture is similar with a bandwidth of 0.25, where each regression uses 116 observations.

results. The coefficient on *time* is -3.7966 with a *t*-statistic of -2.70. The coefficient on *time*² is 0.0009 with a *t*-statistic of 2.70. Both are significant at the 1% level. The quadratic best fit suggests that the turning point came in 1993.

We can also estimate linear regressions dividing the sample at various points in the late-1980s or early-1990s. These specifications yield a negative and statistically significant trend in *tortwin* in the earlier sub-sample and a positive and statistically significant trend in the later one (see Figure 4.3). This pattern, too, is inconsistent with either the average acceptance of, or even convergence to, the strict view of ELR.

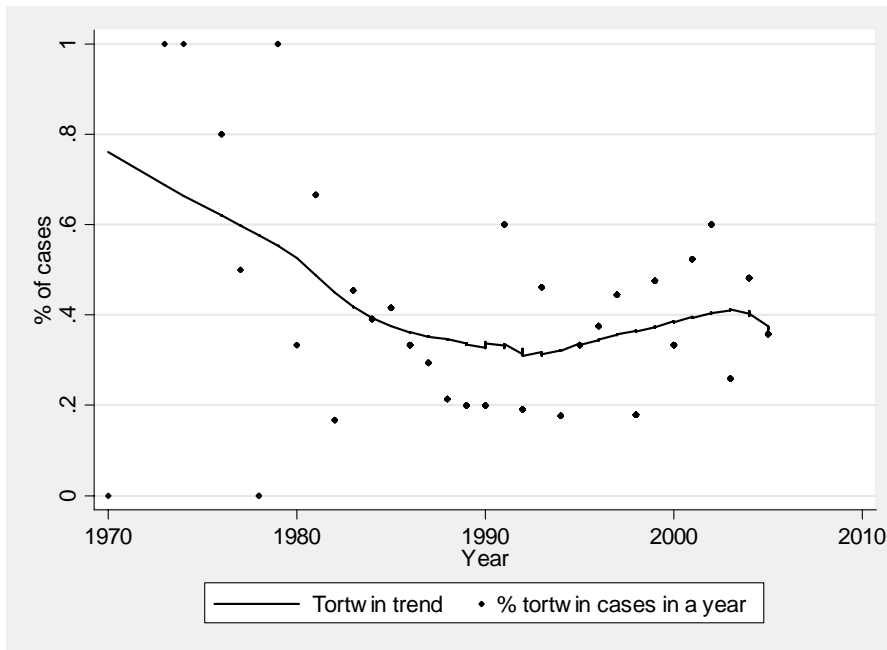


Figure 4.2: Trend of plaintiff victories in tort over time using Lowess estimation with a bandwidth of 0.8

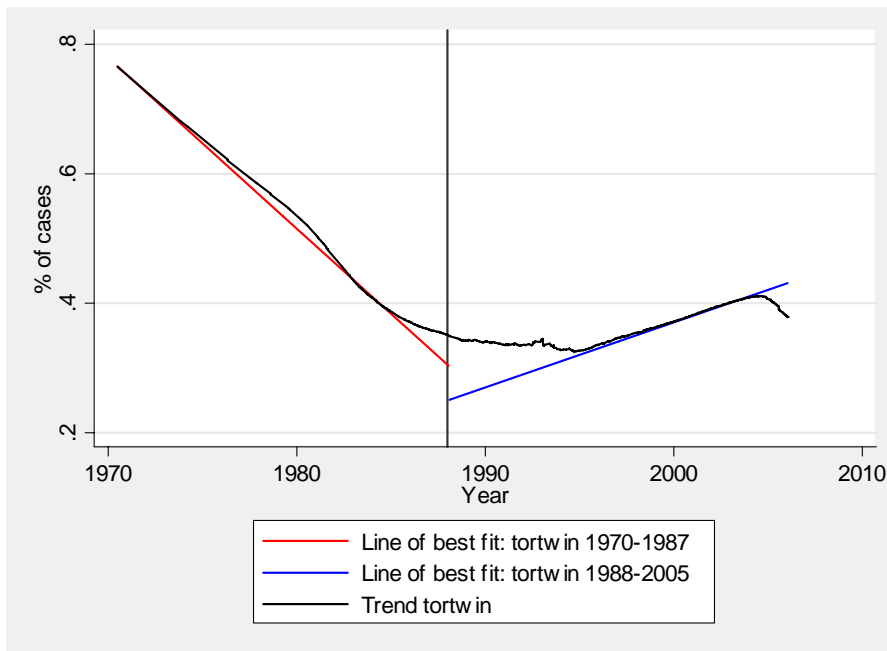


Figure 4.3: Graph illustrating the significance of the downward trend in *tortwin* from 1970 to 1987 ($t = -1.98$) and the upward trend from 1988 to 2005 ($t = 2.05$). The black trend line is the same lowess curve from Figure 4.2.

Figure 4.4 decomposes *tortwin* as a percentage of total cases into generally recognized and idiosyncratic exceptions. Both trend down in the 1970s and 1980s, except that the number of cases decided on the basis of generally recognized exceptions bottom out earlier, in the mid-1980s, at about 20% of all cases, and then begin rising gently (and not statistically significantly) in the mid 1990s to about 30% of all cases, with a decline at the end of the sample period back to 20%. Idiosyncratic exceptions fall until the mid-1990s, to about 10% of all cases – a remarkable testament to apparent convergence to the ELR with generally recognized exceptions – except that they then rise back to around 20% toward the end of the sample period. Both the downward trend before the mid-1990s and subsequent upward trend in idiosyncratic exceptions are significant (Figure 4.5).

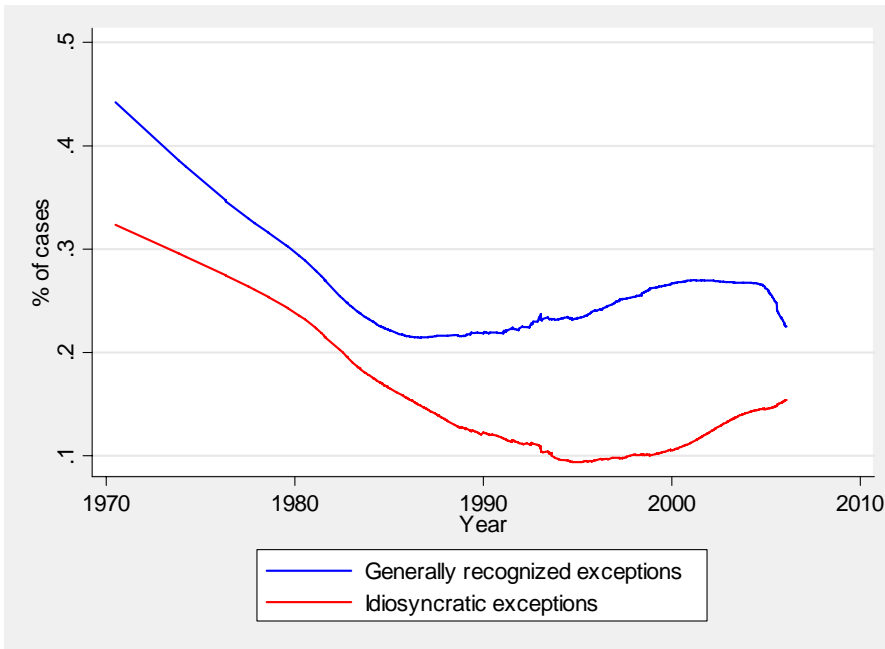


Figure 4.4: Percentage of all cases using generally recognized exceptions (blue) and idiosyncratic exceptions (red).

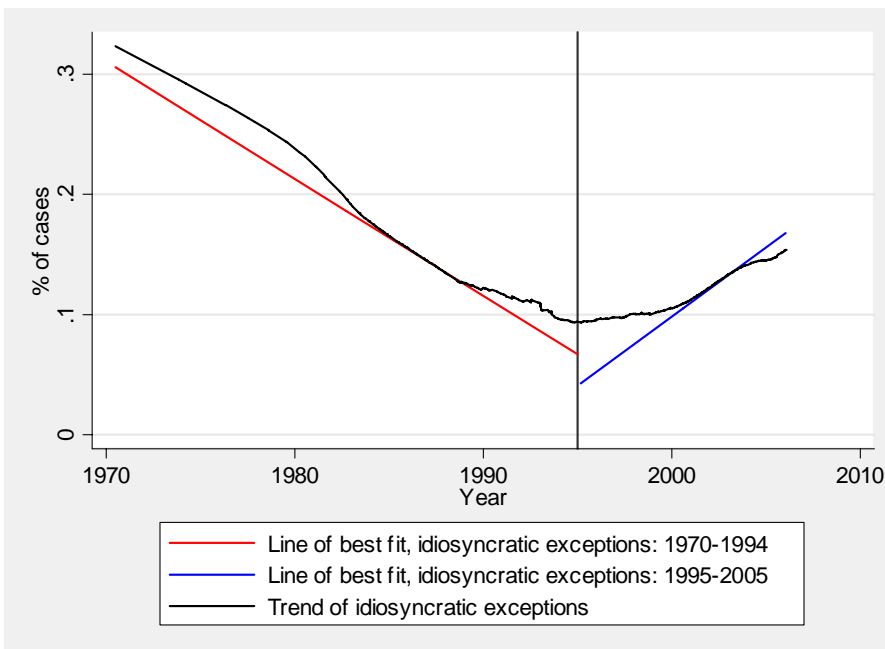


Figure 4.5: Graph demonstrating the significance of the downturn in idiosyncratic exceptions over the period 1970-1993 ($t = -2.02$), and the significance of the upturn in over the period 1994-2005 ($t = 1.83$). The black Lowess curve is the same trend as the red line illustrated in Figure 4.4.

The real story in these data seems to be the growth of idiosyncratic exceptions, both as a percentage of all cases and as a percentage of *tortwin* (see Figure 4.6), in the

last decade of the sample. We do not see convergence to ELR with generally recognized exceptions, and thus reject the middle version of the ELR's efficiency as well. Had this paper been written a decade ago, we would have concluded that the legal rule has converged to nearly universal acceptance of the ELR with generally recognized exceptions. The substantial and statistically significant growth in cases decided plaintiffs' favor by application of the idiosyncratic exceptions in the last decade of the sample precludes such a conclusion today.



Figure 4.6: Percentage of all *tortwin* cases that use idiosyncratic exceptions.

To study these trends in more detail, we next break up the outcome data to determine which exceptions the courts use to allow the plaintiff to avoid the ELR. Figure 4.7 shows the trend of the courts' use of each of the exceptions over time. The decline in plaintiff victories throughout the 1970s and 1980s comes mainly from a decrease in the number of cases in which plaintiffs are allowed to claim independent tort duties to them. Both cases involving generally recognized independent duties and cases involving

idiosyncratic independent duties fall significantly over this period.¹⁶ There is also a significant decline in cases involving independent torts until the mid-1990s.¹⁷

The increase in plaintiff victories from the mid-1990s onwards is harder to break down. While all the exceptions trend upwards, particularly the other property, independent torts, and idiosyncratic independent duty exceptions, none of them individually increases significantly.

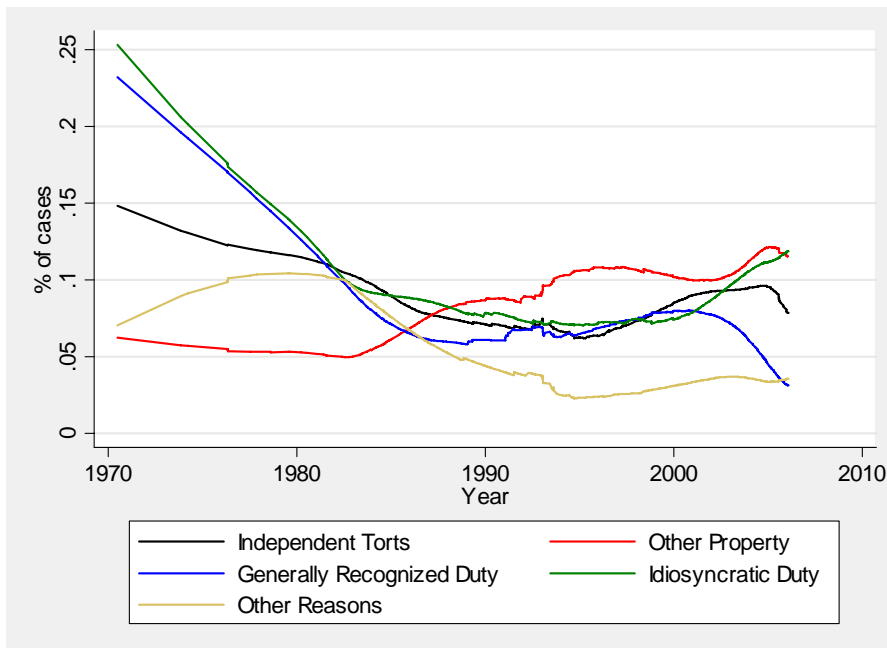


Figure 4.7: The breakdown of the incidence of exceptions over time.

Another way to look at the patterns is by focusing on dissents in judicial opinions; 55 of our 465 cases include at least one dissenting opinion. Overall there is no difference between the frequency of dissents in cases in which the ELR is upheld and in the cases in which an exception is made. But in cases in which the court relies on an exception that is idiosyncratic, the incidence of dissent is, as one would expect, significantly higher, as

¹⁶ For the sub-sample 1970 to 1992, generally recognized independent duties fall significantly: $t = -2.69$ (significant at 1% level). For the sub-sample 1970 to 1998, idiosyncratic independent duties fall significantly: $t = -2.12$ (significant at 5% level).

¹⁷ Over the sub-sample 1970 to 1995, independent torts fall significantly: $t = -2.27$ (significant at 5% level).

“idiosyncratic” implies that the law is unsettled. Of the 113 cases in which generally recognized exceptions were applied, only 10 (8.84%) included a dissent, while in the 57 cases in which idiosyncratic exceptions were applied, 11 cases (19.29%) included a dissent. This difference is significant at the 5% level ($t = -1.97$).

A look at the frequency of dissents over time yields additional insights. As Figure 4.8 shows, there is a significant downward trend in dissents in cases in which the ELR is used to defeat recovery.¹⁸ In other words, when the majority enforces the ELR as a bar to recovery, the presence of opposing voices is diminishing. Dissents in the cases in which exceptions are applied exhibit no statistically significant trends. Thus suggests that courts are continuing to struggle with the exceptions to the ELR.

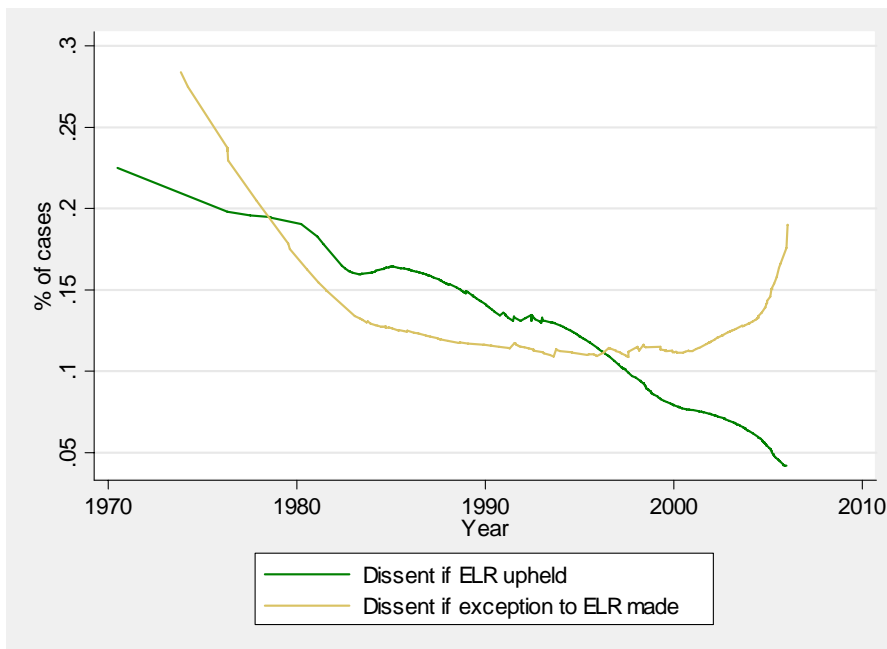


Figure 4.8: Incidence of dissents in cases where the ELR is applied and cases where exceptions are made.

Predictability

¹⁸ Coefficient = -0.00544 ($t = -2.14$).

Parties to a construction-related transaction who are deciding whether to write a contract and if so what to put in it are interested in what a court would do should they have a dispute. Courts might be predictable but still use inefficient rules, which would induce the parties to contract more carefully or take some other measure to minimize the likelihood of getting involved in litigation—all at a cost. If courts are unpredictable, transacting parties will bear an extra cost in the form of uncertainty about the outcome of any dispute that might arise—an uncertainty that a contract (or a more complete contract) would reduce provided the judicial interpretation of contracts is more predictable than the judicial application of the ELR.

Determining whether judicial behavior is predictable in this situation is difficult for us for a number of reasons. First, we do not have all the details of the transactions involved in the cases, and the contracting parties and even the courts know more about those details than the authors of a statistical study can know. Second, predictability depends on when the transaction took place and in what jurisdiction. Third, from the point of view of predictability, we have a highly unrepresentative sample, as it is limited to disputes that went all the way to state appellate courts, indicating that the parties' views of the facts and the law were so different that they could not settle the case.

Still, we can ask, as a start, how predictable the courts are if parties have our full data sample in their heads and believe that courts apply the ELR subject only to generally recognized exceptions. Parties with this knowledge and belief would be correct nearly 88% of the time. The predictability of the rule does not change significantly even if the parties have additional information, such as the state whose courts would resolve the

dispute and the type of plaintiff and defendant that they are.¹⁹ Predictability was much lower at the beginning of the sample, with many fewer cases to base predictions on. That is inevitable at the outset of any common law doctrinal development. More disturbing is that idiosyncratic exceptions were on the rise toward the end of our sample period.

In short, judicial behavior with regard to the application of the ELR in the construction industry is fairly predictable but far from certain. Parties expecting courts to apply the ELR with generally recognized exceptions in the event of a dispute to which the ELR might be applicable are in for a surprise about 12% of the time. We cannot say based on our data how much extra risk-bearing and contracting costs this level of unpredictability entails.

Summary

The story that emerges from the trends we analyze does not confirm any simple theory of the evolution of common law. The law does not start at an efficient point, but it is also very far from being random. The majority of the appellate courts in our sample accept the ELR, and when they do not, they often rely on generally recognized exceptions. Judicial behavior is fairly predictable, but far from certain.

The evolution of the law over time reveals some fascinating patterns. The initial twenty years after the *Seely* decision, the case that set the law on its modern path, are best described as years of growing acceptance of the ELR, with declining application of either

¹⁹ We run a probit regression of the rule being used on case facts, such as state, plaintiff type, defendant type. We predict when a court will use an idiosyncratic exception using this factor-based approach and note that the additional facts do not generate any additional predictive value. This factor-based approach and its extensions have been used by political scientists (e.g., Segal 1984, Richards and Kritzer 2002) to investigate the predictability of (mostly U.S. Supreme Court) case outcomes rather than the predictability of the application of a particular legal rule. See also Cameron and Kornhauser (2005) for a discussion of theoretical issues with this literature.

generally recognized or idiosyncratic exceptions. In the final decade of the sample, however, courts moved away from strict application of the ELR as a result of more frequently invoking some of the generally recognized exceptions, such as the independent tort and other property exceptions, and – more surprisingly – some of the idiosyncratic exceptions as well. The data reveal no convergence to any rule, let alone an efficient rule under either of our candidate definitions of efficiency.

As we noted in the introduction, we cannot reject the view that judicial decisions are efficient if we adopt a sufficiently broad definition of efficiency, one that allows for the possibility that the law and the facts are more complicated than one can learn from reading a judicial opinion. Perhaps if all were known, the cases would be understood to produce efficient outcomes in a larger percentage of cases. But although there are dissents in only about one-eighth of the cases, these dissents are much more frequent when idiosyncratic exceptions are applied, which casts some doubt on the hypothesis that those decisions would be seen as efficient if only enough details were known about them.

So what is behind the time patterns we observe: both the convergence toward the ELR in the first 20 years of the sample and the movement away from it afterwards? In the next section we address this question from different perspectives.

V. Behind the Patterns.

We try to deepen our understanding of the patterns uncovered in section IV by examining five aspects of the evolution of the ELR in the construction industry. First, we examine the claims that plaintiffs make in our sample and ask whether changes in those claims can explain the patterns of court decisions. In a decentralized world of legal

evolution, plaintiffs would try new strategies when they found barriers to recovery with old ones. Perhaps the movement away from the ELR in later years reflects such adaptation, as plaintiffs discover or invent claims to which courts are more receptive.

Second, we examine whether the application of the ELR is influenced by the existence of an explicit contract between the parties. Because the presence of such a contract indicates that the parties considered the various risks of their relationship, courts may be more likely to apply the ELR to tort claims when litigants have a contract.

Third, we investigate the relative economic power of the plaintiff and defendant. Judges' sympathy for weaker parties may help explain deviations from the ELR in cases in which plaintiffs have less economic power than the defendants.

Fourth, we examine court leadership. In 1986 the U.S. Supreme Court issued a decision in an admiralty case, *East River*,²⁰ which broadly endorsed the ELR. Although *East River* is far away from construction and is not binding on state courts applying state law, we can ask whether the decision influenced the state courts in construction cases.

Fifth, we examine state variation in decisions. We ask whether the lack of convergence to the ELR is explained by the fact that in many states there are very few appellate cases involving ELR in construction. Perhaps it is those states that account for lack of convergence in the aggregate. By looking at the states with the highest caseloads, we can ask whether those states exhibit a greater tendency to convergence.

Claims

Figure 5.1 shows that the proportion of cases in which the plaintiff claims negligence has been falling (statistically significantly) since the mid-1980s. While claims

²⁰ *East River S.S. Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858 (1986).

of strict liability have also trended downward since the start of our sample, the trend is significant only over certain periods. As the ELR becomes increasingly accepted, plaintiffs are using types of claim less likely to be barred by it. The increase in claims of fraud is mildly significant since the early 1980s, while the increase in claims of negligent misrepresentation over the same period is strongly significant.²¹ The increase in claims for “other torts” is significant over the course of our entire sample.²² We get very similar results if we look at the claims relative to *tortwin* cases rather than relative to all cases.

The change in the nature of plaintiff claims can explain some of the rise in *tortwins*. Put simply, plaintiffs claim fraud and courts are receptive. However, the changes in claims do not help explain the rise in idiosyncratic exceptions.

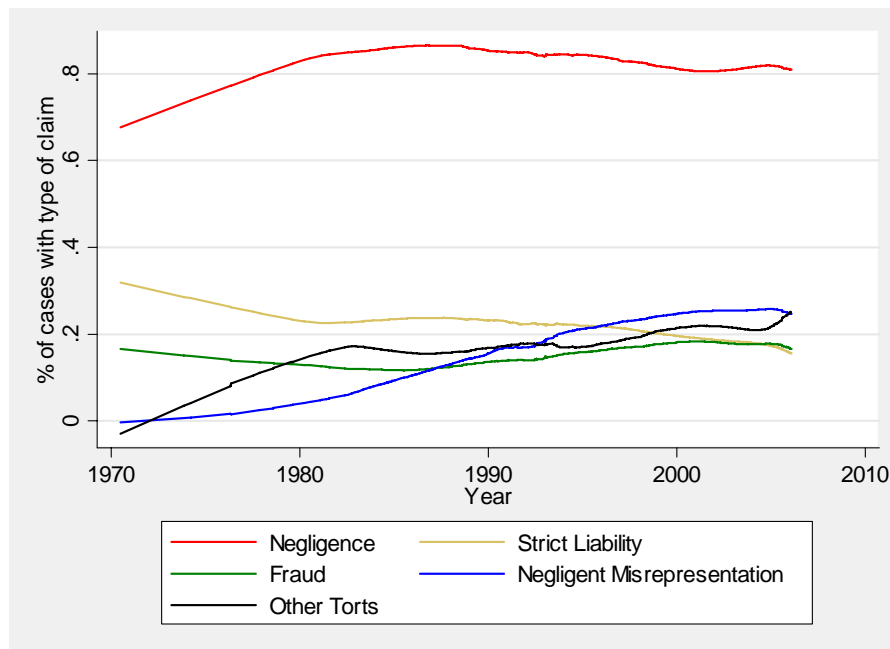


Figure 5.1: Trends in claims made by plaintiffs.

ELR and the Contractual Relationship between Parties

²¹ Over 1983-2005, the trend for fraud is positive and significant at the 10% level ($t = 1.92$). In the same period, the trend for negligent misrepresentation claims is positive and significant at the 1% level ($t = 2.93$).

²² From 1970 to 2005, the trend for “other torts” is positive and significant at the 10% level ($t = 1.78$).

We consider whether judicial application of the ELR depends on whether the parties have an express *written* contract – thus excluding oral contracts, implied warranties, and contractual rights as a third-party beneficiary of someone else’s contracts. If the courts want to promote efficiency, they may be more willing to apply the ELR when the parties have gone to the trouble of defining their relationship in a contract. *Seely* itself may be an example of such logic.

In Table 5.1 the percentage of *tortwin* is greater when plaintiffs do not have an express written contract, although the difference is not quite significant ($t = 1.53$). And courts are significantly more likely to rely on idiosyncratic exceptions when the parties do not have a contract ($t = 1.95$). Courts in effect “make” a contract for the plaintiff when there is no actual contract between the parties, rather than being willing to penalize the plaintiff for having failed to negotiate a contract that would have protected him from the loss that he is suing to recover.

	Cases	Tortwin%	Idiosyncratic%
Parties did <u>not</u> have an express written contract	288	39.27%	14.58%
Parties did have an express written contract	177	32.20%	8.47%

Table 5.1: Breakdown of *tortwin* and incidence of idiosyncratic exceptions depending on whether parties had an express written contract.

If courts are moving toward efficiency, the *tortwin* percentage in cases in which parties have an express written contract should fall over time. The data in Figure 5.2 do not support this hypothesis. Both *tortwin* and the use of idiosyncratic exceptions rise significantly after 1997. (The initial downward trend is not significant.) Courts are becoming *more willing* to allow exceptions to the ELR when the parties have a contract, and more willing to allow idiosyncratic exceptions.

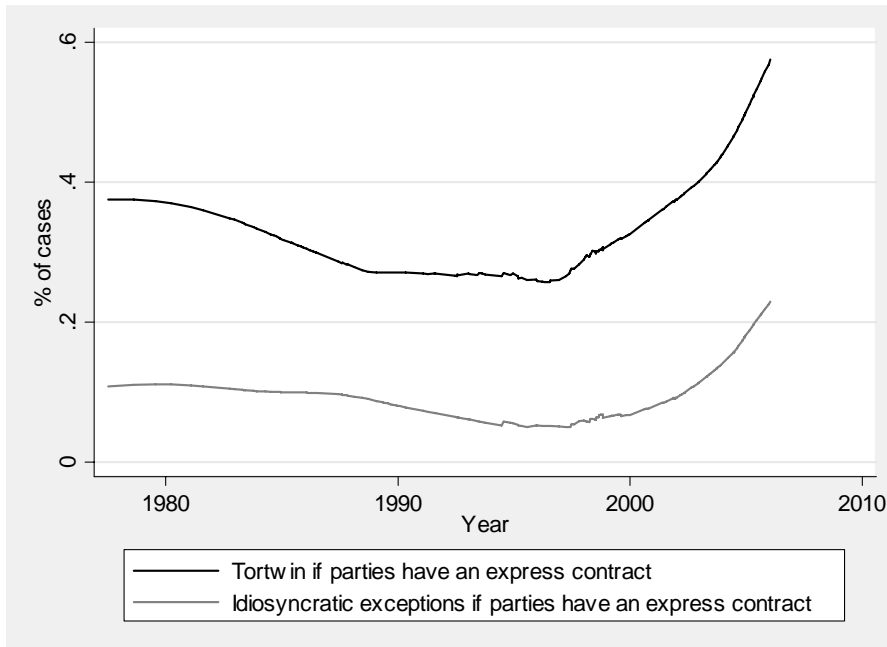


Figure 5.2: *Tortwin* and incidence of idiosyncratic exceptions when examining only the 177 cases where parties have an express contract.

We can further investigate whether success in tort and contract are substitutes or complements in the 291 cases in which plaintiffs claim both tort and breach of contract. Table 5.3 reveals positive correlation (0.2316) between *tortwin* and winning in contract ($t = 4.11$). And there is no statistical difference in the use of idiosyncratic exceptions when plaintiffs win and when plaintiffs lose their contract claims ($t = 0.99$).

	Cases	Tortwin %	Idiosyncratic %
Plaintiff won contract claim	106	45.28%	12.26%
Plaintiff lost contract claim	185	22.70%	8.65%

Table 5.3: Breakdown of *tortwin* and incidence of idiosyncratic exceptions depending on whether plaintiffs won their contract claim.

The focus on the contractual relationship casts further doubt on the hypothesis that the law is converging toward an efficient rule. Although the hypothesis that judges favor defendants who were in a contractual relationship with the plaintiff is weakly supported, the fact that outcomes in tort and in contract are positively correlated suggests that courts are allowing exceptions to the ELR even when claims in contract are valid.

The trends in *tortwin* and in the application idiosyncratic exceptions also suggest that courts increasingly are allowing plaintiffs to recover in tort even when they have an express written contract with the defendant.

Relative Economic Power of the Parties

We now examine the hypothesis that the relative economic power of plaintiff and defendant affects the courts’ application of the ELR. Table 5.4 divides parties into two groups that provide us with a rough proxy for economic power.

Weak parties	Strong parties
<ul style="list-style-type: none"> • Individual property owners and tenants • Associations of residents • Subcontractors and small builders 	<ul style="list-style-type: none"> • Commercial property owners • Public property owners • General contractors • Developers • Architects and engineers • Inspectors • Manufacturers • Suppliers • Other parties (banks, insurance companies, real estate agents)

Table 5.4: Broad division of parties into “weak” and “strong”.

Table 5.5 shows the rate of plaintiff recovery and the incidence of idiosyncratic exceptions for the four types of plaintiff-defendant combinations.

Relationship	Cases (%)	Tortwin %	Idiosyncratic %
Weak plaintiff – weak defendant	73 (15.70%)	43.86%	12.33%
Weak plaintiff – strong defendant	154 (33.12%)	37.66%	17.53%
Strong plaintiff – weak defendant	35 (7.53%)	34.29%	17.14%
Strong plaintiff – strong defendant	203 (43.66%)	33.50%	7.39%

Table 5.5: Breakdown of *tortwin* and incidence of idiosyncratic exceptions by relative economic power of the parties.

There is no statistically significant difference between the groups in *tortwin* percentages. Courts are more likely to apply an idiosyncratic exception when facing a weak plaintiff and strong defendant (17.53% of cases) compared to when both parties are

strong (7.39% of cases). This difference is highly significant ($t = -2.97$). However, the application of idiosyncratic exceptions is also higher when courts face a strong plaintiff and weak defendant (17.14%) than when both parties are strong ($t = -1.89$). No other differences are significant. This evidence offers mild support for the idea that sympathy moves courts to use idiosyncratic exceptions to help weak plaintiffs.

The Potential Effect of the U.S. Supreme Court's Decision in East River

In *East River* (1986) the Court endorsed bright-line ELR. A plaintiff shipbuilder had a contract with the defendant to design, manufacture, and install turbines for four supertankers. The ships malfunctioned and were damaged, and the plaintiff sought to recover the costs of repair, plus income lost while the ships were out of service. The plaintiff initially made claims in both contract and tort; but the contract claims turned out to be barred by the statute of limitations. The negligence claims were rejected by the Supreme Court, which held that customer dissatisfaction with product quality is not a cognizable claim in admiralty tort law. Following the reasoning in *Seely*, the Court held that such claims can be brought only as claims for breach of warranty.

Although the *East River* decision was not binding on state courts, we examine whether it had a significant influence on those courts in the construction realm. Influence is difficult to ascertain here, since, as we showed in Section IV, *tortwin* had been trending down for at least a decade before *East River* and bottomed out in the early 1990s. We find no effect of *East River* on the speed of convergence.

Another way to assess influence is by number of citations. Since *East River* denies recovery, we expect that state court decisions that cite *East River* are likely to

deny liability. Indeed, 52 of the 68 cases (76.47%) in our sample that cite *East River* deny the plaintiff recovery, while only 196 of the 314 cases since *East River* that do not cite the case deny recovery (62.42%). This difference is significant (t -test statistic = 2.21). Still, one needs to be cautious: cases that cite *East River* may do so as cover, trading on the prestige of the Supreme Court, whereas cases that do not cite *East River* can justify not citing it on the ground that an admiralty case is irrelevant to construction disputes. If this explanation is correct, the citation evidence yields some support for the “legal realist” hypothesis that state courts do what they want and use citations to provide rhetorical support for their conclusions.

While *East River* may have had some influence in consolidating support for the ELR, the proportion of cases citing *East River* has fallen since the early 1990s. This trend is significant ($t = -2.24$ for years 1990-2005). We cannot conclude from our data that the U.S. Supreme Court has had a major influence on the state courts’ treatment of ELR, at least in the construction industry.

Variation across States

There is tremendous variation in *tortwin* across states. Kentucky has 100% *tortwin*; Wyoming, Kansas, Virginia, and Maine have 0% *tortwin*. We ask whether *tortwin* can be explained by geographical or economic differences; the answer appears to be no.²³ We ask whether the differences in *tortwin* can be explained by the methods in which judges are selected and retained that different states employ, and again the answer

²³ Testing for differences in *tortwin* across regions does not provide any notable patterns. Testing for differences based on levels of economic growth in each state from 1970 to 2005 generates insignificant results; and testing for differences based on growth in the construction industry in each state from 1970 to 2005 also yields insignificant results.

is no.²⁴ Nor can differences in *tortwin* be explained by differences among judges in political ideology.²⁵

Some states have fewer cases than others, and perhaps states with the highest caseloads, which have had the most experience with the ELR, have more respect for the doctrine. To examine this hypothesis, we focus on the five states with the highest caseloads in our sample. In these states, *tortwin* percentage varies greatly (see Table 5.6). New York is very strict on plaintiffs, with a mere 15.91% *tortwin*, while California is far more lenient, with a 52.94% *tortwin*. High caseload does not explain greater adherence to the ELR: *tortwin* is not significantly affected by the number of cases decided in a state ($t = -1.22$).

STATE	Total cases	<i>Tortwin</i>	% <i>tortwin</i>	Idiosyncratic	Idiosyncratic%
CA	34	18	52.94	3	8.82
FL	47	19	40.43	3	6.38
OH	32	12	37.50	2	6.25
IL	56	18	32.14	4	7.14
NY	44	7	15.91	2	4.55
Total	213	139	34.74	14	6.57

Table 5.6: *Tortwin* and use of exceptions in five states with highest caseloads

Not only do the averages differ greatly across the five busiest states; so do the trends (Figure 5.3). The percentage of *tortwin* in California is high on average but significantly decreasing over time ($t = -2.62$). In contrast, *tortwin* in New York and

²⁴ States differ in the method by which judges ascend to the bench and in the way they are retained. We investigate whether this has any effect on the application of the ELR and its exceptions. We use the categories employed in Choi, Gulati, and E. Posner (2007) to divide states into four types of judicial selection method (appointed, merit-selected, partisan election or nonpartisan elections). The methods by which judges are retained are highly correlated with selection method. The differences in *tortwin* across states of different judicial selection methods are not significant.

²⁵ Using a simple measure of party-adjusted surrogate judicial ideology (“PAJID”) from Brace, Langer, and Hall (2000), we test whether the ideology of the Supreme Court judges in a given state can help explain the variation in *tortwin* across states. In the cases in which the court upheld the ELR to preclude recovery, the average PAJID score was 47.20. In *tortwin* cases, the average PAJID score was 47.46. The difference is not significant ($t = 0.1817$).

Illinois is considerably lower but growing. In Florida, the increase in the frequency of *tortwin* since the early 1980s is extremely significant ($t = 3.49$).

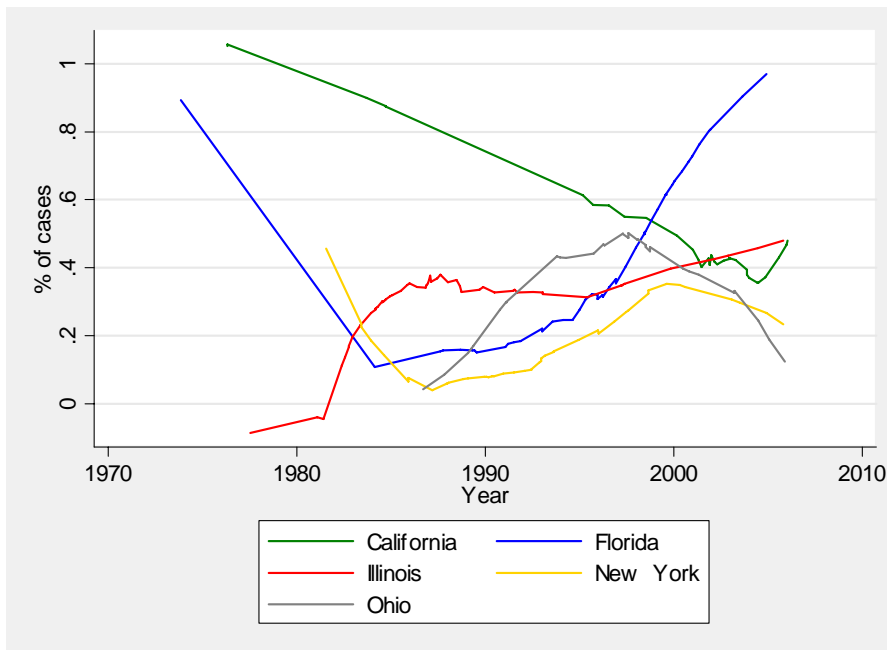


Figure 5.3: *Tortwin* over time in the five states with the highest caseloads

Unlike the overall *tortwin* pattern, the proportion of cases that apply exceptions that are idiosyncratic is influenced by caseload. This inverse relation is significant ($t = -2.85$) and is illustrated in Figure 5.4. The implication is that idiosyncratic exceptions are more likely to be introduced when courts have less of their own experience in this area. This hypothesis is supported by a comparison of the first 10 decisions heard in each state with the subsequent decisions in those states (if the state hears at least 10 cases). 15.81% of the “early” cases in these states applied exceptions that are idiosyncratic, compared to just 8.02% of the “later” cases. This difference is significant ($t = -2.56$).

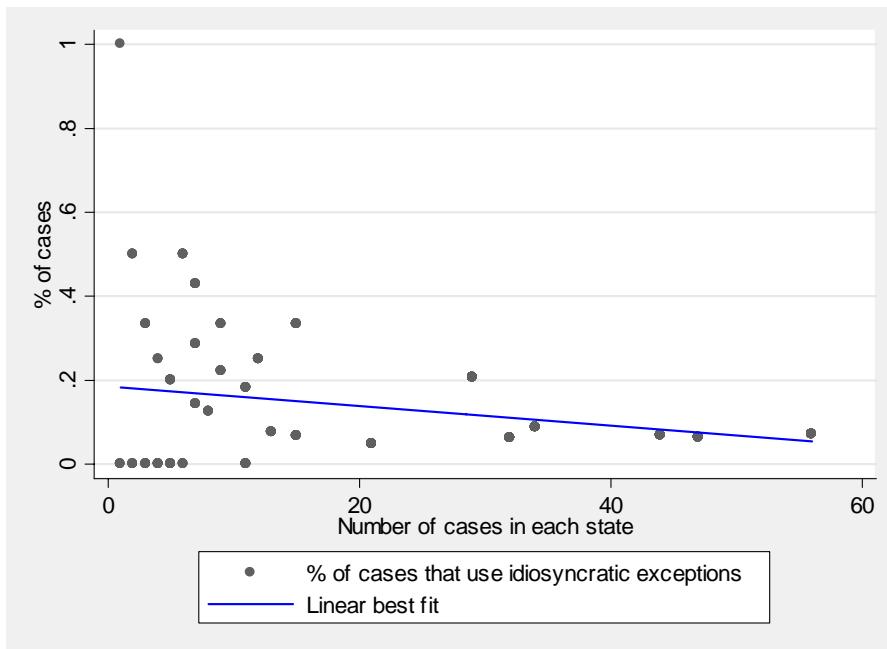


Figure 5.4: Percentage of cases that use idiosyncratic exceptions regressed on the number of cases in a state ($t = -2.85$).

The punch line of this analysis is that low state caseloads might offer an explanation for why we have not seen stronger convergence to the ELR, and more specifically why we have seen an increase in the use of idiosyncratic exceptions in the past decade. Although the ELR is quite widely accepted, the law does not come to a rest, and states continue experimentation, often in ways inconsistent with the ELR and its generally recognized exceptions. Experience slows this experimentation down, as one would expect, but not completely.

The increase in the application of idiosyncratic exceptions is not limited to states with low caseloads. In fact, 76% of idiosyncratic exception cases since 1997 have come from states with 10 or more cases. Wisconsin (the state with the sixth highest caseload) has seen a sharp rise in cases decided by the application of idiosyncratic exceptions. Four of the five largest states have all used an idiosyncratic exception in the last six years of

our sample. Thus, even in busy states we see an increasing tendency of courts to get around the ELR.

VI. Conclusion.

Our investigation of the application of the Economic Loss Rule to construction disputes yields some surprising results. Over the 35 years covered by our study, the doctrine has evolved in a way that cannot be easily described as convergence to efficiency. While over the first quarter century the law moved significantly toward adopting the ELR with generally recognized exceptions, over the last decade it has moved away from this equilibrium. Had we written this paper 10 years ago, we would have found the law converging to ELR with generally recognized exceptions, but the law moved away from that rule afterwards, with no changes in the economic environment to explain the movement. Moreover, the law evolved very differently in different states, which is inconsistent with efficiency in the absence of an economic explanation for the differences among states in the nature of construction disputes.

The lack of full convergence does not mean that judicial behavior is random or that the law is entirely unpredictable. On average in our sample, courts in construction disputes applied the ELR with generally recognized exceptions about 88% of the time, which would give the parties engaged in a transaction in which a potential ELR issue lurked reasonable though not complete certainty. The more unsettling findings are that the law has become less predictable in the last decade, that many states are increasingly using idiosyncratic exceptions to limit the ELR, and that the amount of appellate

litigation involving ELR in construction disputes is growing. These are not signs of the law settling down.

Some additional evidence sheds light on how legal evolution works. Plaintiffs' claims respond to what courts are receptive to, such as claims of fraud. But that is not the whole story. The key reason for non-convergence is that courts distinguish cases and create idiosyncratic exceptions to the prevailing legal doctrine that other courts reject. In the last decade covered by our study, courts increasingly used such exceptions even when the parties had express contracts.

Idiosyncratic exceptions differ across states, with many states going in their own direction with regard to what exceptions they recognize or create. State courts at first responded to a nonbinding 1986 U.S. Supreme Court ruling embracing the bright-line ELR in an admiralty case, but this influence declined over time. There is evidence that state courts with heavier caseloads in this area of litigation are more likely to converge to the adoption of the ELR with generally recognized exceptions, but even in those states there is residual uncertainty.

We conclude that appellate courts exercise a moderate amount of discretion in deciding cases, leaving the law reasonably predictable but far from certain, even after three decades of evolution. The deviations from efficiency are not huge, but they do not disappear over time. There may be evolutionary benefits of such legal flexibility, but the hypothesis that, in traditional commercial areas, common law is predictable and efficient, or at least is moving there, is not supported by the evidence in this very particular sphere.

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Appendix: Construction of the Database

All data are obtained from the *LexisNexis* “Construction” library. To find the cases, we searched the library for state appeals court cases decided prior to December 31, 2005, that satisfy the following criteria: (1) the phrase “economic loss” is found in either the *Overview* or the *Core Terms*; and (2) any of the following terms—“contract!”, “agree!”, or “warrant!”—are found in the *Overview* or the *Core Terms*. The *Overview* is a summary of the case of approximately 150 to 200 words. The *Core Terms* is a list of 30 to 50 key terms that appear in the decision. This search strategy captures all state appeals cases from the construction industry where the ELR defense is raised by defense lawyers. No issue of different coverage periods for different states arises in our sample period.

This search yielded 1171 cases. Of these, 209 were not appellate cases and so were dropped, and another 4 were not from state courts. Another 496 cases were excluded as irrelevant because the *LexisNexis* Construction library turns out to include cases that do not pertain to construction. In 50 cases, more than one dispute is addressed on appeal. For example, a plaintiff may bring claims against the general contractor and subcontractors in one case. When the plaintiff brings different claims against the two defendants and both claims are being heard on appeal, we divide the case into two distinct observations. When the plaintiff brings claims against multiple defendants but the appeal addresses only one of them, it is left as one observation. We have 46 cases that give rise to 2 observations and 4 cases that give rise to 3 observations; the other 412 cases involve single claims decided on appeal. Of the 516 individual disputes thus coded, 37 do not involve tort claims and another 14 involve tort claims that were not appealed. After removing these 51 disputes, we have the sample of 465 observations.