

AN ECONOMIC ANALYSIS OF LAW VERSUS EQUITY

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I. INTRODUCTION

Like “property,” the terms “equity” and “equitable” are hardly missing from legal discourse. They can refer to fairness, a type of jurisdiction, types of remedies and defenses, an owner’s stake in an asset subject to a security interest and other ownership interests, as well as a set of maxims, among other things. These uses of “equity” and “equitable” all trace back to courts of equity, which, with some exceptions, ceased to exist as separate courts or even as a distinct form of jurisdiction by the early twentieth century.¹ So the term “equity” might seem to be an etymological curiosity.

This paper challenges that view. It argues that the notion of equity is functionally motivated and can be given an economic analysis under which it makes sense to have a

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¹ See, e.g., J.H. Baker, *An Introduction to English Legal History* 112-33 (3d ed. 1990); F.W. Maitland, *Equity: A Course of Lectures* (A.H. Chaytor & W.J. Whittaker eds., 1936).

separate decision making mode that is loosely identified with historical equity jurisdiction and jurisprudence.

The fusion of law and equity is not the only reason that one might be skeptical that such an economic account might be given. For one thing, law and economics has addressed several phenomena associated with historical equity. Equitable courts engaged in discretionary ex post decision making, and the rules-versus-standards distinction has not only received detailed economic analysis but has featured as a central building block in law-and-economics theorizing.² Likewise, the distinction between legal and equitable remedies, to the extent that it roughly tracks the choice between damages and injunctions, is said to be captured by the distinction between liability rules and property rules.³ A liability rule sets an official price on an entitlement, whereas a property rule offers a remedy robust enough that is aimed at forcing a duty holder to respect the entitlement or bargain for a consensual exchange. Beyond rules versus standards and liability rules versus property rules, much law-and-economics analysis simply regards equitable concerns as peripheral and possibly reflecting mistaken and myopic judicial ex post meddling.⁴ Vagueness in the law governing actors' conduct carries with it the danger of

² Louis Kaplow, Rules versus Standards: An Economic Analysis, 42 Duke L.J. 557 (1992).

³ Guido Calabresi & A. Douglas Melamed, Property Rules, Liability Rules, and Inalienability: One View of the Cathedral, 85 Harv. L. Rev. 1089 (1972).

⁴ The chilling effect of vague laws was noticed early in law and economics but in terms that made certainty beneficial, if costly to achieve:

The "chilling" of socially valuable behavior by an uncertain law is a potentially serious problem whenever criminal penalties are involved... Not only do criminal sanctions tend to be severe (costly), but it is normally impossible to purchase insurance against criminal liability. The average individual can avoid the risk of being subjected to a criminal penalty only by avoiding criminal activity. But if what constitutes criminal activity is uncertain this is not enough: he can eliminate the risk only by avoiding, in addition to clearly criminal behavior, all other behavior that is within the penumbra of the vague standard.

over- and under-detering.⁵ And outside law and economics, there is a more general debate between formalists, who prefer ex ante rules, and post-realists, who prefer judicial or other official discretion to tailor legal standards to particular problems.⁶ This debate is an echo of earlier conflicts between common law lawyers with their stable and simple but rigid rules and partisans of equity with their fairness-based but sometimes arbitrary interventions, with the former accusing the latter of measuring law with “the Chancellor’s Foot.”⁷

In our post-fusion, post-legal realist world, the virtues of combining law and equity are largely lost on us. Commentary either veers towards formalism or contextuality across the board. And the remnants of equity are reduced to a few dimensions: the timing of decision making or damages-versus-injunctions.

This paper offers a path out of this dilemma. I argue that a defined combination of law and equity is likely to be superior to using one or the other decision making mode alone. Moreover, the equitable decision making mode is not simply a matter of ex post

Isaac Ehrlich & Richard Posner, *An Economic Analysis of Legal Rulemaking*, *J. Legal Stud.* 257, 263 (1974). For a discussion, see Carol M. Rose, *Crystals and Mud in Property Law*, 40 *Stan. L. Rev.* 577 (1988).

⁵ See, e.g., John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 *Va. L. Rev.* 965 (1984).

⁶ See, e.g., Curtis Bridgeman, *Default Rules, Penalty Default Rules, and New Formalism*, 33 *Fl. St. U. L. Rev.* 683 (2006); Symposium, *Formalism Revisited*, 66 *U. Chi. L. Rev.* 527 (1999).

⁷ Baker, *supra* note 1. For the most famous critique of equity is Selden’s:

“Equity is a Roguish thing: for law we have a measure, know what to trust to; Equity is according to the Conscience of him that is Chancellor, and as that is larger or narrower, so is Equity. 'Tis all one as if they should make the Standard for the measure we call a Foot, a Chancellor's Foot; what an uncertain Measure would be this. One Chancellor has a long Foot, another a short Foot, a Third an indifferent Foot: 'Tis the same thing in the Chancellor's Conscience.”

John Selden, *Equity*, in *Table-Talk: Being the Discourses of John Selden, Esq.* 43, 43–44 (London, J.M. Dent & Co. 2d ed. 1689).

decision making or the use of injunctions. Instead, equity in private law is a coherent package of features motivated largely by one overriding goal: preventing opportunism. Private law sets up simple and stable structures as platforms upon which people can coordinate.⁸ It employs information hiding such as where property law makes much property-internal information irrelevant for dutyholders: I need not know the features of the owner or the history of transactions to know not to take a car I do not own from a parking lot.⁹ The problem with such simple modular structures is that they are sometimes vulnerable to people with *too much* information. So to take a simple example, the law of trespass makes certain exceptions for wandering cattle in open range areas and for good faith building encroachments. But those who seek to take advantage of these exceptions deliberately are subject to the full force of the injunctive remedy.

In this paper I will show that a large range of features of the equitable mode are associated with dealing with this problem of opportunism. The features include the operation of equity in personam and not in rem, ex post discretionary decision making, the emphasis on good faith and notice, the employment of moral standards, and equity's element of inherent vagueness. The problem then becomes how to cabin such a powerful tool. In theory, some of these features, such as in personam application and other jurisdictional rules as well as the type of morality it invokes, place limits on the use of equity in order to prevent it from swallowing up the modular structures of the common law.

⁸ Henry E. Smith, Intellectual Property as Property: Delineating Entitlements in Information, 116 Yale L.J. 1742 (2007).

⁹ See J.E. Penner, The Idea of Property in Law 75-76 (1997).

This paper offers a functional rather than a historical account of equity. Nonetheless, what went under the heading of equity turns out to be close to the package of features one would need for a “safety valve” that is aimed at deterring opportunism. Historically, equity judges and commentators had some idea that this was going on.¹⁰ For example, Justice Story recognized that it is foundational that equity must be open-textured in light of the ability of parties to opportunistically evade their obligations, or as he put it, “[f]raud is infinite” given the “fertility of man’s invention.”¹¹ Courts also self-consciously saw themselves as following an Aristotelian tradition of equity, with courts of equity often quoting Aristotle’s distinction between law and equity in which equity corrects “law where law is defective because of its generality.”¹² One reason law fails is that the need for general rules leaves loopholes wide open for the opportunists to exploit. But this awareness dissipated over time, particularly with the fusion of law and equity. Indeed one of the most famous late-period commentators on equity, Zechariah Chafee, took the expansive view that “[e]quity is a way of looking at the administration of justice;

¹⁰ See Robert Lowry Clinton, *Classical Legal Naturalism and the Politics of John Marshall’s Constitutional Jurisprudence*, 33 *J. Marshall L. Rev.* 935, 948 (2000) (discussing Carl Dibble’s identification of a “moderate Enlightenment” tradition of legal interpretation associated with Grotius, Blackstone, and Marshall, that emphasized the role of equity and located the need for interpreting laws not in the ambiguity of language but in the possibility “that corrupt, duplicitous persons will ‘treat the law in a sophisticated manner’ in order to advance their own individual interests”), quoting Carl M. Dibble, *The Lost Tradition of Modern Legal Interpretation* 5 (1994) (unpublished essay prepared for delivery at the 1994 Annual Meeting of the American Political Science Association).

¹¹ 1 J. Story, *Commentaries on Equity Jurisprudence, as Administered in England and America* 184 n.1 (9th ed. 1866) (quoting a Letter from Lord Hardwicke to Lord Kaimes (June 30, 1759)). Or, as Chancellor Ellesmere put the point: “The Cause why there is a Chancery is, for that Mens Actions are so divers and infinite, That it is impossible to make any general Law which may aptly meet with every particular Act, and not fail in some Circumstances.” *The Earl of Oxford’s Case*, 21 *Eng. Rep.* 485, 486 (Ch. 1615).

¹² Aristotle, *Nicomachean Ethics* 317 (G.P. Goold ed., H. Rackham trans., Harvard Univ. Press 1982); see also, e.g., *Riggs v. Palmer*, 22 *N.E.* 188, 189 (N.Y. 1889) (quoting Aristotle on equity); Eric G. Zahnd, *The Application of Universal Laws to Particular Cases: A Defense of Equity in Aristotelianism and Anglo-American Law*, 59 *Law & Contemp. Probs.* 263, 270-75 (Winter 1996) (documenting influence of Aristotelian equity on Anglo-American law); but cf. Darien Shanske, *Four Theses: Preliminary to an Appeal to Equity*, 57 *Stan. L. Rev.* 2053 (2005) (arguing that Aristotle’s equity was not primarily legal).

it is a set of effective and flexible remedies admirably adapted to the needs of a complex society; it is a body of substantive rules.”¹³ This is true as far as it goes, but this implies few limits on the proper domain of equity. Indeed it has always been contestable what that domain is, and in our post-fusion, post-legal-realist world, there are fewer and fewer limits on equity.

The article first sets the stage for the safety valve theory of equity in Part II by defining the problem that opportunism poses for systems of relatively bright line law, whether judicially or legislatively created. Part III shows how the anti-opportunism theme helps explain the features of equity in all its manifestations in maxims, defenses, and remedies. Part IV turns to a theoretical account of how equity acts as a safety valve aimed at opportunism and offers a simple information cost explanation of the nature of the equitable safety valve. In Part V, I turn to one area of private law – contracts – that one might expect to be least appropriate for equitable intervention, because parties are often expected to devise anti-opportunism devices themselves. I present a simple model of the conditions under which even parties in contractual privity can gain from a backdrop of equity and how equitable intervention can be expected to increase with the severity of the potential opportunism and to decrease in the chilling effect of ex post discretionary equity. Part VI traces out some implications for the post-Realist debate between formalists and contextualists and the vestiges of equitable jurisdiction in the role that Delaware courts play in corporate law. Part VII concludes.

¹³ Zechariah Chafee, Jr., Foreword, in *Selected Essays on Equity* iii (Edward D. Re ed., 1955); see also Zechariah Chafee Jr., *Some Problems of Equity* (1950).

II. THE PROBLEM OF OPPORTUNISM

Structures of rights can be much simpler than they would have to be if they had to be air tight in the face of opportunism. This problem is very familiar from tax law, where the rules are under intense pressure from those seeking to minimize their taxes.¹⁴ To prevent this, the law can attempt to plug every hole and anticipate every type of evasion ex ante. But given the many ways of evading and the expertise of the potential evaders, it sometimes makes sense to announce broad anti-evasion standards in order to prevent broad types of evasion.¹⁵ This saves on the many instances where evasion does not occur. And it avoids the problem of evaders exploiting their knowledge of exactly where the bright line is. Plugging nine out of ten holes is sometimes no better than plugging none.

A similar problem somewhat closer to traditional equity arises with damages remedies. If a potential violator knows too much about the value of entitlements and the value that a court will place on them, an informed violator can game the system by cherry picking property rights to violate: the violators will systematically choose undervalued assets to take.¹⁶ Raising the damages across the board will deter many beneficial takings – for the purposes of the argument, those where the violator values the entitlement more

¹⁴ See, e.g., Kyle D. Logue, *Tax Law Uncertainty and the Role of Tax Insurance*, 25 *Va. Tax Rev.* 339, 362-68 (2005); David A. Weisbach, *An Economic Analysis of Anti-Tax-Avoidance Doctrines*, 4 *Am. L. & Econ. Rev.* 88 (2002); see also Alan Gunn, *Tax Avoidance*, 76 *Mich. L. Rev.* 733 (1978) (describing doctrines and expressing skepticism about inquiry into intent).

¹⁵ David A. Weisbach, *Formalism in the Tax Law*, 66 *U. Chi. L. Rev.* 860 (1999); see also Stanley S. Surrey, *Complexity and the Internal Revenue Code: The Problem of the Management of Tax Detail*, 34 *L. & Contemp. Probs.* 673, 707 n 31 (1969); see also Sarah B. Lawskey, *Probably? Understanding Tax Law's Uncertainty*, 157 *U. Pa. L. Rev.* 1017, 1032 (2009) (arguing that tax law uses probabilistic doctrines because “the essence of a tax shelter is that it technically complies with the law while nonetheless violating the substance or intent of the law, which is no easy thing to determine.”).

¹⁶ Henry E. Smith, *Property and Property Rules*, 79 *N.Y.U. L. Rev.* 1719 (2004).

than the holder – but trying to figure out who is an opportunistic violator will be difficult. In light of this, opportunistic violations, when they come to light, are subject to injunctions, and possibly punitive damages. And a rebuttable presumption for injunctions is used to deter most of the rest of the opportunism.¹⁷

So far so familiar. But I will argue that the problem of opportunism is a general one and that equity in many of its facets reflects a concern with this widespread problem of opportunism. In this Part, I will first define and illustrate the problem that opportunism presents.

A. What Is Opportunism?

Perhaps the most salient feature of opportunism is the difficulty in defining it. Nonetheless, although identifying exactly what constitutes opportunism will be difficult in advance, one can offer definitions of opportunism that allow us to identify it with *hindsight*. The irreducible need for some hindsight is at the heart of the equitable decision making mode.

In law and economics, the most famous definition of opportunism is that of recent Nobel laureate Oliver Williamson: opportunism is “self-interest seeking with guile.”¹⁸ The problem is that we need to know what guile is and why it’s bad. Guile is related to fraud, which in turn is a knowing misrepresentation that is intended to induce another to part with an entitlement and that succeeds in doing so.¹⁹ Fraud is in general social-welfare-decreasing, and the optimal amount of fraud in the world – ignoring enforcement

¹⁷ See, e.g., Henry E. Smith, Exclusion and Property Rules in the Law of Nuisance, 90 Va. L. Rev. 965 (2004).

¹⁸ Oliver E. Williamson, *The Economic Institutions of Capitalism* 47 (1985).

¹⁹ Or, in Susan Koniak’s plain-English definition, “lying to someone to get them to give you their stuff.” Susan P. Koniak, Corporate Fraud: See, Lawyers, 26 Harv. J.L. & Pub. Pol’y 195, 198 (2003).

costs – would be zero.²⁰ Accordingly, everyday morality has a clear view of fraud: bad. Legally, fraud is narrowly defined but there is a larger set of misrepresentations that have an effect similar to fraud. Harking back to a nineteenth century tradition, Richard Epstein based his theory of contractual unconscionability on this idea of near-fraud.²¹ Behavior that seems infected with fraud but is not provable as such can be deterred by withholding enforcement from the party responsible for the unconscionability. As we will see, the practical problem turns out not to be to define opportunism with exactitude but to find visible proxies that are closely associated with opportunism.

B. Why Opportunism Is a Problem

Many have criticized the use of opportunism in economics as unnecessary.²² These criticisms have a great deal of force. Models of self-interest combined with asymmetric information can explain a lot of the behavior we would call opportunistic. Also, if opportunism is simply playing outside the rules then it reduces to imperfect enforcement.

Instead, I suggest that opportunism is behavior that is undesirable but that cannot be cost-effectively captured – defined, detected, and deterred – by explicit ex ante

²⁰ These arguments against fraud parallel those against theft. See, e.g., Richard L. Hasen & Richard H. McAdams, *The Surprisingly Complex Case Against Theft*, 17 *Int'l Rev. L. & Econ.* 367 (1997); Fred S. McChesney, *Boxed In: Economists and Benefits from Crime*, 13 *Int'l Rev. L. & Econ.* 225 (1993); Gordon Tullock in *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 *W. Econ. J.* 224, 228-31 (1967).

²¹ Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 *J. L. & Econ.* 293, 293, 293-301 (1975). On the nineteenth century view that unconscionability referred to fraud that could not readily be proved, see, e.g., *Seymour v. Delancey*, 3 *Cow.* 445, 521-22, 15 *Am.Dec.* 270 (N.Y. Sup. 1824) (“Inadequacy of price, unless it amount to conclusive evidence of fraud, is not itself a sufficient ground for refusing a specific performance of an agreement”) (citing cases); James Gordley, *Equality in Exchange*, 69 *Cal. L. Rev.* 1587, 1639 (1981).

²² Peter Klein, *Does Transaction Cost Economics Need Opportunism?*, Oct. 6, 2006, <http://organizationsandmarkets.com/2006/10/06/does-transaction-cost-economics-need-opportunism/>; see also Oliver E. Williamson, *Opportunism and its Critics*, 14 *Managerial & Decision Econ.* 97 (1993) (defending usefulness of notion of opportunism against social science critics).

rulemaking. Opportunism is residual behavior that would be contracted away if ex ante transaction costs were lower. Not coincidentally, it often violates moral norms, which are incorporated into the ex post principles that deal with opportunism.²³

Opportunism is not the same thing as fraud. Fraud can be defined ex ante, and, although not all of it can be detected, the penalty can be raised to make up for the low probability of detection.²⁴ Opportunism is different. It often consists of behavior that is technically legal but is done with a view to securing unintended benefits from the system, and these benefits are usually smaller than the costs they impose on others.

Opportunism in private law is a major problem because of the nature of the structures that the non-equitable parts of private law – loosely identified with the common law but also including statutes – establish to govern behavior in the mine run of cases. Consider property. As I have argued elsewhere, property sets up modular structures that manage the complexity of the interactions of actors with respect to resources.²⁵ A starting point for property is to use an exclusion strategy to define the “thing” and then to delineate rights wholesale as a first cut through the interface between the bubble defined by the exclusion strategy and the rest of the world. Thus, as mentioned earlier, the interface between the basic package of rights to a car and the rest of the world is a simple one behind which much information is hidden.

²³ [Compare discussions of opportunism in Brinig; Cohen; Muris].

²⁴ See, e.g., Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. Pol. Econ.* 169 (1968); A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 *Harv. L. Rev.* 869, 887-96 (1998).

²⁵ Smith, *supra* note 8; Henry E. Smith, *Institutions and Indirectness in Intellectual Property*, 157 *U. Pa. L. Rev.* 2083 (2009).

In this way, the structure of rights is modular. As a method of managing complexity, modularity relies on a system's being nearly decomposable, that is, one in which there are clusters of elements that interact relatively intensely with each other but which interact more sparsely with elements of other clusters.²⁶ If a system is nearly decomposable, one can hide each cluster in the module and define the interface in terms of the limited interactions between the module and the rest of the system.²⁷ The advantage of this procedure is that it creates options to change modules without having to worry about hard to foresee ripple effects. For example, a car's fuel injection system can be altered or replaced without having to worry about effects on other components like the braking system. Likewise, a print module in a software program can be altered without affecting other modules except in defined ways. And a boilerplate severability or choice-of-law provision can be modified with minimal effects on the other provisions of a contract.²⁸ Without the modular structure, the car, the program, or the contract would change overall in unpredictable ways as a result of small changes to one of its parts. Or the system – the car, the program, the contract – will have to be frozen to prevent even small changes that cannot be kept local. A nonmodular system is likely to be either more chaotic or more rigid than a modular one through a wide range of levels of complexity.

²⁶ Herbert A. Simon, *The Sciences of the Artificial* 195-200 (2d ed. 1981).

²⁷ See, e.g., 1 Carliss Y. Baldwin & Kim B. Clark, *Design Rules: The Power of Modularity* (2000); *Managing in the Modular Age: Architectures, Networks and Organizations* (Raghu Garud et al. eds., 2003); Richard N. Langlois, *Modularity in Technology and Organization*, 49 *J. Econ. Behav. & Org.* 19 (2002); Ron Sanchez & Joseph T. Mahoney, *Modularity, Flexibility, and Knowledge Management in Product and Organization Design*, 17 *Strategic Mgmt. J.* 63 (Special Issue Winter 1996).

²⁸ Henry E. Smith, *Modularity in Contracts: Boilerplate and Information Flow*, 104 *Mich. L. Rev.* 1175 (2006).

In property the basic modules are the packages of rights which make property-internal details about features of the owner of the resource or the owner's activities largely irrelevant to the outside world, including the class of in rem duty holders. If A owns Blackacre, B (along with everyone else) is told as a first cut to keep out. Defining violations in terms of crossing of the boundary is over- and underinclusive, but at low cost it indirectly protects a wide range of interests in use. Sheltering behind the exclusion right are A's interest in growing crops, building and maintaining a residence, parking cars, and so on.

This first cut at modularization is not enough. The system of interactions is not fully decomposable but only partially so. A more elaborate interface is needed than a system of absolute and hermetic rights to exclude. Here is where contracts, tort law such as nuisance, regulation, and even criminal law serve to enrich the interface. If a problem involving conflicting uses is important enough we may need to address it more directly in a governance strategy.²⁹ For example, wafting odors may need to be regulated by the law of nuisance, and policed for reasonableness. Zoning, for all its intertwined benefits and

²⁹ Henry E. Smith, *Exclusion Versus Governance: Two Strategies for Delineating Property Rights*, 31 *J. Legal Stud.* S453 (2002). I am drawing more of a distinction between the mechanisms of delineating rights and the interests they serve. Traditionally, property rights included rights of possession, use and disposition. See, e.g., *United States v. Gen. Motors Corp.*, 323 U.S. 373, 377-78 (1945) (stating that a more accurate conception of property rights is an individual's right to possess, use, and dispose); 1 William Blackstone, *Commentaries* 138-39 (discussing an individual's right of property as "free use, enjoyment, and disposal"); Richard A. Epstein, *Takings: Private Property and the Power of Eminent Domain* 22 (1985) (citing Blackstone's conception of property); Eric R. Claeys, *Takings: An Appreciative Retrospective*, 15 *Wm. & Mary Bill Rts. J.* 439, 442 (2006) (discussing Richard Epstein's book and its idea of property rights as "possession, use, and control"); Adam Mossoff, *The Use and Abuse of IP at the Birth of the Administrative State*, 157 *U. Pa. L. Rev.* 2001 (2009) (discussing the bundling metaphors and exclusion conceptions of property). This traditional trinity of rights more closely matches the interests that property serves. Others would propose a more plastic and ever-changing set of interests in property that are directly reflected in a plastic and changing bundle of rights (or other legal relations). See, e.g., Thomas C. Grey, *The Disintegration of Property*, in *NOMOS XXII: Property* 69 (J. Roland Pennock & John W. Chapman eds., 1980). I claim that the exclusion strategy is the starting point and that this protects most owners uses most of he time but that when a use interest becomes important enough it may receive individualized delineation, as in servitudes (largely ex ante), nuisance (more ex post), and zoning (ex ante and ex post).

costs,³⁰ systematically governs the interface between packages of rights in parcels in the same geographic neighborhood.

The result of this modularization of structures of rights is that interactions can be very complex within a relatively simple system. Different actors need to know different amounts and types of information. In rem duty holders mostly need to know the least: they need to know to keep off.³¹ Even interactions like that between railroads emitting sparks and farmers with haystacks are kept modular using the boundary of the land: the farmer is not required to anticipate the negligence of the railroad and the railroad cannot presume that the farmer behind the property boundary will take cost-effective precautions against negligence or other wrongful conduct by the railroad.³² As a tort rule focused on

³⁰ See, e.g., Edward L. Glaeser & Joseph Gyourko, *The Impact of Building Restrictions on Housing Affordability*, 9 *Econ. Pol’y Rev.* 21 (2003); Edward L. Glaeser, Joseph E. Gyourko, & Raven E. Saks, *Why Have Housing Prices Gone Up?*, 95 *Am. Econ. Rev.* 329 (2005) (Pap. & Proc.); see also Bengte L. Evenson, *Understanding House Price Volatility: Measuring and Explaining the Supply Side of Metropolitan Area Housing Markets* (Illinois State University Department of Economics Working Paper 2002).

³¹ See, e.g., Robert C. Ellickson, *Property in Land*, 102 *Yale L.J.* 1315, 1328-29 (1993) (noting that fences and other boundary markers are more readily apparent to outsiders than a group’s internal work rules); Thomas W. Merrill & Henry E. Smith, *What Happened to Property in Law and Economics?*, 111 *Yale L.J.* 357, 388-94 (2001) (discussing simplicity of messages about property to dutyholders in the context of social norms and causation of harm); Henry E. Smith, *The Language of Property: Form, Context, and Audience*, 55 *Stan. L. Rev.* 1105, 1116-17 (2003); see also Thomas W. Merrill, *Trespass, Nuisance, and the Costs of Determining Property Rights*, 14 *J. Legal Stud.* 13, 16 (1985) (noting that the ad coelum rule involves “[n]o weighing or balancing of costs and benefits,” but rather is “exceptionally simple and exceptionally rigorous” (internal citations omitted)); ; Carol M. Rose, *Rethinking Environmental Controls: Management Strategies for Common Resources*, 1991 *Duke L.J.* 1, 18-20 (contrasting “KEEPOUT” and “RIGHTWAY” strategies in terms of administrative costs).

³² See *LeRoy Fibre Co. v. Chicago, Milwaukee & St. Paul Ry.*, 232 U.S. 340 (1914). Wood’s treatise gives a classic formulation:

It is the duty of every person or public body to prevent a nuisance, and the fact that the person injured could, but does not, prevent damages to his property therefrom is no defense either to an action at law or in equity. A party is not bound to expend a dollar, or to do any act to secure for himself the exercise or enjoyment of a legal right of which he is deprived by reason of the wrongful acts of another.

1 H.G. Wood, *A Practical Treatise on the Law of Nuisances in Their Various Forms: Including Remedies Therefor at Law and in Equity* § 435 (3d ed. 1893) (citation omitted).

the bilateral relations of the two parties this is puzzling,³³ but it is quite consistent with the information-hiding effect of the property module.³⁴

The problem with modular rights stems from actors who have *too much* information, because they are in a position to engage in opportunism. This would not be such a problem except that to handle it *ex ante* would require very elaborate interface conditions that would undermine the simplicity and flexibility of the modular system. Consider four situations familiar from law and economics.

In the law of building encroachments, the original approach was to enjoin encroaching structures.³⁵ An encroaching structure is regarded as an intentional and continuing trespass,³⁶ thereby bringing it into a traditional rule of near-automatic injunctions.³⁷ This poses an extreme hardship if the building owner must tear the building down and bargaining has reached an impasse. Even a bargain would involve great leverage *ex post* for the encroached upon party who is in a position to demand something just short of the tear-down cost to sell the injunction. This is wasteful from an *ex post* point of view. The possibility of such leverage *ex post* can lead to socially

³³ Susan Rose-Ackerman, Dikes, Dams, and Vicious Hogs: Entitlement and Efficiency in Tort Law, 18 J. Legal Stud. 25, 35-38 (1989) (discussing the lack of contributory negligence as a defense where real property is involved); see also Mark F. Grady, Common Law Control of Strategic Behavior: Railroad Sparks and the Farmer, 17 J. Legal Stud. 15 (1988) (analyzing tort law and judicial doctrines regulating behavior by injurer and victims).

³⁴ Smith, *supra* note 8; Smith, *supra* note 25.

³⁵ See, e.g., *Pile v. Pedrick*, 31 A. 646 (Pa. 1895); Restatement (First) of Restitution § 42(1) (1937).

³⁶ At least when the problem comes to the attention of the encroacher.

³⁷ Restatement (Second) of Torts § 158 (“One is subject to liability to another for trespass . . . if he intentionally . . . (c) fails to remove from the land a thing which he is under a duty to remove”); *id.* § 161(1) (“A trespass may be committed by the continued presence on the land of a structure . . . which the actor tortiously placed there whether or not the actor has the ability to remove it”).

wasteful precautions ex ante.³⁸ There has been a tendency to soften the remedy in the case of good faith improvers: if the encroachment was done as a result of a good faith mistake, the remedy may shift from an injunction to the payment of damages to acquire the sliver of land.³⁹ Similar considerations apply when a building is located in good faith on someone else's land entirely.⁴⁰ Equity will allow a claim for restitution as an alternative to a purchase of the land (giving the encroached upon party the choice).⁴¹ The idea is to avoid "disproportionate hardship" to the good faith encroacher. But in both situations, a bad faith encroacher or improver will be faced with the full injunctive remedy.⁴²

Similarly in personal property, mixing one's labor or materials with another's thing can give rise to a claim under the law of accession, under which the improving party will be able to keep the improved thing upon the payment of damages to the plaintiff in the amount of the value of the unimproved thing.⁴³ For example, if A mistakenly and in good faith carves B's piece of marble into a statue, A might be able to

³⁸ Stewart W. Sterk, Property Rules, Liability Rules, and Uncertainty about Property Rights, 106 Mich. L. Rev. 1285 (2008); see also Vincenzi Denicolò et al., Revisiting Injunctive Relief: Interpreting *eBay* in High-Tech Industries with Non-Practicing Patent Holders, 4 J. Competition L. & Econ. 571 (2008).

³⁹ See *Golden Press, Inc. v. Rylands*, 235 P.2d 592 (Colo. 1951); *Raab v. Casper*, 124 Cal.Rptr. 590 (Cal. Ct. App. 1975) (California Good Faith Improver Act); Kelvin H. Dickinson, Mistaken Improvers of Real Estate, 64 N.C. L. Rev. 37, 42-49 (1985).

⁴⁰ [See, e.g., *French v. Grenet*, 57 Tex. 273, 279 (1881).]

⁴¹ [*Somerville v. Jacobs*, 170 S.E.2d 805 (W. Va. 1969).]

⁴² [See cases cited in *Golden Press*] For an extreme example in which a court punished an apparently originally good faith improver who demolished the building after fruitless negotiations with the encroached upon landowner, see *Producers Lumber & Supply Co. v. Olney Building Co.*, 333 S.W.2d 619 (Tex. Ct. Civ. App. 1960).

⁴³ *Wetherbee v. Green*, 22 Mich. 311 (1871); Richard A. Epstein, Possession as the Root of Title, 13 Ga. L. Rev. 1221 (1979); Thomas W. Merrill, Accession and Original Ownership, 1 J. Legal Analysis (no. 2 2009); Smith, *supra* note 8, at 1766-77.

keep the statue and pay B the cost of the marble or furnish B with new marble. Again, the worry is that one who has acted in good faith will face disproportionate hardship from the normal rules of ownership and the ordinary course of legal remedies. But bad faith is often simply disqualifying: one cannot invoke accession if one knows of the rights violation. Similarly in contracts and unjust enrichment, officious intermeddlers, such as uninvited house painters, are those who knew they were violating someone else's right to be free from contract or obligation.⁴⁴ A good faith mistaken house painter, by contrast, might have a claim in unjust enrichment.⁴⁵

Another situation in which the interface of modular rights includes a loosening is animal trespass in open range areas. In such areas one is not liable for grazing by animals that stray onto another's unfenced land.⁴⁶ But those who deliberately send their animals to graze on another's land are trespassers.⁴⁷

Finally, there are situations in which permissible activities become impermissible if the motivation is pure spite. Thus one is free to erect a fence at the edge of one's property. But if the plaintiff can show that the fence was erected for the sole purpose of annoying the neighbor, then it can be enjoined (in equity) as a spite fence.⁴⁸

⁴⁴ See, e.g., John P. Dawson, *The Self-Serving Intermeddler*, 87 *Harv. L. Rev.* 1409, 1409 (1974). Admiralty law also tends to deny remedies to “an opportunist or an officious intermeddler.” *B.V. Bureau Wijsmuller v. United States*, 702 F.2d 333, 338, 1983 AMC 1471, 1477 (2d Cir. 1983) (quoting *Phelan v. Minges*, 170 F. Supp. 826, 828, 1959 AMC 975, 977 (D. Mass. 1959)).

⁴⁵ See, e.g., *Falcke v. Scottish Imperial Ins. Co.*, [1886] 34 Ch.D. 234, 248 (App. Cas.).

⁴⁶ See, e.g., Robert C. Ellickson *Order without Law: How Neighbors Settle Disputes* 42-43 (1991); Kenneth R. Vogel, *The Coase Theorem and California's Animal Trespass Law*, 16 *J. Legal Stud.* 149 (1987).

⁴⁷ *Light v. United States*, 220 U.S. 523, 537 (1911) (noting that fencing out rules “are intended to condone trespasses by straying cattle; they have no application to cases where they are driven upon unfenced land in order that they may feed there”).

⁴⁸ See, e.g., *Flaherty v. Moran*, 45 N.W. 381 (Mich. 1890); cf. *Kuzniak v. Kozminski*, 65 N.W. 275 (Mich. 1895) (no liability for mixed motives).

In each of these cases, the deliberate (bad faith) wrongdoer is treated more harshly than the innocent one. The problem is that the actor in each situation knows the structure and is trying to use this knowledge to employ the structure for ends outside the set that the structure was meant to serve. The modular structure is not in a one-to-one relationship with the interests it serves, precisely in order to save on delineation cost. But the indirectness between means and ends gives an opening to those with enough knowledge to employ the modular structure for unapproved ends. The problem is opportunism. By the same token, the disproportionate harm leads us to suspect that the good faith encroacher, improver, etc., is the victim of opportunism on the part of the one “standing on his extreme rights,” to use the traditional phrase. More on this in the next Part.

Equity can solve this problem of opportunism. The simplicity of the modular structure leaves many openings for opportunism, but, ex post, a decision maker in the equitable mode can observe the behavior and its effects. Particularly where the actor in question has committed the act with knowledge of the modular structure, we have added assurance that opportunism has occurred. The question is how to target this intervention so that equity itself does not undermine the modular structure. Equity would swallow the law if, for example, equity reevaluated all behavior ex post with a view toward its fit with the interests to be promoted. This would amount to a fully nonmodular ex post system.

III. EQUITY AS A SOLUTION TO OPPORTUNISM

Equity is a private law solution to opportunism. In this Part, I will show that equity is a coherent mode of decision making in which features work together to combat

opportunistic behavior that undermines the modular structures of the common law.

Without the modular structures there would be less reason for the equitable mode.

A. The Maxims of Equity

Starting with the maxims of equity makes sense both because they give a good idea of the content and nature of substantive equity and because they have attracted much of the skepticism about equity.⁴⁹ They are controversial in that some commentators think they have no value and even a few courts deny they exist. The criticism is that, like the canons of statutory interpretation,⁵⁰ they are too vague and uncertain, that they sometimes conflict, and that they don't constrain judicial decision making. Indeed for just these reasons, a proto-realist and expert on equity like Roscoe Pound found little value in the maxims themselves.⁵¹ Nevertheless, many courts cite them and they have not disappeared.⁵² I will argue that they are useful guidelines and that we should be asking whether the maxims and their uses give us a clue as to what is going on in equity. I will further argue that a closer look at the maxims reveals that they indicate the contours of a decision making mode in which judges are asked to combat opportunism, rather than merely reflecting that judges are engaged in a "reasonable modification of existing law."

⁴⁹ [See, e.g., John Norton Pomeroy, *Remedies and Remedial Rights* § 45, at 51 (Boston, Little, Brown, & Co. 1876); 1 John Norton Pomeroy, *A Treatise on Equity Jurisprudence* § 97, at 80-84 (San Francisco, A.L. Bancroft & Co., 1881.)]

⁵⁰ Karl N. Llewellyn, *Remarks on the Theory of Appellate Decision and the Rules or Canons About How Statutes Are to Be Construed*, 3 *Vand. L. Rev.* 395 (1950).

⁵¹ Roscoe Pound, *The Decadence of Equity*, 5 *Colum. L. Rev.* 20, 20-26 (1905).

⁵² Howard W. Brill, *The Maxims of Equity*, 1993 *Ark. L. Notes* 29 (1993); Charles M. Gray, *The Boundaries of the Equitable Function*, 20 *Am. J. Legal Hist.* 192, 202-06 (1976) (illustrating how courts of equity were prohibited from addressing real estate disputes); Roger Young & Stephen Spitz, *SUEM—Spitz's Ultimate Equitable Maxim: In Equity, Good Guys Should Win and Bad Guys Should Lose*, 55 *S.C. L. Rev.* 175, 177 (2003) (listing nine equitable principles used by the South Carolina courts, including "[e]quity follows the law" and "[e]quity act in personam, not in rem").

Even Chafee, who offered the capacious definition of equity noted earlier, did observe that the maxims of equity pertain to the conduct of the parties. We can refine this further by noting how the conduct in question fits a theory based on party opportunism. Let's examine the maxims in turn.

Organizing the maxims into categories is a little artificial because, as I am arguing, the various features of equity, including its themes, work together – holistically – as a safety valve against party opportunism. Nevertheless, we can make five rough groupings by theme and note that individual maxims can partake of more than one theme – and indeed that the maxims are often so closely related as to make their individuation a little arbitrary in the first place.

1. Cabining Maxims

It may seem odd to start with what equity is not, but equity is a safety valve – it is exceptional. Traditionally, the limits on equity were jurisdictional, and they were considered first, as a threshold matter. This structure expressed the aspiration to make equity exceptional and difficult to obtain – not that things always worked out that way. On the other hand, where this exceptional domain obtains, equity can be quite severe, as we will see.

(a) Equity follows the law.

This maxim is the first of several that help define the domain of equity. Because equity is a safety valve, the threshold question is whether we are in the domain.⁵³ In the

⁵³ See, e.g., Chafee, *supra* note 13, at 305-06 (“[W]hen equity was administered in a separate court of chancery ... unless the bill averred some reason for coming into equity [i.e., a basis for seeking particular equitable remedy], that court had no business at all to do anything about the case.”). Chafee saw this principle acting like subject matter jurisdiction. Laura S. Fitzgerald, *Is Jurisdiction Jurisdiction?*, 95 *Nw. U. L. Rev.* 1207, 1256 n.163 (2001).

days of separate equity courts, this threshold question was partly jurisdictional. The maxim, “equity follows the law” often leads the list of maxims, and it theoretically constrains the domain of equity.⁵⁴ Equity “won the battle” with law, but in a self-imposed restraint, it was not supposed to contradict the law.⁵⁵

The maxim that equity follows the law has special force in property cases. Property rights, as part of the modular structure of the common law, are supposed to be stable, and moreover they are in rem in the sense of availing against others generally. Because of this wide and indefinite audience, the introduction of idiosyncratic features of property through detailed ex post equitable decision making would greatly increase information costs.⁵⁶

This maxim of equity following the law and the associated principle of not interfering with basic property rights might seem to be contradicted by trusts and equitable property. Instead, the special features of beneficial interests and other “equitable property rights” cause them not to alter basic property rights when the informational impact on third parties would be large.⁵⁷ Instead, trusts themselves are

⁵⁴ For instance, equity would act in personam and would “follow the law,” especially with respect to property rights. See, e.g., 1 Joseph Story, *Commentaries on Equity Jurisprudence as Administered in England and America* §§ 26-27, 30, 64 (Melville M. Bigelow ed. 13th ed., Fred B. Rothman & Co. 1988, 2d printing 1999) (1853) (differentiating between courts of law and equity and explaining the various interpretations of equity “follow[ing] the line”).

⁵⁵ I bracket for now the question of the incentive for equity courts to exercise this self-restraint. Expansive equity jurisdiction could create backlash and it also increased workloads in courts that became very overburdened. On the role of competition between the common law courts and the tendency toward efficiency that can result, see Todd J. Zywicki, *The Rise and Fall of Efficiency in the Common Law: A Supply-Side Analysis*, 97 *Nw. U. L. Rev.* 1551 (2003).

⁵⁶ See Thomas W. Merrill & Henry E. Smith, *Optimal Standardization in the Law of Property: The Numerus Clausus Principle*, 110 *Yale L.J.* 1, 4, 33 (2000); Smith, *supra* note 31.

⁵⁷ See Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 *Colum. L. Rev.* 773, 843-49 (2001).

modules that present a relatively clean interface to the outside world. Also, if an equitable claim follows an asset into remote hands it is only of relevance to a subset of the world, namely future holders of the asset. Typically, enforcement of such equitable property rights against third parties also requires that the new holder have notice (or failed to give value to acquire the asset), but the law does not require such a person to make much effort to acquire notice. All this reduces the information costs of equitable property. In one recent analysis, equitable property is analyzed as a right against a right.⁵⁸ If so, the modular structure of the predicate right helps contain complexity costs. So for example if an equitable lien follows an asset, this is not relevant for most people interacting with the asset, such as potential tortfeasors. Someone who damages a car is responsible for the value of the car, out of which the lien will be paid, but is not responsible for the presence of the lien or any other effect on the lien holder.

More generally, equity rarely creates a remedy in the complete absence of a legal duty even where morally questionable behavior is going on. Thus, Young and Spitz collect a number of cases that can be characterized as featuring a “good guy” and a “bad guy,” but because the case is not “in equity,” the court does not intervene with an equitable remedy.⁵⁹

Likewise, the comprehensiveness of a statutory scheme may displace equity. For example, an eminent domain statute that specifies remedies can displace equity, as where a public authority exercises eminent domain but then abandons the planned project for

⁵⁸ Ben Mcfarlane & Robert Stevens, *The Nature of Equitable Property* (forthcoming, 4 J. Equity No. 1 (2010), University College London Law Research Paper; Oxford Legal Studies Research Paper No. 10/2009, available at SSRN: <http://ssrn.com/abstract=1350473>).

⁵⁹ Young & Spitz, *supra* note 52.

lack of funds. Even if the former owners wish to repurchase at the price agreed to under the threat of condemnation six months earlier, equity will not supply a duty to reconvey to the old owners.⁶⁰ The statute has created a new ownership with no such strings attached even though the public authority is acting very shabbily – and one suspects, spitefully, in this context.⁶¹

(b) Equity acts in personam, not in rem.

Another maxim that distinguishes equity from the common law and originally had a jurisdictional dimension is the in personam character of equity. We will encounter this aspect of equity in the hot news doctrine: the right, growing out of unfair competition, is only quasi-property, not full in rem property. Likewise it is said that equity is not supposed to interfere with in rem property rights.

Instead, equity originally only acted against the person. Equity courts could order a person within its geographical jurisdiction to do something and if such person did not, the court could hold the person in contempt, meaning a fine or jail.⁶² Originally courts of equity could not give remedies other than an order to a person, in personam. Injunctions themselves cannot be “in rem”: an injunction generally cannot bind all who had notice of it but rather only those who were specifically named and those acting in concert with them.⁶³ Gradually this principle was loosened, for certain categories of cases and certain trivial ministerial acts that the court could then perform directly. For example, now

⁶⁰ Indigo Realty Co. Charleston, 314 S.E.2d 601 (S.C. 1984); see Young & Spitz, *supra* note 52, at 178-79.

⁶¹ This is not to say that a statutory scheme of eminent domain should displace all aspects of equity. For example, if someone seeking eminent domain for a “public use” on the basis of blight has contributed to the blight, one could argue that such an entity is trying to profit from its own wrong.

⁶² See Int’l Union, United Mine Workers v. Bagwell, 512 U.S. 821 (1994).

⁶³ See, e.g., Rigas v. Livingston, 70 N.E. 107 (N.Y. 1904).

statutes at both the state and federal levels give courts power to transfer property within the jurisdiction, with in rem effect,⁶⁴ and courts have made creative use of equitable liens.⁶⁵ And in some cases of liens and contractual specific performance, such short cuts came to be allowed.⁶⁶

Nonetheless, there are functional reasons for not losing sight of the maxim that equity acts in personam. We would expect that in personam effects give rise to lower third-party information costs than do in rem commands, and a version of equity that did not hesitate to produce in rem effects would be destabilizing, complex, and present higher information costs. Consider the famous case of *J.R. v. M.P.*⁶⁷ That case involved a negotiable instrument and the defendant in equity had negotiated the instrument to a bona fide purchaser, instead of canceling it or destroying it after the debt had been paid. The court held the defendant in contempt but did not disturb the obligation. The point of a negotiable instrument is that a bona fide purchaser need not do a lot of inquiry and can retransfer without complication. The information-hiding effected by the negotiability is left in place, but the opportunist is hammered, and given an incentive to reimburse the obligor on the instrument.

⁶⁴ 4 J. Pomeroy, A. Treatise on Equity Jurisprudence § 1317 (4th ed. 1919).

⁶⁵ See Young & Spitz, *supra* note 52, at 182; citing Thornton v. Thornton, 328 S.C. 96, 492 S.E.2d 86, 92 (1997).

⁶⁶ [Reader pp. 18-19]

⁶⁷ Yearbook, 37 Henry 6, 13, pl. 3 (Court of Common Pleas, 1459).

(c) Equity will not aid a volunteer.

Again, the presence of a legal obligation is important. This maxim is related to the officious intermeddler and what counts as unjust enrichment. The officious intermeddler is likely to be an opportunist.

2. Direct Operation Maxims

The in personam aspect of equity also relates to another important feature: its direct action upon the person, tailored to a particular problem. Injunctions, the quintessential equitable remedy, act against named parties (and those acting in concert with them) and can be very finely tailored, both in their specificity and their breadth, to the problem at hand. Several maxims express the direct nature of equity's interventions.

(a) Equity will not suffer a wrong to be without a remedy.

This maxim captures much of the nature of equitable intervention both in its positive and negative aspects. Opportunists could take advantage of gaps in the common law system of remedies. Equity would step in to supply a remedy but, especially in light of the first maxim about following the law, equity would not act unless the legal remedy was inadequate.

For example, an opportunist may refuse to perform an act that is necessary for someone else to benefit from an entitlement. In *Taff v. Smith*,⁶⁸ an ex-wife refused to surrender an insurance policy, which was required to designate the decedent's mother as the new beneficiary. This may be a claim for reformation, which is in equity.⁶⁹ Notice

⁶⁸ 103 S.E. 551 (S.C. 1920).

⁶⁹ Young & Spitz, *supra* note 52, at 180.

too that in the view of the court, the ex-wife is trying to profit from her own wrongful omission, and in that sense is acting opportunistically.

Again, the division of labor between law and equity is relevant: no equity unless the remedy at law (usually damages) is inadequate. Some commentators such as Douglas Laycock have called into question whether this requirement of irreparable injury actually holds true.⁷⁰ As Laycock has argued, the irreparable injury cases (in which damages are found to be inadequate, thus paving the way for an injunction), seem to be all over the lot. It is hard to give an example that would be worth litigating that some court or other has not found to meet the criteria for irreparable injury (hence the “death” of the rule). But if equity is, as I argue, a decision making mode that is directed against hard-to-prove opportunism, we should not be asking for a rule in the first place. There is little point in tracing the outer contours of the cases to find such a rule, because what is really going on, according to this theory, is an effort to stop opportunism.

This presents an obvious empirical challenge. How do we know that two cases, one in which the legal remedy is found inadequate and the other in which it is found adequate, differ in that the former contains opportunism and the latter does not? In some cases, there are hints of opportunism and we might be able to design test scenarios in an experiment, but by and large the evidence for the safety valve theory of equity based on opportunism will have to rely on more indirect evidence: does the pattern of principles and cases fit the theory as a whole?

The division between law and equity is not self-defining and can implicate important policies. It is often forgotten that unfair competition and trade secret have

⁷⁰ See, e.g., Douglas Laycock, *The Death of the Irreparable Injury Rule* (1991); Douglas Laycock, *The Death of the Irreparable Injury Rule*, 103 *Harv. L. Rev.* 687, 688-701 (1990).

some of their origins in equity. Even the famous case of *International News Service v. Associated Press*,⁷¹ was a case in equity, as the Court emphasized, and the decision rested largely on the idea that a wrong will not be without a remedy. Interestingly, the Court was worried about disturbing or even creating property rights, and it emphasized that the right to prevent misappropriation of “hot news” is *quasi-property* (in a rare invocation of that term) that would not have in rem effect. It would just bind competitors for a limited amount of time. Nonetheless, commentators have tended to follow Justice Brandeis’s dissent and Judge Learned Hand’s later decisions in expressing skepticism about such a generative principle in the area of intellectual property.⁷² It is a worthwhile question, though, whether the equitable approach can be cabined sufficiently to allay these concerns.⁷³ Also, as I will argue later, the post-equity substitute for equitable tests is the multi-factor balancing test. On this view it is not surprising that the best judicial restatement of *INS v. AP* hot news doctrine, by Judge Winter in *National Basketball Association v. Motorola*,⁷⁴ features just such tests.

(b) Equity regards as done that which ought to be done.

Another way to combat opportunism is to undo it directly. Some such cases involve the opportunistic refusal to perform an act. If the court can use a fiction that the act has been done, the opportunism will not have its effect. The court treats parties as if

⁷¹ 248 U.S. 215 (1918).

⁷² *Id.* at 250 (Brandeis, J., dissenting); see also *Cheney Brothers v. Doris Silk Corp.*, 35 F.2d 279 (2d Cir. 1929) (Hand, J.).

⁷³ Henry E. Smith, *Does Equity Pass the Laugh Test?: A Response to Oliar and Sprigman*, 95 Va. L. Rev. In Brief 9 (2009), <http://www.virginialawreview.org/inbrief/2009/04/20/smith.pdf>; Henry E. Smith, *Equitable Intellectual Property: What’s Wrong with Misappropriation?* (draft, May 2011).

⁷⁴ *National Basketball Association v. Motorola, Inc.*, 105 F.3d 841 (2d Cir. 1997). [Trade secret and *Dupont*.]

the right things have been done, and by doing so often erases the benefits of opportunism directly.

(c) Equity imputes an intent to fulfill an obligation.

This maxim is related to the one that declares that equity regards as done that which ought to be done. Again, it allows courts to deny bad faith a scope for action.

3. Contextualizing Maxims

Within its domain, equity is less formal, i.e. more open to contextual information, than is the common law. Equity seeks individualized justice in which opportunism has no scope for exploiting the defects of the law that stem from its generality (Aristotle's concern again).

(a) Equity regards substance rather than form.

One tactic of opportunists is to invoke form over substance. This is very familiar from tax law, where not coincidentally one anti-opportunism device is the doctrine of substance over form.⁷⁵ The idea is that substance is less manipulable than form, in that form need not match up with substance. As mentioned earlier, in a simple modular structure form will diverge from substance, giving rise to opportunities for opportunism.⁷⁶

(b) Equity delights to do justice and not by halves.

This maxim is related to form-over-substance in that an opportunist can seek to take advantage of a limited view of the situation. If formalism is relative invariance to

⁷⁵ See sources cited in notes 14-15 supra.

⁷⁶ See Henry E. Smith, Mind the Gap: The Indirect Relation Between Ends and Means in American Property Law, 94 Cornell L. Rev. 959 (2009).

context,⁷⁷ the idea here is that a formal view that takes less context into account is vulnerable to manipulation. Context matters, and half-justice is an invitation for opportunism. In this maxim the court reserves the right to widen the frame if that will allow the law and the interests it serves to be more congruent. Compare the step-transaction doctrine in tax, which allows multiple activities to count as one transaction if this will give a more accurate picture of economic reality so as to prevent tax avoidance.⁷⁸

4. Moralizing Maxims

As is well known, equity relies directly on basic morality. Historically the courts of equity were “courts of conscience,” and the early Chancellors were clerical officials, among their many duties.⁷⁹ As we will see, the notions of right and fairness are not totally free-form – they are supposed to be cabined – but equity is by necessity open-textured, receiving much of its substance from everyday moral disapproval of deceptive behavior.

(a) Equity will not allow a wrongdoer to profit from his own wrong.

This maxim is almost a statement of the anti-opportunism principle. Equity will not apply a remedy that furthers the wrongdoing of the one asking for it.⁸⁰ And it will apply other equitable remedies like reformation to find the alternative to the wrong-

⁷⁷ See *infra* note 135 and accompanying text.

⁷⁸ See Weisbach, *supra* note 15, at 861; see also Gunn, *supra* note 14 (arguing against anti-abuse rules based on taxpayer purposes).

⁷⁹ See, e.g., Baker, *supra* note 1, at 112-28; but cf. Mike Macnair, *Equity and Conscience*, 27 *Oxford J. Legal Stud.* 659 (2007) (arguing that equity as a court of conscience originally meant that the judge knew and could draw on facts not in evidence).

⁸⁰ The principle is sometimes referred to as a policy of the common law and the “anti-slayer” rule has sometimes been codified. See Jesse Dukeminier, Robert H. Sitkoff, & James Lindgren, *Wills, Trusts, and Estates* 149-51 (8th ed. 2009). I am interested here in the equitable version.

furthering remedy that is now off-limits. In the classic case of *Riggs v. Palmer*,⁸¹ the court held that a grandson may not profit from his own wrong by getting any share of his grandfather's estate after the grandson murdered his grandfather in order to prevent him from changing his will. The court applied principles of equity both to the interpretation of the wills statute and to the will itself, and resoundingly stated that “[n]o one shall be permitted to profit by his own fraud, or to take advantage of his own wrong, or to found any claim upon his own iniquity, or to acquire property by his own crime.”⁸² The problem here is not just that the grandson committed an evil act but that he did so with a view to how it would redound to his advantage under the laws of wills and inheritance.⁸³ Notice that the standard for the maxim to apply to avoid the straightforward application of the wills act is absurdity or (manifest) unreasonableness. Equity is not supposed to be used for borderline policy calls, which dovetails with the focus on disproportionate hardship (see below).

Interestingly, Ronald Dworkin used *Riggs* as a springboard for critiquing positivism and for developing a theory of law based on moral principles that would in principle yield right answers.⁸⁴ In this, Dworkin can be read as a proponent of equity

⁸¹ 22 N.E. 188 (N.Y. 1889).

⁸² *Id.* at 190.

⁸³ By contrast, where the evil act is done without such advantage in view and where the advantaged party did not commit the act there is no scope for the principle to apply. Thus in a later New York case in which a husband killed his wife, the husband's parents were allowed to take under the residuary clause of the son's will. *In re Covert*, 761 N.E.2d 571 (N.Y. 2001).

⁸⁴ Ronald Dworkin, *Taking Rights Seriously* 17-45 (1977).

always being available. Historically and aspirationally – and, I argue, functionally – equity applies in a narrow domain, but potentially stringently within that domain.⁸⁵

(b) Equity is equality.

This maxim sounds in fairness. Equality is a major focal point and has been shown in psychological studies to exert a gravitational pull.⁸⁶ Opportunists can be regarded as trying to move away from equality, although equality may be context-specific. One virtue of equality as a presumptive baseline is that if people share widespread intuitions about what constitutes equality in given situations, this baseline is not as open to manipulation as some other more artificially constructed baseline.⁸⁷ Also, if an opportunist has to share gains proportionally with others, there will be less of an incentive to engage in opportunism. In the end, this maxim gives courts some leeway for intervening against opportunism without having to justify itself in detail. The advantages and disadvantages of deciding this way are characteristic of equity.

(c) Between equal equities the first in order of time shall prevail.

Like equality, priority is a focal point, and in many situations – but not all – it is not open to manipulation. So prior in time wins, as long as there is no imbalance of equities.

⁸⁵ Equity need not concern itself with a constant set of problems. The opportunism in *Riggs* is now well known and many states have so-called “anti-slayer” statutes, which spell out the disqualification of killer’s from taking under their victims’ wills or intestacy. See *supra* note 80.

⁸⁶ [See, e.g., John B. Van Huyck et al., *Credible Assignments in Coordination Games*, 4 *Games & Econ. Behav.* 606 (1992); see also Richard H. McAdams, *A Focal Point Theory of Expressive Law*, 86 *Va. L. Rev.* 1649 (2000).]

⁸⁷ See Young & Spitz, *supra* note 52, at 184; see also Thomas W. Merrill & Henry E. Smith, *The Morality of Property*, 48 *Wm. & Mary L. Rev.* 1849, 1867 (2007).

(d) She who seeks equity must do equity.

One method of dealing with opportunism is to deny equitable remedies and defenses to those whom the court views as opportunists. This maxim is related to the principle of not allowing a wrongdoer to profit from his own wrong. The maxim of requiring one who seeks equity to do equity helps prevent equitable remedies from themselves becoming tools of opportunism. This can easily happen where someone is trying to obtain an injunction in a contract in which that party has already engaged in sharp dealing. Interesting are cases in which one party relies on a representation by the other about future behavior. For example in *Ingram v. Kasey's Associates*,⁸⁸ the lessee who had an option assured the owner that he would not exercise the option but did anyway after the owner had agreed to another sale. The court cited the need to do equity (and clean hands) in order to get specific performance. This example also illustrates the tension of equity with rules like the parole evidence rule, in the case of integrated agreements. (Indeed, the exceptions to some rules like the Statute of Frauds have their origins in equity.⁸⁹) In another example, one cannot ask for the equitable remedy of a resulting trust where the purpose and effect is to defraud creditors.⁹⁰

(e) He who comes into equity must come with clean hands.

“Unclean hands” is another term for opportunism, and this proposition about clean hands is also considered not just a maxim but an equitable defense (see the next section). It is worth noticing that unclean hands, like other equitable determinations, is

⁸⁸ 531 S.E.2d 287 (S.C. 2000); Young & Spitz, *supra* note 52, at 186.

⁸⁹ See, e.g., David J. Ibbetson, *A Historical Introduction to the Law of Obligations* 28, at 203 n.4 (1999).

⁹⁰ *Hayne Federal Credit Union v. Bailey*, 489 S.E.2d 472 (S.C. 1997); Young & Spitz, *supra* note 52, at 187.

far less of a balancing test than one might think. While some assessment of the severity of the opportunistic behavior may be occurring sub rosa, the unclean hands maxim and the unclean hands defense make unclean hands a complete obstacle to using equity. In this it is very similar to “she who seeks equity must do equity,” but it is potentially broader. The two maxims are often cited together. Again, the danger is letting equity itself become a tool in the hands of opportunists.⁹¹ For example, if someone near the age of majority repudiates a contract opportunistically, that person is under no legal obligation, but a court will not afford the repudiator an injunction against interference with the new contract.⁹²

Also limiting the maxim is the principle that opportunism in the transaction in question is all that counts.⁹³ Thus if someone lies to another and seeks specific performance, the defense applies. If someone is a liar, a thief, or a notorious bad actor in

⁹¹ Unclean hands is also related to the potential for someone to profit from his own wrong, by brazenly enlisting the court’s aid. The Second Circuit recently captured this relationship well:

“Chutzpah” as a legal term of art is analytically similar to “unclean hands,” though not necessarily coterminous with that concept as understood in Chancery. The “classic definition” of chutzpah has been described as “that quality enshrined in a man who, having killed his mother and father, throws himself on the mercy of the court because he is an orphan.” Leo Rosten, *The Joys of Yiddish* 92 (1968). Courts in this Circuit have employed the “classic definition” and contemporary variations where a party’s conduct is especially and brazenly faulty.

Motorola Credit Corp. v. Uzan, 561 F.3d 123, 128 n.5 (2d Cir. 2009) (Cabranes, J.) (citations omitted) (summarizing cases involving former state senator serving sentence for selling stolen bonds who sued purchasing bank for negligence in accepting the bond leading to his conviction, and case in which a person who was mauled by the 450-pound Siberian tiger he was raising along with an alligator sued city and police attempting to rescue the animals for entering without a search warrant.)

⁹² *Carmen v. Fox Film Corp.*, 269 F. 928 (2d Cir. 1920).

⁹³ *Scattaretico v. Puglisi*, 799 N.E.2d 1258, 1261-62 (Mass. App. Ct. 2003) (“A person is not to be deprived of civil justice merely because he has sinned in the past; his wrongdoing must have been related directly to the present situation to justify his being barred.”); *id.* at 1262 n.16 [Chief Baron Eyre who, according to Chafee, *supra* at 8, first uttered the maxim, “A man must come into a Court of Equity with clean hands,” was well aware of the point: “it does not mean a general depravity; it must have an immediate and necessary relation to the equity sued for.” *Dering v. Earl of Winchelsea*, 1 Cox Eq. 318, 319, 29 Eng. Rep. 1184, 1185 (Ex. 1787).]

general but not in a given transaction, equity is still available to that person. This keeps equity more cabined, as a safety valve or refinement of the modular structure of rights.

Particularly interesting in terms of constraining equity is the limit on the clean hands doctrine where public records are at stake. In *Seagirt Realty Corp. v. Chazanof*,⁹⁴ the New York Court of Appeals held that the unclean hands doctrine would not apply, even if some earlier land transactions were inequitable, where the plaintiff is suing for a new deed to replace a lost one from those transactions. Even a voluntary reconveyance to a fraudulent grantor is good as between the parties, and moreover the accuracy of the land records is at stake. The Court placed great weight on Chafee's views on this conflict between clean hands and the land records:

It must also be remembered, as we are reminded by the late Professor Zechariah Chafee, that moral indignation against the plaintiff must operate, not in a vacuum, but in harmony with other important purposes and functions of the substantive law involved. As he criticized the application of the unclean hands doctrine in a situation similar to that here present, 'This ethical attitude seems entirely out of place. What ought to count is the strong social policy in favor of making the land records furnish an accurate map of the ownership of all land in the community. Whatever A's old misdeeds, he is the lawful owner of this lot and the records ought to show this fact. The existing record falsely makes R owner. It may mislead scores of honest citizens people who have strong reasons for wishing to buy the lot, such as creditors of A, creditors of R, or lawyers drawing deeds of adjoining lots who are anxious to insert an accurate description. What is the sense of perpetuating an erroneous land record in order to penalize A for past misdeeds by causing him inconvenience? (Footnote omitted.) Better regard his dirty hands as washed during the lapse of twenty years rather than mess up the recording system.' (Chafee, *Some Problems of Equity*, 21-22 (1950).)⁹⁵

Seagirt Realty was a close case, as reflected in the intermediate appellate decision and the dissents, but it does reflect how equity peters out as in rem information costs increase.

⁹⁴ 96 N.E.2d 254 (N.Y. 1963).

⁹⁵ *Id.* at 256.

(f) Equity aids the vigilant and diligent.

Like unclean hands, this maxim is related to a defense, namely laches. Although it is harder to say, opportunism may be at the edge of the picture here too. Unreasonable delay in asserting one's rights calls forth reliance on the part of others. The danger is that this prejudice may be deliberate, i.e. opportunistic. Again, courts do not like to become instruments of oppression.

5. Disproportionate Hardship Maxims

Equity uses disproportionate hardship as one of its main proxies for opportunism. Situations of disproportionate hardship correlate with opportunism because one party may be using extreme leverage against the other. What makes this problematic is when this happens in a way that would be contracted away (or, alternatively one would not approve behind the veil of ignorance). The disproportionate hardship is especially problematic if it occurs unexpectedly and we therefore suspect that one party is simply taking unfair advantage of the other. Interestingly, a (perhaps somewhat broader) notion of disproportionate hardship lies at the heart of the civil law doctrine of abuse of right, which despite the lack of equity courts in such systems, resembles my reconstruction of equity as an anti-opportunism device.⁹⁶ Disproportionate hardship is also one of the factors for injunctive relief, as we will see.

(a) Equity abhors a forfeiture.

Here too the focus is on unjust-looking results, but opportunism may be the real culprit. I suggest as a hypothesis that the anti-forfeiture maxim comes in broader and narrower versions. The broader one is the familiar ex post effort to rescue people from

⁹⁶ [cites]

dire consequences. But such a purely ex post and expansive version is not the only possible one. As with unconscionability, which is likewise hard to define and comes in various scopes and strengths, there may be a narrower and more targeted version of the anti-forfeiture maxim. Richard Epstein has suggested that unconscionability be limited to near-fraud – what we might term “opportunism.”⁹⁷ Likewise, the core of the anti-forfeiture maxim might be said to be those cases in which the extreme consequences – disproportionate hardship – are the result of sharp dealing, misleading behavior, and other forms of opportunism. As Carol Rose notes, forfeitures are situations involving disproportionate hardship that often involve “mopes” or “ninnies” on one side and (importantly from our point of view) “sharp dealers” on the other, waiting to take advantage.⁹⁸ Again, if the virtue of the maxim is that such opportunism need not be proved or spelled out in an opinion, that is also its weakness: it gives a lot of discretion to judges, it is easily misunderstood as broader than it is, and it is difficult to test empirically.

If so, another hypothesis worth exploring is that mistake and fraud, which are also triggers for equity, are related to the anti-forfeiture doctrine in that all three come at the same problem – opportunism – from different angles.⁹⁹ In general, unexpected ex post situations featuring disproportionate hardship tend to call forth self-serving, overreaching behavior.

⁹⁷ Epstein, *supra* note 21.

⁹⁸ Rose, *supra* note 4, at 587-88, 598-99.

⁹⁹ [Cf. penalty doctrine in contracts. *Truck Rent-A-Center v. Puritan Farms 2nd*, 361 N.E.2d 1015 (N.Y. 1977).]

(b) Between equal equities the law will prevail.

Equity is not about balancing and near-equipose, but rather equity concerns itself with major problems where the law is unlikely to be inadequate in the face of opportunism.

B. Equitable Defenses

We have had occasion to mention some of the equitable defenses in connection with the maxims. I argued that unclean hands and laches deter opportunistic behavior. In this section, I consider another defense, estoppel, and the question whether it makes sense to have a separate class of equitable defenses at all.

Estoppel refers to the refusal of a court to allow someone to take a later position inconsistent with an earlier one, where someone else has reasonably relied on the earlier representation and allowing an effect to the later position would result in injustice. The situation is rife with the possibility of opportunism.

The general assumption in our post-realist, post-fusion era is that there is no point in pairing equitable defenses to equitable remedies or claims. Yorio has argued that there is a danger, though, of making remedies all or nothing if equitable defenses apply across the board.¹⁰⁰ The safety valve theory offered here is consistent with this view of equity. As we have seen with defenses like unclean hands, the safety valve theory also suggests that equitable defenses should not be used in a fashion that leads to large third-party information costs, especially where opportunism is not the central issue.

¹⁰⁰ See Edward Yorio, A Defense of Equitable Defenses, 51 Ohio St. L.J. 1201 (1990).

C. Injunctions

Injunctions are the classic equitable remedy. They implicate opportunism both in the behavior they are directed against and in the dangers that injunctions themselves present.

I have argued elsewhere that one reason to favor property rules as the default and liability rules as an exception is the possibility of opportunism on the part of potential takers of entitlements.¹⁰¹ In a situation in which the current owner values the entitlement more than the taker but cannot prove this value to a court, we must worry that an opportunistic taker will cherry pick entitlements to take. This is possible especially if courts announce a valuation methodology in advance, thereby giving rise to an arbitrage opportunity. Wider use of injunctions can prevent this type of opportunism.

Injunctions themselves can facilitate opportunism, as is more widely recognized. A party can insist on an injunction even though it is much more costly to the defendant than it benefits the plaintiff. If so, the plaintiff can extract a supracompensatory amount from the defendant. For this reason, injunctions have been considered a discretionary remedy: courts leave the door open to denial of injunctions where the risk of opportunism is great.

The problem of injunctions in patent law is, I argue, a problem of potential opportunism that calls for a safety valve from the (rebuttable) presumption for injunctions. “Patent troll” is hard to define, and the question is under what circumstances patent owners can be considered to be overcompensated and what that means.¹⁰² A broad

¹⁰¹ Smith, *supra* note 16, at 1764-68, 1774-85.

¹⁰² Compare Mark A. Lemley & Carl Shapiro, Patent Holdup and Royalty Stacking, 85 Tex. L. Rev. 1991, 2037-38 (2007) (arguing for systematic overcompensation from injunctive remedy); Gerard N. Magliocca,

definition of “troll,” such as one embracing any nonpracticing entity, casts too wide a net: it means that an inventing entity that makes money through licensing will be disadvantaged in negotiations in a way that a practicing entity will not. The clearest “troll” problem would be patent holders with patents that are easy to design around ex ante who wait until reliance by another makes the patent hard to design around ex post.¹⁰³ This narrower patent troll problem is very similar to the dilemma in building encroachments, and, as I argue elsewhere, the traditional approach to injunctions includes safety valves well suited to deal with trolls in this narrower sense of opportunism.¹⁰⁴ In particular, even the Supreme Court’s four-part test for injunctions in *eBay v. MercExchange*,¹⁰⁵ which is a modified version of the test for preliminary injunctions, should be read in light of the equitable traditions the court invokes. This traditional equitable mode makes irreparable harm and the inadequacy of the legal remedy the threshold (formerly jurisdictional) questions.

Likewise the other factors accord with a concern with opportunism. The “balance of the hardships” asks whether the injunction would visit a “grossly disproportionate

Blackberries and Barnyards: Patent Trolls and The Perils of Innovation, 82 Notre Dame L. Rev. 1809 (2007) (analogizing troll problem to nineteenth century “patent sharks”); with Vincenzo Denicolò, Do Patents Over-compensate Innovators?, 22 Econ. Pol’y 679 (2007) (finding little evidence of overcompensation); John M. Golden, “Patent Trolls” and Patent Remedies, 85 Tex. L. Rev. 2111 (2007) (critiquing case for overcompensation).

¹⁰³ See Denicolò et al., supra note 38.

¹⁰⁴ Smith, supra note 25, at 2125-32.

¹⁰⁵ 547 U.S. 388, 390 (2006). The Court has reiterated this test outside the patent context. *Monsanto Co. v. Geertson Seed Farms*, 130 S. Ct. 2743, 2756-57 (2010).

¹⁰⁶ John M. Golden, Mark R. Gergen & Henry E. Smith, *An Accidental Revolution: Hardship and the Supreme Court’s Test for Permanent Injunctions* (draft, April 2011).

hardship” on the defendant.¹⁰⁷ The balance of the hardships sounds as if one should be asking who suffers the worse hardship (a tilt off from equipoise) or even be conducting a mini-cost-benefit analysis for the injunction.¹⁰⁸ Not so. The traditional approach was to look for disproportionate hardship or gross imbalance of the hardships,¹⁰⁹ which is a good proxy for opportunism. Likewise the public policy factor is not a comprehensive cost-benefit test either but counsels against an injunction in cases of clear damage to the public, especially in public health.

IV. EQUITY AS HYBRID DECISION MAKING

In this Part, I argue that decision making that is a hybrid between law and equity is likely to be superior to law or equity alone. Overall, law is the starting point and the default mode, and equity is a “safety valve.” Equity applies in a smaller domain with an eye to deterring opportunism, but where it applies it is vague and ex post.

Previous models have focused on legal commands individually. Consider the law and economics analysis of rules and standards. Rules are formulated ex ante and standards leave more content to be determined ex post. For each legal directive, lawmakers face a choice to couch the directive as a rule or a standard. As Kaplow has

¹⁰⁷ See, e.g., 42 Am. Jur. 2d Injunctions § 35 (2005) (“Even if the wrongful acts are indisputable, an injunction may be denied if the payment of money would afford substantial redress and if the injunction would subject the defendant to grossly disproportionate hardship.”); see also See Richard A. Epstein, A Clear View of The Cathedral: The Dominance of Property Rules, 106 Yale L.J. 2091, 2102 (1997) (arguing that “essentially the appropriate solution is to allow injunctive relief when the relative balance of convenience is anything close to equal, but to deny it (in its entirety if necessary) when the balance of convenience runs strongly in favor of the defendant. The usual presumption is that the exploitation risk is greater than the holdout risk. This presumption can be reversed by a showing of the dramatic difference in values . . .”); Herbert F. Schwartz, Injunctive Relief in Patent Infringement Suits, 122 U. Pa. L. Rev. 1025, 1045-46 (1964) (suggesting a “grossly disproportionate hardship” standard); Henry E. Smith, Institutions and Indirectness in Intellectual Property, 157 U. Pa. L. Rev. 2083 (2009).

¹⁰⁸ [cites]

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explored, rules are more expensive to create but cheaper to enforce.¹¹⁰ For example, figuring out the right numerical speed limit may require a lot of study (and political negotiation), but it is easy for the police and courts to apply. It is also cheap for people to know where they stand (as speeders or not). By contrast, a standard is cheaper to formulate (for example, “drive reasonably”), but more expensive at the enforcement stage. Unless the standard relies on some widely shared knowledge (such as a custom or a moral intuition), it may also be more costly for people to inform themselves about what is forbidden. Under either rules or standards, actors might not inform themselves; the interesting case is one in which actors will inform themselves under the rule but not the standard.¹¹¹

Other models focus on the role that vagueness plays in chilling behavior. Actors will overcomply with a legal command that is vague because the private benefits and costs of the probability of liability around the mean are not symmetric; overcompliance can externalize costs of the actor’s behavior.¹¹² On this view, vagueness is considered undesirable and would be eliminated where it not costly to do so.

More recently, some commentators have started finding benefits to vagueness beyond the savings in the delineation costs that would have to be incurred in converting them to brightline rules. Because it leads to higher litigation costs, vagueness can serve as a signaling or commitment device.¹¹³ If so, this helps explain why parties pick vague

¹¹⁰ Kaplow, *supra* note 2.

¹¹¹ *Id.* at 575-76.

¹¹² Calfee & Craswell, *supra* note 5.

¹¹³ See, e.g., Albert Choi & George Triantis, *Completing Contracts in the Shadow of Costly Verification*, 37 *J. Legal Stud.* 503 (2008); Albert Choi & George Triantis, *Strategic Vagueness in Contract Design: The*

terms in their contracts despite the seeming low cost of drafting and enforcing a brightline rule-like substitute provision. In a vein somewhat similar to the informal tax avoidance literature,¹¹⁴ Ferguson and Peters model how vagueness can itself be beneficial when a subset of actors are looking for loopholes to exploit in an explicit brightline rule.¹¹⁵ But in their model vagueness still causes a chilling effect and inefficiency in the legal system. The optimal level of vagueness, which will be positive on their model, requires a tradeoff between the benefits of combating loopholes on the one hand and incurring the cost of the chilling effect and the costs to the legal system from vagueness on the other. The chilling effect is especially important for unsophisticated actors. They show that an “Orwellian” equilibrium, in which rules are both “overly” strict and vague, maximizes social welfare. Nevertheless, like most of the previous literature on vagueness, their model assumes that the legal system is made up one type of rule, or at the least that the decision whether to make any given legal directive vague or strict is a freestanding one.

The choice between law and equity, however, is not fully captured as a law-by-law, doctrine-by-doctrine choice of rules versus standards. As reflected at one time in the separate jurisdictions of the law and equity courts, this paper will treat law and equity as two interacting decision-making modes. Law is the default and equity is the safety valve. Further, the features of equity – importantly, the ex post discretionary nature of decision-making but also in personam operation, the emphasis on good faith and notice, the

Case of Corporate Acquisitions, 119 Yale L.J. 848 (2010); George G. Triantis, The Efficiency of Vague Contract Terms," 62 La. L. Rev. 1065 (2002).

¹¹⁴ See sources cited in notes 14-15 supra.

¹¹⁵ Michael F. Ferguson & Stephen R. Peters, But I Know it When I See it: An Economic Analysis of Vague Rules (January 2000), available at SSRN: <http://ssrn.com/abstract=218968>.

employment of moral standards, and some inherent vagueness – are captured in the safety valve theory.

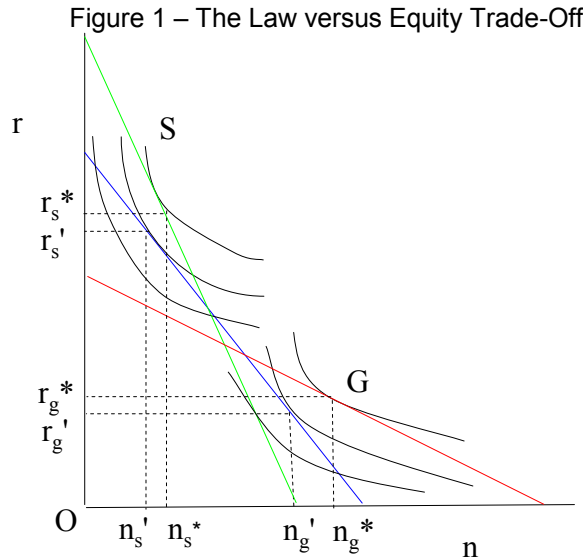
We need to consider four types of actors. Sophisticated actors are those who will impose social costs through efforts at manipulating rules. Unsophisticated actors are those who cannot manipulate the system but are wrongly perceived by a judge to be sophisticated. Garden variety actors are those who neither can manipulate nor appear to do so. Devious actors are those who manipulate but escape detection. Consider the situation in which garden variety actors are the most numerous. The design issue is how much to use vague rules. If all actors were garden variety, there would be no rationale to use vague rules other than to save the costs of formulating a brightline rule. If the costs from chilling behavior are added to the impact on the legal system (formulation, understanding, and enforcement) and the result is negative, there would be no rationale for the vague directive. If all actors were sophisticated or some are sophisticated and some unsophisticated, then there is a rationale for vagueness, as on the Ferguson and Peters model. When we have all types of actors, we can remove the burden of the chilling effect from some of the normal actors by making equity exceptional – a safety valve – which applies only to actors who appear sophisticated to the judge. This unfortunately includes some actors who would be garden variety if errors were zero but who appear sophisticated – that is, they are unsophisticated. The cost of the safety valve comes from the Type I errors of mistakenly seeing what would be garden variety actors as sophisticated (making them “the unsophisticated” in my terminology), as well as the Type II errors of wrongly seeing as garden variety those actors who are actually

sophisticated (making them what I am calling the “devious”), as well as any net costs of vagueness itself on the working of the legal system.

If sophistication is rare but its impact from each actor is severe, it makes sense to delineate an exceptional domain in which vague directives are used. Not only is some use of vagueness in the system sometimes welfare increasing, its benefits can be procured at less cost by confining it to a safety valve. A related way to capture the law is to start with its similarity to the problem of property versus contract, and their different “audiences” of duty holders: property reaches a wide, anonymous, and disparate audience and contractual duties are directed to a narrower more personalized audience (with a variety of contractual provisions such as boilerplate in mass contracts in between).¹¹⁶ To reach the more extensive “in rem” audience, communication costs will be higher (especially the costs of processing the message), or the communication has to be more formal (less information per unit of delineation cost). Something analogous is true of law versus equity. If the legal system used the same style of decision making for both the sophisticated and the garden variety, we have the green budget line, which leads to (n_s', r_s') for the sophisticated and (n_g', r_g') for the garden variety. The two groups however present different costs and benefits of numbers and formalism, with units of delineation cost more effective on the extensiveness of the audience margin (n), rather than the intensity of the information margin (r). The sophisticated are the opposite: fewer in number, more worth targeting, and more expert and easily reached with intense

¹¹⁶ Smith, supra note 31; Smith, supra note 28. I do not rule out the possibility that equity sends one message to official decision makers and another to primary actors, or, perhaps more likely, one message to decision makers and the sophisticated actors on the one hand and the garden variety actors on the other. On such “acoustic separation” with a primary focus on the criminal law, see Meir Dan-Cohen, Decision Rules and Conduct Rules: On Acoustic Separation in Criminal Law, 97 Harv. L. Rev. 625 (1984).

information. Separate decision making (blue for “law” and red for “equity”), leading to (n_s^*, r_s^*) for the sophisticated and (n_g^*, r_g^*) for the garden variety.



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- n = audience size
- r = information rate
- C = isobenefit for contract
- S = isobenefit for the sophisticated
- G = isobenefit for the garden variety

Breaking up the budget into two separate budgets lead to attaining a higher level of utility with the same resources for delineation (including enforcement).

Equity’s in personam operation and its employment only where the legal remedy is inadequate, are two methods of creating an exceptional safety valve. Emphasis on good faith and notice can be seen as an attempt to distinguish the sophisticated from everyone else, as candidates for ex post, vague, and harsh treatment by equity. Use within the equitable safety valve of moral standards obtains the benefits of anti-

manipulation but by using familiar tools, making it less expensive than constructing standards out of whole cloth.

V. EQUITY AND CONTRACTUAL PRIVACY

Equity will apply differently in various areas of private law, and it goes beyond the scope of this Article to survey equity for similarities and differences across property, torts, contracts, and even more equity-based areas like unjust enrichment, trusts, and so on. Perhaps most challenging for the anti-opportunism theory of equity as a safety valve is the law of contracts, which is therefore worth considering in further detail. There is a conventional case against equity in contracts, with practical and theoretical aspects. On the practical side, the tendency is for equity to have been submerged in very expansive ex post judicial interventions in contracts. Starting with Legal Realism and especially in the 1960s and 1970s, courts shaped contract law to be more ex post and mandatory. For example, courts expanded the notion of unconscionability to strike down contracts that seemed unfair ex post. Contracts that were not the product of negotiation or could be regarded as reflecting a nebulous “unequal bargaining power” were particularly vulnerable to judicial rewriting. Precontractual liability apparently expanded through promissory estoppel.¹¹⁷ Some even saw the death of contract as contracts became assimilated to torts based on wrongs defined in terms of unfair behavior of various kinds.¹¹⁸

¹¹⁷ See, e.g., *Hoffman v. Red Owl Stores, Inc.*, 133 N.W.2d 267, 275 (Wis. 1965); but cf. Robert E. Scott, *Hoffman v. Red Owl Stores* and the Myth of Precontractual Reliance, 68 Ohio St. L.J. 71 (2007).

¹¹⁸ See, e.g., Grant Gilmore, *The Death of Contract* 87 (1974) (arguing that “being reabsorbed into the mainstream of ‘tort’”).

Much early law-and-economics commentary was a reaction against substantive judicial review, especially second-guessing of contracts on fairness grounds. More generally, the theoretical literature highlights the many ways that contractual parties can deal with opportunism on their own, usually through ex ante contracting.¹¹⁹ Thus, law-and-economics scholars have emphasized how contractual provisions may allocate risks and how difficult it is to evaluate these devices ex post. For example in liquidated damages, a party that has high subjective damages might bargain for high damages.¹²⁰ When an apparently unexpected risk comes along, the temptation may be for a court to set such a remedy aside as a penalty even though the remedy came within what the parties bargained for. Further, structural devices can be used to combat opportunism. Vertical integration can be used to solve the problem of ex post hold up.¹²¹ Asset ownership can, on a smaller scale, prevent incentives to engage in individually maximizing behavior that shrinks the contractual surplus.¹²² As for off-the-rack contract law, the focus is likewise ex ante. In situations of asymmetric information, penalty default rules have been proposed in order to force the informationally advantaged party to cough up private information that he might use to make his share of the contractual pie

¹¹⁹ See, e.g., Alan Schwartz & Robert E. Scott, Contract Theory and the Limits of Contract Law, 113 Yale L.J. 541 (2003).

¹²⁰ See, e.g., Charles J. Goetz & Robert E. Scott, Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach, 77 Colum. L. Rev. 554, 594 (1977); Alan Schwartz, The Myth that Promisees Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures, 100 Yale L.J. 369 (1990).

¹²¹ See, e.g., Benjamin Klein, Robert G. Crawford & Armen A. Alchian, Vertical Integration, Appropriable Rents, and the Competitive Contracting Process, 21 J.L. & Econ. 297 (1978).

¹²² See, e.g., Sanford J. Grossman & Oliver D. Hart, The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration, 94 J. Pol. Econ. 691 (1986); Oliver Hart & John Moore, Property Rights and the Nature of the Firm, 98 J. Pol. Econ. 1119 (1990); see also Oliver Hart, Firms, Contracts, and Financial Structure (1995).

larger at the expense of making the overall pie smaller.¹²³ In all of this commentary, the theme is how to design mechanisms that the parties can vary in order to deal with the opportunism problem *ex ante*.

A few commentators have highlighted the fact that parties themselves sometimes pick vague terms for their contracts.¹²⁴ Even if the critics of *ex post* judicial decision making are correct that courts have overused standards, this literature notes that parties may have reason sometimes to choose vague terms. For one thing, it may simply be cheaper to defer to *ex post* decision making on issues that come up rarely, in a private version of rules versus standards.¹²⁵ Or there may be strategic advantages to vagueness in that because it causes high litigation costs a vague provision can be used to commit to the contract itself.¹²⁶

Even this latter literature on the benefits of vagueness and standards does not suggest that vague *ex post* standards should be mandatory or even strong defaults. The emphasis is still on the parties and their efforts to constrain opportunism.

There is one strand of the literature that has focused on the problem of opportunism as a problem for substantive judicial decision making.¹²⁷ This literature has

¹²³ Ian Ayres & Robert Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 *Yale L.J.* 87 (1989).

¹²⁴ See Choi & Triantis, *supra* note 113; Triantis, *supra* note 113.

¹²⁵ Kaplow, *supra* note 2.

¹²⁶ Choi & Triantis, *supra* note 113.

¹²⁷ See George M. Cohen, The Fault that Lies Within Our Contract Law, 107 *Mich. L. Rev.* 1445 (2009); George M. Cohen, The Negligence-Opportunism Tradeoff in Contract Law, 20 *Hofstra L. Rev.* 941 (1992); Timothy Muris, Opportunistic Behavior and the Law of Contracts, 65 *Minn. L. Rev.* 521 (1981).

come under criticism for not paying attention to the parties' ability to choose methods of dealing with opportunism.¹²⁸

As mentioned earlier, this paper's approach to equity is in a sense a more robust and general version of Epstein's account of unconscionability.¹²⁹ Epstein notes that force and fraud are unproblematically forbidden but are hard to prove.¹³⁰ The problem is near-fraud, which for Epstein is either actual fraud that cannot be proven or conduct so closely associated with fraud that presuming it to be fraud helps more than it hurts transacting. Epstein would rule out expansive substantive unconscionability, but he opens the door for courts to review contracts for proxies for fraud even if fraud cannot be proven: essentially certain proxies for fraud set the presumption against the party acting in a questionable fashion. He analogizes unconscionability to the Statute of Frauds in that it deals with fraud indirectly by identifying classes of contracts that are suspicious and subjecting them to a writing requirement.¹³¹ The idea is that setting the presumption against such contracts will produce more benefits in terms of preventing errors than it will cause harm through the invalidation of legitimate deals. Contracts with parties under the age of majority are an example. The furthest Epstein is willing to go is a case in which recently

¹²⁸ See, e.g., Robert E. Scott, In (Partial) Defense of Strict Liability in Contract, 107 Mich. L. Rev. 1381 (2009); see also Richard Craswell, When Is a Willful Breach "Willful"? The Link Between Definitions and Damages, 107 Mich. L. Rev. 1501 (2009).

¹²⁹ Epstein, *supra* note 21.

¹³⁰ Even the anti-vagueness literature is consistent with a concern with fraud itself, but there problem of fraud is treated as a separate one that is subject to sanction. Defining fraud and penalizing it criminally or through tort is unproblematic because the optimal amount of fraud is zero. Only detection and enforcement costs make it optimal to tolerate positive amounts of fraud.

¹³¹ *Id.* at 302.

returned Vietnam War veterans in receipt of accumulated back pay were targeted with a high pressure sales pitch for unattractive municipal bonds.¹³²

The safety valve theory of equity extends both the anti-fraud and anti-opportunism literatures. My argument is that equity uses a somewhat broader set of proxies than on procedural unconscionability to ferret out opportunistic behavior, which falls in a narrower range than in fault-based theories of contract law. Equity, if it can be cabined, still falls short of the wide ranging ex post substantive (post-)Realist contract law.

As commentators in the opportunism school have pointed out, ex post contract law may sometimes be the most cost-effective method of constraining opportunism. The question is when and how far those ex post devices should be difficult to contract around. Consider a sequential model. Two parties consider whether to contract. If they do, at the insistence of the garden variety (non-sophisticated) party G, the parties can take some costly precaution to prevent G from being taken advantage of through the ex post opportunism of the sophisticated party S. If the precaution is taken, the contractual surplus is lessened by its cost (and by assumption the cost shared in proportion to the other gains of contracting), but the sophisticated party does not engage in opportunism. If, on the other hand, the precaution is taken, then S is faced with a choice. S can be nice or nasty. If there is no equity mechanism in place, S will choose to be nasty. In which case, G will insist on precaution when it is cost-effective in G's view on average to take it, but S will be nasty otherwise. If the cost of precaution is high enough there will be no contract. Now add equity. Now where G takes no precaution, a court using proxies will impose a cost on S when it thinks S is nasty. This will be subject to some error which

¹³² Id. at 304.

will be reflected in a chilling cost when S is actually nice. Now the question is whether and when equity with its chilling effect can be a more cost-effective response to S's opportunism than is the ex ante precaution (and the alternative of no contract). It can be shown that the likelihood of using equity under these circumstances should decrease with the size of the chilling effect (as is familiar) but should also increase in the size of the potential transfer from G to S through opportunism. (See the appendix.) It makes sense for equity to develop proxies for the opportunities for opportunism and limit itself to this defined domain in order to diminish its chilling effect on legitimate behavior.

The first of these proxies and the most direct one is bad faith (along with its extreme form, maliciousness). The safety valve theory of equity suggests that bad faith and maliciousness should be keyed to opportunism.

Another cluster of proxies relates to the contractual situation being unforeseeably different from the one anticipated. Mistake is a central category of equity and it is also a defense in contracts. Less obviously, equity looks for situations of "disproportionate hardship." These can lead to or reflect attempts to engage in opportunism. For example, the cost of completion cases can be interpreted as directed against opportunistic invocation of the letter of a contract. So insisting on tearing down a house to replace Cohoes with equal-quality Reading pipe is so costly compared to the evident benefit that it invites the danger of opportunistic invocation of the letter of the contract.¹³³ Situations of disproportionate hardship that were within the contemplation of the parties, such as a casualty that materializes under an insurance contract, do not reflect opportunism. But equity uses interpretive presumptions to prevent opportunism without closing the door to

¹³³ *Jacob & Youngs, Inc. v. Kent*, 129 N.E. 889 (N.Y. 1921).

explicit risk allocation. This is in a sense a generalization of the prophylactic version of unconscionability discussed earlier.

The safety valve theory also permits us to revisit the question of remedies in contracts. Damages can become inadequate where performance is hard to value and this valuation problem is magnified by opportunism. Furthermore, as we have seen, courts realize that the prospect of an injunction can be wielded by parties opportunistically.

Finally, unlike other areas of private law the question arises for contracts whether equitable principles should be displaceable by contract and if so how easily.¹³⁴ If opportunism is the problem, the danger is that a rigid rule of allowing contracting around might itself invite opportunism. But mandatory equity is open to the longstanding criticism of ex post analysis in contract law that it frustrates parties' objectives and chills behavior. These positions can be reconciled if we consider equitable principles high-level guideposts that are increasingly difficult to contract around as they become more high-level. In this they are like the (ex ante) rules of contract formation themselves. There is little to be gained and much invitation to error if we allow people to vary the law of contract formation. Similarly with equity and opportunism. There is little to be gained and much to be lost by allowing people to easily contract around an equitable safety valve.

¹³⁴ For an argument that in the case of sophisticated parties, courts should defer entirely to parties' choice of means rather than employing what they call "equity," see Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. Rev. 1023 (2009). With sophisticated parties, the likelihood that equity will be less costly than the parties' chosen means will be less likely. But to the extent that opportunism is not fully foreseeable, equity still has a role to play as argued in the text. For example one might employ the same proxies for opportunism but negate them to the extent that the contract addresses the problems directly. Although one could imagine allowing generalized contracting around the possibility of opportunism, this accommodation may not be worthwhile along the same lines that rules of contract formation are mandatory. Compare also courts' reluctance to allow even sophisticated parties to bargain around the duty of good faith altogether, rather than opting out of specific applications of what otherwise might be required under a duty of good faith.

Somewhat unexpectedly, equity still has a role in situations in which parties are in a direct contractual relationship. In other words, equity still has a place – albeit a limited one – in situations of contractual privity.

VI. FURTHER IMPLICATIONS

Seeing equity as a safety valve directed at opportunistic behavior provides a new perspective on several other debates in disparate areas of the law.

Most straightforwardly, if equity is best seen as serving as a safety valve against opportunism, this helps resolve some of the debates over formalism in the law. As I have argued elsewhere, formalism is a matter of degree: a system is formal to the extent that it is invariant to context.¹³⁵ Thus, the language of first-order logic is more formal than English because interpretation requires more context in the latter.¹³⁶ One factor pushing away from reliance on formalism is its vulnerability to opportunism. Thus in the post-fusion era when legal realists and their successors argue for maximal potential use of context, they are in a sense arguing for equity all the time.¹³⁷ This has the potential of undermining the simplicity and stability (otherwise) of the formal law. On the other side, formalists will be driven to more elaborate *ex ante* formulations in the face of party opportunism. The result tends to be multi-factor tests or, to be very formal, rules that are not tailored toward goals. The conflict was quite overt in the case of *Grupo Mexicano de Desarrollo, S.A. v. Alliance Bond Fund, Inc.*,¹³⁸ in which the question was the availability

¹³⁵ See, e.g., Francis Heylighen, Advantages and Limitations of Formal Expression, 4 Foundations Sci. 25, 49-53 (1999) (equating formality of language with context independence); Smith, *supra* note 56, at 1112 (“[A]n expression is formal to the extent that its meaning is invariant under changes in context.”).

¹³⁶ And within a natural language, semantics is more formal than pragmatics.

¹³⁷ Smith, *supra* note 56, at 1177-83; Smith, *supra* note 28, at 1214-19.

¹³⁸ 527 U.S. 308 (1999).

of preliminary injunctions to freeze unrelated assets in a suit in which only money damages were being sought. The majority per Justice Scalia held that because that power did not exist at equity at the time of the Federal Judiciary Act of 1789, federal courts may not issue such preliminary injunctions.¹³⁹ In dissent, Justice Ginsburg favored the availability of such preliminary injunctions based on the flexibility and generativity of the equity power.¹⁴⁰ For her, the test for a preliminary injunctions cabined the power enough, but with no apparent structure or bite to these limits. Both polar positions overstate matters. The theory here suggests that equity should be available but only by applying the “test” for injunctions narrowly. In *Grupo Mexicano*, the defendant was apparently acting quite opportunistically, and the preliminary injunction would serve to protect jurisdiction over assets and prevent judgment-proofness, concerns fitting well within the traditional domain of equity and its role as an anti-opportunism device.

Interestingly, equity as a safety valve may also shed some light on the question of Delaware Equity and the debate over Delaware corporate law. Does Delaware compete with other states for corporate charters and does this lead to a race to the bottom,¹⁴¹ a race to the top,¹⁴² or some form of leisurely walk?¹⁴³ Commentators have noticed that

¹³⁹ Id. at 332-33. Freezing orders, or *Mareva* injunctions as they are also known, are familiar in Commonwealth jurisdictions.

¹⁴⁰ Id. at 342 (Ginsburg, J., dissenting).

¹⁴¹ William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *Yale L.J.* 663, 666 (1974) (race to the bottom).

¹⁴² Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. Legal Stud.* 251, 256 (1977) (arguing against race to the bottom and tentatively for a race to the top); see also Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *Yale L.J.* 2359 (1998).

¹⁴³ Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 *Colum. L. Rev.* 1908 (1998) (monopolistic competition); Ralph K. Winter, *The “Race for The Top” Revisited: A Comment*

Delaware's Chancery Court judges have a reputation for high quality, and that Delaware corporate law has built into it much scope for judicial discretion.¹⁴⁴ Most importantly, the court has a self-conception and a reputation for infusing its jurisprudence with morality, which can be interpreted as anti-opportunism.¹⁴⁵ This is consistent with a role for equity and the Chancery Court after all is a court of equity. And, to the extent empirical studies suggest that Delaware corporate law is efficient,¹⁴⁶ it is mildly suggestive evidence for this paper's thesis that an equitable safety valve aimed at rooting out opportunism can improve on all law alone.

VII. CONCLUSION

Equity serves as a refinement to the law where the law invites opportunism. Private law sets up relatively simple modular structure of rights that well-informed actors can exploit in hard-to-foresee ways. As a result, equity intervenes in a limited domain, acts in personam, emphasizes good faith and notice, reflects common sense morality,

on Eisenberg, 89 Colum. L. Rev. 1526, 1529 (1989) (pointing out that the history of antitakeover legislation suggests that instead of a race there is a leisurely walk to the top).

¹⁴⁴ Kamar, *supra* note 143 (describing indeterminacy and evaluating it negatively).

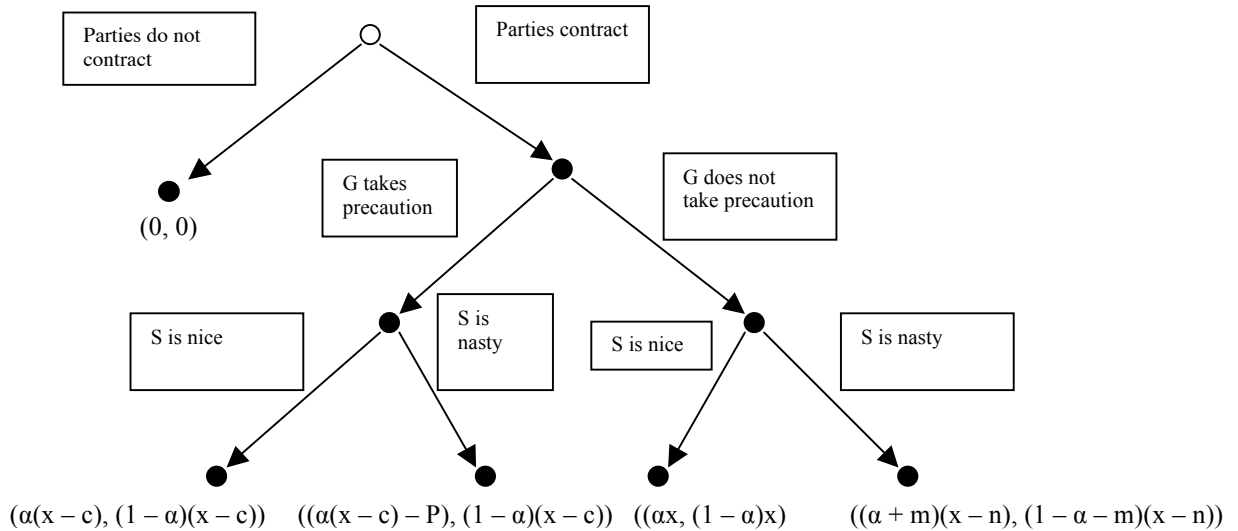
¹⁴⁵ See, e.g., William T. Allen, Professor Scheppelle's Middle way: On Minimizing Normativity and Economics in Securities Law, 56 Law & Contemp. Probs. 175 (Summer 1993) (Chancellor of the Delaware Court of Chancery arguing for role of morality in law because courts must be especially concerned with the least powerful, "our legal order is a constituent part of our moral universe" and "our system of legal rules must ultimately conform with the dominant moral sentiments of the age of the law is achieve a productive balance between dynamic change and social stability"); Stephen J. Massey, Chancellor Allen's Jurisprudence and the Theory of Corporate Law, 17 Del. J. Corp. L. 683 (1992). For a classic statement of the spirit of equity, see Schnell v. Chris-Craft Industries, 285 A.2d 437, 439 (Del. 1971) (stating that "inequitable action does not become permissible simply because it is legally possible."); William T. Quillen, Constitutional Equity and the Innovative Tradition, 56 Law & Contemp. Probs. 29, 51 (Summer 1993) ("In an intricate world, the strength of basic morality can still be fostered well as a separate discipline in a distinct institution. . . . [I]t is amazing how true the current court is to the tradition of English Chancery.").

¹⁴⁶ Compare Robert Daines, Does Delaware Law Improve Firm Value?, 62 J. Fin. Econ. 525, 556 (2001) (finding evidence consistent with a role for Delaware corporate law in improving firm value) with Guhan Subramanian, The Disappearing Delaware Effect, 20 J. L. Econ. & Org. 32, 57 (2004) (finding "Delaware effect" to be limited to small firms in the period 1991-1996).

widens the contextual frame, employs vague standards and ex post judicial discretion, and uses sanctions rather than prices. Historically and descriptively, the law versus equity distinction tracks the expectations of this view of equity fairly well. Normatively, the safety valve theory suggests that employing the equitable decision making mode in addition to a simple, stable law proper can be superior to either decision making mode by itself.

APPENDIX

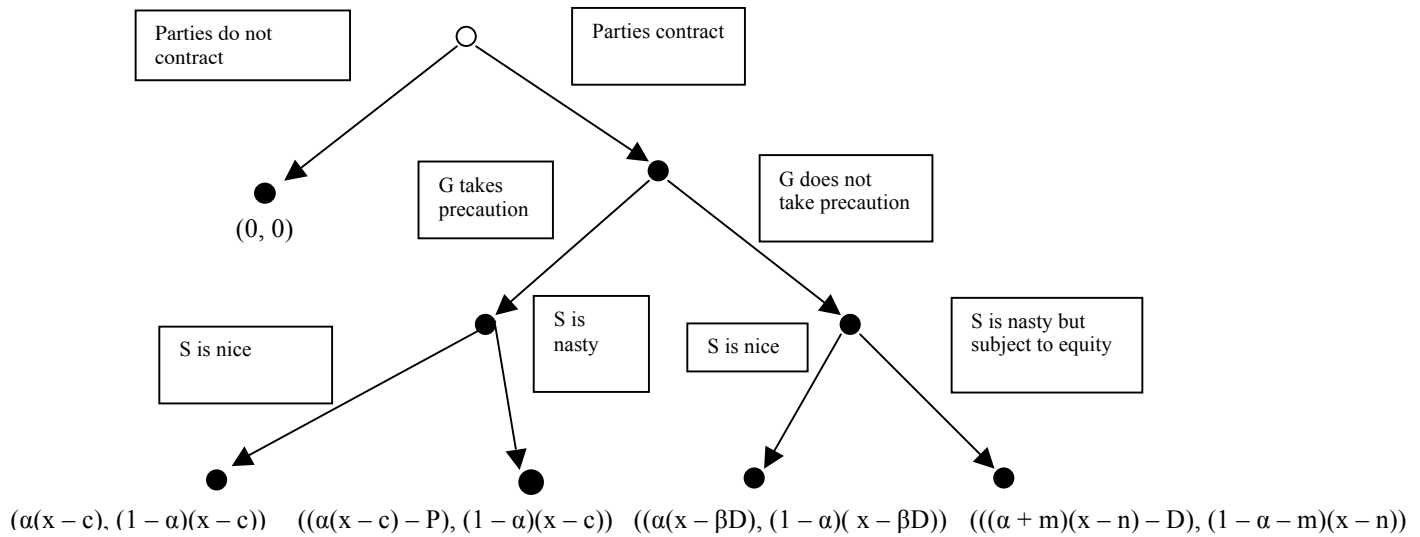
Consider first the role of equity in a contract between what a court takes to be a sophisticated (S) and a garden variety party (G). The parties must decide whether to contract, with S getting proportion α ($0 < \alpha < 1$) of the surplus, and the rest, i.e. $(1 - \alpha)$, going to G . At G 's insistence the parties can take a precaution at cost c , which (by nonessential assumption is shared in the same proportion). If S is nasty after the precaution is taken S is penalized with penalty P . If G does not take the precaution and there is no equitable decision making mode, S then decides whether to be nice or nasty (opportunistic). By being nasty, S can get a greater proportion ($\alpha + m$) of a smaller surplus ($x - n$). The payoffs are shown in Figure 1:



Payoffs: Sophisticated's, Garden Variety's

Figure 1

In such a situation the precaution should be taken if $c < n$. (Notice here that the opportunist S cannot cause the surplus to become negative and has an incentive to leave G with a positive amount to satisfy G 's participation constraint.) Now consider whether adding an equitable decision making mode can make things better. Here we add to the no-precaution branch a possibility of S being subject to equity (a defense for G , denial of an injunction, equitable interpretation, unconscionability, and the like). See Figure 2. If S is nasty and is subject to equity, S suffers an equitable detriment D . But at the same time the equitable decision making mode casts a shadow over normal contracting when S is nice (in terms of the chilling effect), which is in proportion to D ; that is, the surplus is decreased by βD .



Payoffs: Sophisticated's, Garden Variety's

Figure 2

To make sure *S* is nice, the payoff to *S* from being nasty, $((\alpha + m)(x - n) - D)$, must be less than the payoff from being nice, $(\alpha(x - \beta D))$, and in addition contracting must be worthwhile (which will be true when $x > \beta D$). So $D > (mx - mn - an) / (1 - \alpha\beta)$. We are interested in when the payoff from niceness under no-precaution-plus-equity is greater than the payoff under ex ante precaution, which requires comparing the respective loss of surplus from the precaution (c) and the chilling effect (βD). Equity will be favored when $c > \beta((mx - mn - an) / (1 - \alpha\beta))$ and $x > \beta D$. The likelihood that equity will be useful is decreasing in β (the chilling effect), and increasing in m , the size of the potential opportunistic transfer. “Disproportionate harm” is in proportion to $(2\alpha + 2m - 1)$, which is the difference between *S*'s share of the surplus, $\alpha + m$, and *G*'s share, $1 - \alpha - m$, where *S* is nasty. This is increasing in m but also in a α , which represents the rest of *S*'s bargaining power. Equity will be successful to the extent it finds good proxies for n and negative proxies for β .

Generalizing beyond contract, the scope for equity potentially increases. *S* need not leave *G* any surplus and thus n can even exceed 1. If so, then equity will be useful in a wider range of situations (because $c > \beta((mx - mn - an) / (1 - \alpha\beta))$) will be more likely to hold).

[Set-up for the more general situation: There is a set of n actors who live for one period and derive utility U from consuming. Each engages in an activity that produces output $P(x)$ with x the level of some set of activities. The social welfare $W = nU$. $P(x)$ yields benefits $B(x)$ at a cost of $C(x)$. ($B'(x) > 0$, $C'(x) > 0$, $C''(x) > 0$ and $B'(0) > C'(0)$. $B(0) = C(0)$ and $B''(x) = 0$. Production has positive and negative externalities: Fraction β of production is appropriated by the actor generating it, and the rest $(1 - \beta)$ redounds to others. On the cost side, α of the costs of the activity is borne by the actor, with the rest $(1 - \alpha)$ falling on others. $\alpha \in [\alpha_0, \alpha_1]$, $0 < \alpha_0 < \alpha_1 < 1$, $\alpha_1 > 1 - \beta$.

For now assumed identical actors for each of whom the profit from the activity is:

$$\pi = \beta B(x) - (1 - \alpha)C(x)$$

with utility

$$U = \pi + (1/n)S$$

where

$$S = \sum_{i=1}^n [(1 - \beta)B(x_i) - \alpha C(x_i)]$$

is the sum of the externalities.

Social welfare is the sum of net benefits:

$$W = n[B(x) - C(x)]$$

Solving for the first-order condition of maximization gives:

$$B'(x^*)/C'(x^*) = 1$$

Instead actors choose higher levels of a (x^\wedge):

$$B'(x^\wedge)/C'(x^\wedge) = (1 - \alpha)/\beta$$

An official decision maker chooses α_r to constrain actors to choose α between α_0 and α_r , but because of erosion from opportunism by actors α is higher by $e(\lambda)$, which is a function of the ability to engage in opportunism (λ). For now assume that vague ex post standards are more expensive than ex ante rules, with an impact $h(v, \alpha)$ on activity levels.

We have four groups of actors, who will pick different activity intensities.

Garden: $\alpha_g = \alpha_r$

Devious: $\alpha_d = \alpha_r + e(\lambda, v)$

Unsophisticated: $\alpha_u = \alpha_r - h(v, \alpha_u)$

Sophisticated: $\alpha_s = \alpha_r + e(\lambda, v) - h(v, \alpha_s)$

For social welfare function the contribution of the activities of these actors once they are subject to the legal regime will depend on their proportion in the population and the error rate of the courts in classifying them. Let p be the proportion of actors subject to the equity safety valve. Of those the Type I error rate is e_1 , so that the proportion of unsophisticated actors is e_1p and the proportion of sophisticated actors is $(1 - e_1)p$. Likewise for those $(1 - p)$ actors not subject to the equity safety valve, who are subject to the legal regime only, the Type II error rate is e_2 , so that the proportion of devious actors is $e_2(1 - p)$ and the proportion of garden actors is $(1 - e_2)(1 - p)$.

Social welfare is:

$$W = (1 - e_2)(1 - p)P(x_g) + e_2(1 - p)P(x_d) + e_1pP(x_u) + (1 - e_1)pP(x_s)$$

And for each type of actor utility is

$$U_i = \beta B(x_i) - (1 - \alpha_i)C(x_i) + (1/n)S$$

Investment distortion can be proxied by the excess intensity of the devious and sophisticated over everyone else. It can be shown that condition for positive vagueness involves the initial impact of vagueness on the manipulation effect to be greater than the net chilling effect: $h_v(0, \alpha_u) - h_v(0, h_s) = -e_v(\lambda, 0)$.

This can be generalized to our four cases, the difference being that there are two choices: not only the level of but p . For $p = 0$, the system reduces to the choice of vagueness. Otherwise the impact of vagueness, including net error costs, is traded off against the net chilling effect. As the set of garden actors (g) becomes larger and the impact on the legal system from vagueness (net of the effects) becomes larger, and as e_2 grows relative to e_1 (Type II errors are more severe than Type I errors), p shrinks and the equitable safety valve becomes narrower.]