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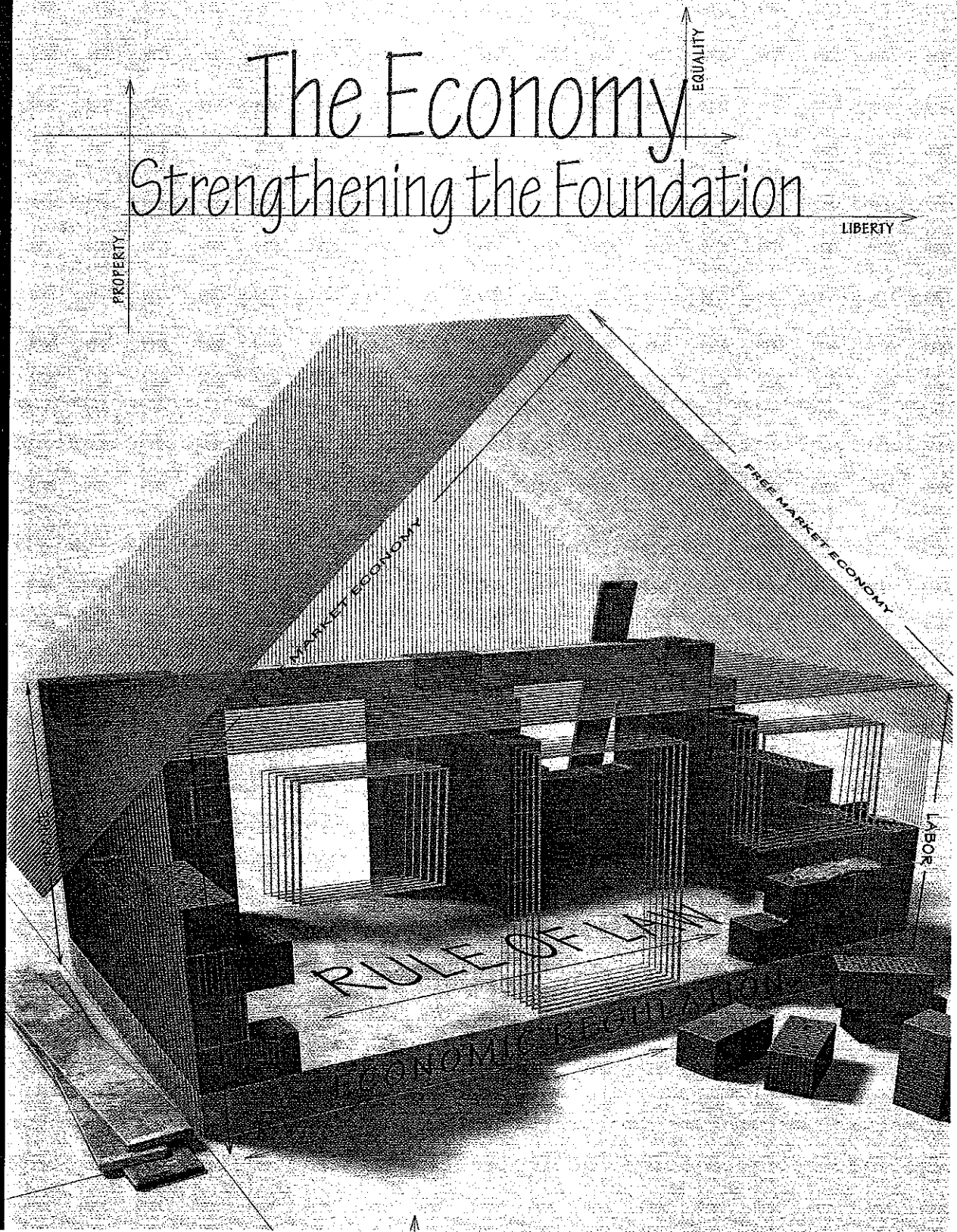
The Economy
Strengthening the Foundation



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INTRODUCTION

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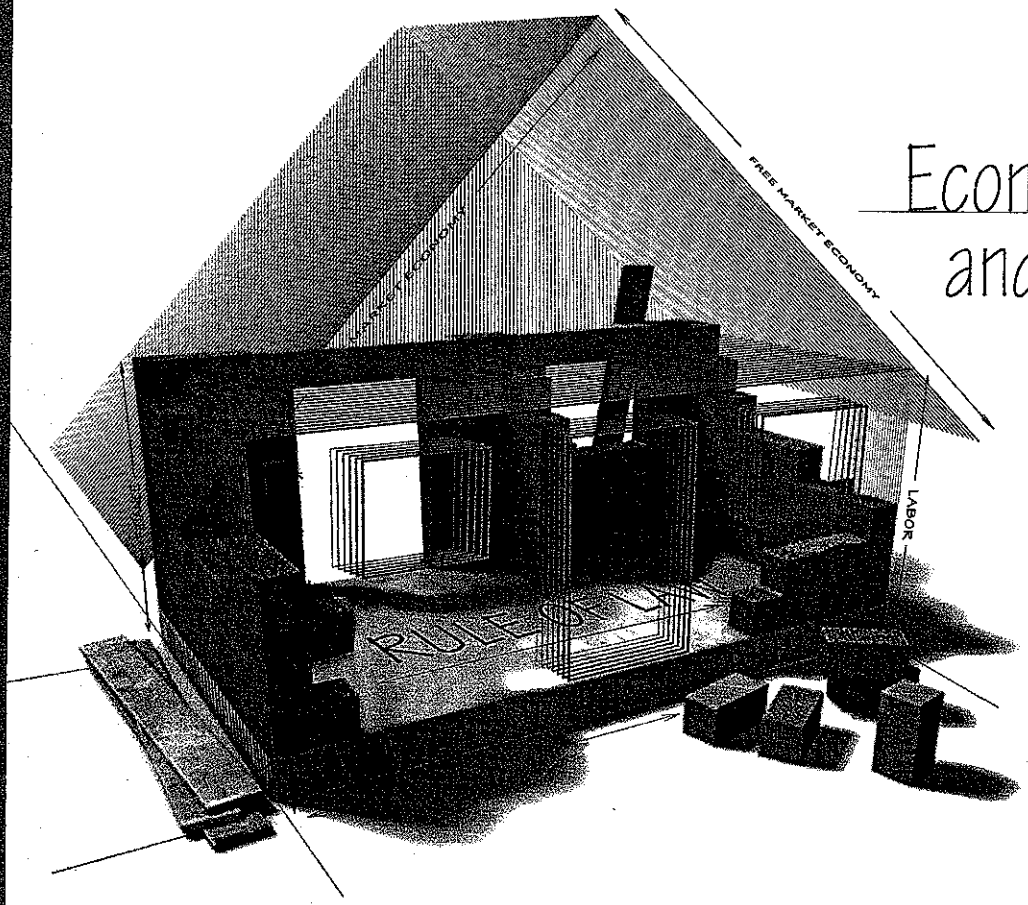


Economic Regulation and the Rule of Law

Minimum Standards for the Legal Framework of a Free and Democratic Society

By Joseph William Singer

The subprime mortgage crisis has plunged the United States into a recession worse than any seen since the Great Depression. How did this happen? The causes are complex, but it seems clear that we got into this mess partly because of failures by market actors and partly because of inadequate regulation. We focused so much on the benefits of deregulation of credit markets that we forgot the ways in which markets can fail. Those failures had enormous effects. Market actors created packages of property rights that lacked both transparency and inherent security. When the housing bubble burst, the negative external effects of these unstable property rights were enormous; the lack of appropriate regulation of these markets has wrecked the world economy.

Markets, Regulation, and the Judicial Role

What does this mean for judges? Judges need to understand the mutually necessary relationship between markets and regulation. This insight should affect the way judges interpret statutes and regulations, as well as the common law rules of contract, tort, and property. The traditional approach assumes that less government is better; small government appears to promote both freedom and economic efficiency. This way of looking at the issue places the burden of persuasion on those who seek to regulate markets. But as the current crisis shows, we will have neither freedom nor efficiency without appropriate government regulation of markets. Markets are structured by law and they need regulation to function effectively. In important classes of cases, limitations on both contractual terms and allowable packages of property rights are necessary to ensure that market relationships promote human interests rather than building a house of cards whose collapse sweeps the ground from under our feet. The house we live in (the market economy) is one built on a regulatory foundation—a foundation without which it cannot function.

How Law Promotes Liberty

It is a commonplace that freedom without law is not liberty, but it is not so well understood that the free market needs a legal structure. That structure is created by regulations that determine the allocation of property rights and the rules under which market transactions occur. "Free markets" need rules; this means that liberty is not possible without regulation. Paradoxically, the liberty we experience in the private sphere is only possible because of the regulation we impose in the public sphere. Indeed, it is fair to say that when we talk about liberty, what we are talking about is the benefits of living within a just regulatory structure.

This may seem paradoxical. After all, most people would agree that a free society needs law, but the claim that there is no liberty without regulation is likely to raise objections; to many, that formulation is jarring or even nonsensical. For some deep reason, people like the idea of law but they shudder at the idea of being regulated. Maybe when we think of law we focus on the security it provides us, but when we think of regulation we focus on the ways it limits our freedom of action. Of course, we only get security by limiting freedom of action, and if we think we can get the benefits of law without the costs of regulation, then we are deluding ourselves.

The observation that liberty requires regulation is neither trivial nor radical. It is, however, an insight that is both important and very easy to forget. Consider the way we frame legal questions about the market. When we imagine ways to respond to social problems, we tend to distinguish

"market solutions" from "regulatory solutions." We ask: "When should the law interfere with the free market?" or "Why limit freedom of contract?"

When we frame our questions this way, we characterize regulations as constraints on liberty. If we define liberty as negative liberty or complete freedom from any external constraint, then there are no apparent limits on the kinds of arrangements that are socially acceptable. This seems attractive only if you do not think about it too deeply, and Thomas Hobbes explained why: without law we have the war of all against all and that makes life "solitary, poore, nasty, brutish, and short." In reality, states that lack the effective rule of law are not paradises; rather, they are war zones like Iraq and Somalia. For the concept of liberty to be meaningful, we need regulations designed to ensure peace and tranquility. In other words, the liberty we care about includes just laws.

The Legal Structure of the "Free" Market

The legal realists taught us that this truth is also true about the market. The free market is not the war of all against all; it is a zone of social life structured by law. The free market operates against a backdrop of regulation—regulations we too often take for granted. Indeed, the legal realists taught us that the market simply *is* a regulatory structure. Our regulations, both statutory and common law, shape the house that we live in, and the liberty that we value comes from having built that house and the environment around it. And the character of those background regulations matters enormously; they determine the shape of our social world and the character of our economic relationships.

Viewed this way, our aversion to the regulatory state looks less and less rational. We talk about regulating the market as if every regulation reduces our freedom. We do this despite the fact that our actual, working conception of freedom includes the benefits of regulation. Is there a way to frame the way we talk about market regulation in a manner that acknowledges the legal realist insight that regulation is not only part of the rule of law but often promotes liberty?

The answer is yes. We should reframe the way we think about the relation between liberty and regulation in a manner that is better attuned to the values we actually hold as a society. Instead of assuming that all regulations limit liberty, we should recognize that all economic activity and all contracts are subject to regulations that set minimum standards for economic and social relationships. Some of those minimum standards regulations merely set rules of the road, others protect consumers from being defrauded or injured by defective products and practices, while still others such as fair housing laws define the contours of our way of life. These regulations do not limit our liberty; rather they enact minimum standards for legal relationships in a free and democratic society.

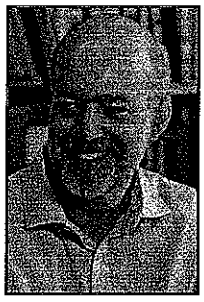
The Free Market Model

Free market advocates sometimes do not appreciate the importance of regulation in a free society. The libertarian model of the free market assumes that people should be free to make any agreements they wish. Limitations on freedom of contract prevent people from satisfying their preferences and reaching mutually advantageous deals. In so doing, regulations appear both to interfere with individual autonomy and to inhibit economic efficiency. Mandatory terms in contracts are especially suspect from this standpoint because they induce contracting parties who do not want those terms to react by bargaining about other terms, increasing the cost charged for services or providing or buying fewer services—all of which may make one or more parties worse off in their own terms than they would be in the absence of the regulation. By interfering with the terms that the parties would have agreed to in the absence of regulation, regulations are thought to reduce the joint welfare of the parties while preventing them from acting as they please. In this view, mandatory terms should only exist to prevent the contracting parties from imposing severe negative externalities on third parties when transaction costs prevent those third parties from protecting their interests by affecting the terms of the contract that harm them. Even then, limitations on freedom of contract are only justified if we are sure that the overall social harm caused by the contract terms at issue outweighs its overall social benefit.

The libertarian version of the free market model understands the market as a freestanding area of social life characterized by free choices of individual market participants. Regulations are built on top of the market and are thought to restrict it or interfere with it. This paradigm of the free market contains important truths because the freedoms that it describes are important freedoms; however, it is incomplete and misleading. It fails to describe adequately the fact that the market is a zone of social life structured by law, it fails to describe adequately existing law or values, and it exaggerates the extent to which we actually desire unfettered contractual freedom.

The Tension Between "Freedom of Contract" and "Ownership"

By way of contrast, consider the estates system model found in a first-year property law course. The estates system defines a dozen ways to divide up interests in land. When particular rights are transferred from one person to another, the estates system requires a set of other rights to go along for the ride, defining a few bundles of rights that owners can create. In effect,



Joseph William Singer is the Bussey Professor of Law at Harvard Law School. A version of this article was given as a talk at Harvard Law School and a longer version was published as *Things That We Would Like to Take for Granted: Minimum Standards for the Legal Framework of a Free and Democratic Society*, 2 HARV. L. & POL'Y REV. 139 (2008). He can be reached at jsinger@law.harvard.edu.

these rules impose mandatory terms in real estate contracts. For example, restraints on alienation of fee simple interests are usually void, as are covenants restricting occupancy of land by race or religion today. Similarly, we do not allow owners to create landlocked parcels: if you sell your backyard you must grant the new owner an easement to go across your remaining land to get to a public road. The core policy underlying the estates system is not freedom of contract but the promotion of alienability. Traditionally, this has meant increasing the marketability of land by preventing owners from creating certain kinds of encumbrances on ownership such as future interests and covenants. Property law consolidates powers over land in current owners, freeing them to use their property as they wish without restrictions imposed by prior owners. Historically, this policy effectively took power away from feudal lords and pushed it downwards to give it to those who lived on the land.

Alienability thus promoted freehold ownership and prevented enforcement of arrangements that could lead to the reemergence of feudalism. Full control over land was thought to increase the autonomy of owners, while the absence of restrictions on land use promoted its free use and efficient transfer to others. In addition, making land transferable made it subject to market forces and thus played a role in dispersing ownership of land among many people rather than leaving ownership concentrated in the hands of a few aristocratic families. Land use restrictions may initially serve the interests of those who create them, but, over time, their utility may diminish. In addition, transaction costs may inhibit those who would benefit from getting rid of such restrictions from contracting with owners of the restricted property to remove them. If all of this is correct, the policy of promoting alienability actually has democratizing effects: it prevents oppression, encourages mobility, ensures freedom, protects both efficiency and equality, and generates widespread dispersal of ownership.

But this means there is an important tension between the free market model concept of "freedom of contract" and the property law concept of "ownership." Property law restricts the ability of owners to divide up property rights in ways that lead to the undue concentration of ownership or encumber real estate with socially undesirable limitations on use or transfer. We do this to protect the autonomy of current owners and to promote equal access to land ownership. Property law achieves these goals by limiting freedom of contract. Here is the paradox: The more absolute the use rights of current owners, the more restrictions on freedom of contract society must impose.

Contractual Freedom Requires Legal Limits

Here is a second version of the paradox. The Civil Rights Act of 1866, 42 U.S.C. § 1981, grants all persons the "same right . . . to make and enforce contracts . . . as is enjoyed by white citizens." To grant individuals the same right to contract as is enjoyed by white citizens, the Supreme Court has placed a duty on retail stores to sell goods to customers regardless of their race. The customer's right to contract is protected by imposing a duty to contract on the store. This seems to violate freedom of contract norms; ordinarily, free contract means you get to choose whether to contract with someone *or not*. But the Civil Rights Act has been interpreted to *require* stores to enter contracts with customers if the only reason for the refusal to contract is the race of the customer. The right to contract of the patron limits the freedom of contract of the store owner.

The patron's right to contract is also a right to buy the goods offered by the store; this protects the patron's right to become an owner of the shirts sold in the store. However, the law protects the *right to acquire* property by denying the store owner the freedom *not to sell* the shirts. Again, society limits freedom of contract in order to enable individuals to become owners and to enjoy equal access to the market economy.

The concept of "freedom of contract" certainly appears to be in some tension with the concept of "ownership." Worse still, both concepts appear to be in tension with themselves: the right to contract is enforced by imposing a duty to contract; thus, freedom of contract is promoted by limiting freedom of contract. The right to acquire property is enforced by imposing a duty to sell; thus, property rights are promoted by limiting property rights. What all this means is that contractual freedom promotes both liberty and equality only if it occurs within boundaries set by law.

> Contractual freedom promotes both liberty and equality only if it occurs within boundaries set by law.

How Regulations Promote Autonomy by Helping Us Get What We Want

Libertarians assume that regulations limit liberty by paternalistically substituting the government's judgment about what is in the best interest of the parties for that of the parties themselves. But property law suggests that the law may impose mandatory terms in contracts—not because the lawmakers think they know better than the contracting parties what is in their best interests, but because such regulations are the only way to create the arrangements that the parties *themselves* want.

For example, suppose you want to buy a house in a residential neighborhood. The only way to ensure that you will not be living next door to a funeral parlor or a gas station is to create a real covenant binding the grantor's remaining land or getting the town to enact a zoning law. Covenants are binding on future owners whether they agree to them or not. Although this seems to limit freedom of contract, it does so to ensure that a particular kind of property right can be created. If we want to create this particular type of property right—a

house located in a neighborhood with other houses and no nonresidential uses unless all affected owners unanimously consent to those uses—then we *must* adopt regulatory rules that allow property rights to be bundled this way. This, in turn, requires imposing such regulations on future buyers whether or not they make a similar express promise; the law declares that anyone who buys a restricted lot, and is on notice of the restrictions, will be deemed to have agreed to those restrictions, regardless of what her contract says. In this case, we promote freedom of contract (the ability to contract to create this package of property rights) by limiting freedom of contract (preventing owners from selling property free of the restrictions).

The free market model conceptualizes mandatory rules as interferences with freedom of contract and, hence, limitations on autonomy. But if these rules help the parties get what they want—and if the parties cannot get what they want *without* those regulations—then it makes no sense to characterize those rules as necessarily liberty-inhibiting; rather, although they limit freedom of action, they appear to be liberty-enhancing. Similarly, such regulations do not substitute the government's judgment of what is in the best interests of the parties for the judgment of the parties themselves. Rather, market participants demand these regulations in order to create a legal framework that enables them to get what they want.

Do these regulations *prevent* parties from getting what they want, or do they *help* parties get what they want? On the surface these regulations seem to limit freedom of contract. But if this is so, why are such regulations so prevalent? We have such laws because people demand them as a way to respond to social problems. We can observe extensive regulations even in our most libertarian states. This suggests that we do have a settled consensus that markets should be subject to minimum standards regulations.

Minimum Standards Regulation

Our state and federal statutes create a comprehensive network of regulations that set minimum standards for contractual relationships—minimum standards that we take for granted. One definition of taking something for granted is "to expect something to be available all the time and forget that you are lucky to have it."[1] We expect the protections afforded by government regulation, but then we complain about big government. When we make such complaints, it is evident that we are taking government regulation for granted; we forget that we are lucky to have it.

The recent financial crisis demonstrates why some contract terms and packages of property rights are outlawed in a well-functioning market system. Property rights have externalities; although we want owners to have a great deal of freedom in packaging property rights and shaping contractual relations as they see fit, we must regulate market relations to avoid packages of rights that cause negative social effects. The current crisis was caused by lenders issuing subprime variable rate mortgages to persons who could not afford them, followed by securitization of those loans into incomprehensible packages whose real value was hidden from purchasers who took unreasonable risks in buying them. When the housing bubble burst, as economists were telling us it would at some point, these property packages led to a massive financial crisis that has placed the entire U.S. economy on shaky ground. The current situation shows how certain packages of property rights may lead to the wreck of the economy if no legal controls are placed on the packages we are allowed to create and market.

The free market model sees regulation as sitting on top of the market, limiting it, or crushing it. The minimum standards model, on the other hand, treats regulation as the foundation on which the market sits, without which it would sink into the earth. Freedom of contract works only because we have built that foundation. The framework of regulation created by both the common law of tort and property and by our extensive statutory law is what allows our contract system to focus more narrowly on the private interests of the parties. Minimum standards regulations define *things that we would like to take for granted.* Some of these things are so fundamental that we convert them into legal rights. Many of them are so fundamental that we forget that we are lucky to have them.

Contours of Our Way of Life

These minimum standards regulations do more than merely set the rules of the road; rather, they define the contours of our very way of life. Consider the New Jersey case of *State v. Shack*, with which I start my property class.[2] There, a farm owner hires migrant workers to harvest his crops. When a doctor and a lawyer enter the farm to provide professional services to the workers living there, the owner confronts them with a gun and refuses to let them visit the workers unless they do it in the owner's office under his watchful and protective eye. The lawyer objects, the owner calls the police, and the doctor and the lawyer are both arrested for trespass.

It seems like an open and shut case—the doctor and lawyer certainly seem to be trespassing. They are on the owner's land without his consent. And the workers' employment contract certainly contains no right to receive visitors in the barracks where they are housed. But the New Jersey Supreme Court was uninterested in the agreed-upon terms of the contract. Instead, the court sought a "fair adjustment of the competing needs of the parties, in light of the realities of [their] relationship."[3] Rather than asking whether the contract was voluntary and what its terms were, the court asserted that certain "rights are too fundamental to be denied" merely because the contract fails to provide for them.[4] The court said:

> [W]e find it unthinkable that the farmer employer can assert a right to isolate the worker in any respect significant for the worker's well-being. The farmer, of course, is entitled to pursue his farming activities without interference. . . . So, too, the migrant worker must be allowed to receive visitors there of his own choice, . . . and members of the press may not be denied reasonable access to workers who do not object to seeing them. . . .
>
> [T]he employer may not deny the

> worker his privacy or interfere with his opportunity to live with dignity and to enjoy associations customary among our citizens. These rights are too fundamental to be denied on the basis of an interest in real property and too fragile to be left to the unequal bargaining strength of the parties.[5]

From the standpoint of free market ideology, this all seems to represent the heavy hand of paternalistic regulation by an activist court: the judges think they know better than the workers what is in their best interest.

But there is something quite odd, if not disingenuous, about framing the problem in that way. That description makes it appear as if we are choosing between good things (like freedom, self-determination, and autonomy) and bad things (like regulation, paternalism, and Big Brother). This choice structure fails to acknowledge that anything bad comes from deregulation or that anything good comes from regulation. Moreover, it suggests that freedom always increases when regulation decreases.

Yet we know that bargaining takes place in the context of a particular property system, an existing distribution of property, a set of market regulations, and a detailed legal structure. If we really wanted to make the choice one of deregulation versus regulation, we would start with *no rules at all*. That would make it a choice between anarchy and government, between the war of all against all and the rule of law. But this would be an easy choice—no one wants to live in a society without the rule of law. The truth of the matter is that we are not starting from a standpoint of deregulation; we are starting from a regulatory structure. We are not choosing whether to regulate; the real issue is what regulations we should have. In other words, what we really want to know is: What background rules will govern interactions in the marketplace?

In a Free Society, Some Demands Are Off the Table

In the bargaining process, landlords and tenants have the right to demand various things from each other; however, the framework of a free and democratic society requires some demands to be taken off the table. Some demands are out of line. Tenants have the right not to be asked certain things, like relinquishing the right to receive visitors. Similarly, according to the Supreme Court of New Jersey, the farm owner cannot legitimately demand that his workers relinquish the right to receive government services meant for their benefit. These are minimum standards for the contractual relationship.

Chief Justice Weintraub's opinion argued that "'no trespass' signs represent the last dying remnants of paternalistic behavior."[6] That terminology is confusing. When we talk about paternalism today, we usually think about government rules that limit what contracts we can enter into; because we think we know better than the government what is in our best interest, we think it is paternalistic for the government to regulate the terms of our contracts. Here the court argued that it would be paternalistic *not* to regulate the contract. How could that be?

The answer is that the court was thinking about an older form of paternalism, one that is very familiar to property lawyers: the paternalism of the plantation or the feudal manor where the lord treated everyone in his demesne as part of his family under his autocratic control. The farm owner in *State v. Shack* wanted to act like a lord—he wanted to control his workers' private lives; he wanted to be a master and to treat his workers like servants. The Supreme Court of New Jersey said no, holding that some preferences should not be indulged. Our legal system does not, in fact, seek to satisfy all preferences whatever they happen to be. A free market is not a feudal society; it is not a slave society; it is not an apartheid society; it is not a caste society; and it is not a company town. The "free market" describes a particular sort of social order, and that order is premised not only on freedom of contract but on the equal status of persons. This means that the liberty of each party to the deal must be limited in certain ways to protect the liberty of the other.

When we ask "why interfere with freedom of contract?" we pretend that any and all contractual relationships can be respected in a free and democratic society. *But we know this is not the case.* If we recognize the contribution that law makes to liberty, we will recognize that *all* contracts are subject to minimum standards regulations that take certain contract terms off the table. So when we deliberate over injecting a mandatory term into a contract, we should be asking a different question: "What *are* the minimum standards for transactions like this?"

The farm owner in *State v. Shack* wanted to act like a lord—he wanted to control his workers' private lives. The New Jersey Supreme Court said no, holding that some preferences should not be indulged.

To answer this question, we should acknowledge that our concept of the free market is embedded in a larger conception of the free and democratic society. We will misunderstand the free market if we do not see it as situated in this larger political setting. The abolition of feudalism, the eradication of slavery and racial segregation, the promotion of equal rights for women, and the protection of the rights of consumers all represent fundamental changes in social and legal institutions within which market relations occur. We are not merely concerned with rules of the road, nor is our only goal the satisfaction of human wants. We are—or we should be—interested in whether the terms of a given contract violate

minimum standards of decency. Are they consistent with the minimum standards governing the legal framework of a free and democratic society that treats each person with equal concern and respect?

Economists have taught us to ask: "What contract would the parties have made if they had perfect information?" But political philosophers have taught us a different set of questions. John Rawls might ask: "What would the contract have said if the parties did not know on which side of the bargaining table they would be sitting?" When we ask the Rawlsian question, it is possible we will conclude that a particular contract term does violate minimum standards of a free and democratic society. And when that happens, our questions may become more pointed and confrontational. Instead of asking: "What are the minimum standards for this kind of transaction?" we might find ourselves asking: "What gives you the right to treat your workers so badly?" Or perhaps even: "Would you want your son or your daughter to work under conditions like this?"

We do not ask these questions because we want the courts or legislatures writing the details of every contract. We ask them because people have obligations as well as rights. We ask them because some preferences cannot be indulged and some demands are out of line. We ask them because minimum standards regulations do more than set the rules of the road; they construct the framework of a free and democratic society that treats each person with equal concern and respect. We will debate what those minimum standards are and how to best achieve them. But that is a debate we should have. ■

Endnotes

1. The Free Dictionary, http://idioms.thefreedictionary.com/take+for+granted (last visited Sept. 30, 2006) (taken from Cambridge International Dictionary of Idioms (1998)).
2. 277 A.2d 369 (N.J. 1971).
3. *Id.* at 374.
4. *Id.*
5. *Id.* at 374–75.
6. *Id.* at 373.