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Beware of Legal Transitions: A Presumptive Vote for the Reliance Interest

RICHARD A. EPSTEIN*

Transitions are, by nature, always dangerous. Ask what is most dangerous about flying an airplane, and the answer is taking off or landing. Want to find where automobile accidents are likely to happen? Try getting in and out of parking lots. Wonder when accidents occur at home? It’s getting in and out of cars, houses, beds or chairs. Transitions are risky because they inject a new dynamic into what is otherwise a more static process. The multiplication of possibilities that transitions create increases the risk of harm in any ongoing process, even after people take added precautions in order to counter the dangers. We run these risks because of the gains that transitions generate; no one wants to wear the same clothes in winter and summer, or to remain stock-still in the same spot for hours on end. In a very real sense, social transitions of all sorts and descriptions are as unavoidable as the transition from day to night (to which many of these transitions in fact respond). Simply put, transitions are an inseparable part of ordinary life.

Transitions are not only fixed features of our everyday lives. They are also fixed features of our legal and social environment. It goes without saying that the pressures of social and technological: the plow often cry out for readjustments in legal policy. In some instances, it is necessary to correct previous mistakes in policy. In other cases, it is necessary to adapt old legal rules to new technologies farming, the printing press, the railroad, the radio or the Internet. We, therefore, witness a constant procession of incremental changes through the common law, and larger systematic changes through regulation, taxation and the modification of liability rules. The grand question is what is the proper social attitude toward the management of these legal transitions? Should they be

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encouraged or discouraged? Be systematic or incremental? For those legal transitions that prove desirable, should they be implemented by constitutional amendment, legislation, common law adjudication, or market mechanisms?

To this ubiquitous question, the common answer as of late is in favor of a “pro-retroactivity norm—associated mainly with [Michael] Graetz and [Louis] Kaplow—builds on the idea that such a norm, if well published and made somewhat binding on government decisionmakers, would give private parties, firms and individuals, an incentive to efficiently anticipate legal change.” This theory invokes an implicit norm of least cost avoidance. Private parties are thought to be better able to adapt to changes in the legal order than governments are to anticipate the behavior of private parties. Therefore, the risk of legal change is placed not on the parties who initiate that change but on those whose expertise is said to allow them to anticipate any changes that might be made. The new framework in which this position is urged is avowedly consequentialist, in which the punch line is that we should prefer an “anticipation-based” approach to the earlier “reliance-based” approach. The latter is more closely associated with the categorical norms from the Kantian or natural law tradition, and it was closely entwined with the notion of the rule of law.

I yield to no one in my belief that consequentialism offers the appropriate framework for analyzing legal rules. Ironically, however, as in so many other cases, the basic skeptical instincts of the natural lawyers, often seen as backward looking and anti-consequentialist, do better by this consequentialist analysis than the newer approach that explicitly invokes forward looking norms. The proper approach starts with a strong presumption and not a categorical denial: beware of legal transitions. Wherever possible try to keep the legal framework constant, and allow the response to societal changes to take place through private adjustments. To give but one example, changes in technology and preferences may lead to sharp changes in the terms of many employment contracts, but they offer scant justification for altering the older rules that favored freedom of contract and allowed for the contract at will. In

other contexts, however, the outcome could easily be different: With water rights, for example, changes in the intensity of use may well call for the alteration of these rules in order to reduce the pressure on common pool assets. In this water case, the transition is justified because of tangible and immediate changes to the conditions and consequences of the current legal regime. Common pool assets, once thought unlimited, have become demonstrably finite, and therefore require a regulatory response. The basic justification for this transition is that simpler rules of capture do a weak job in preventing the exhaustion of common pool assets, so that when demand spikes, more must be invested in controlling access to the resource for the benefit of all involved. The same is true with respect to various kinds of pooling arrangements that can be for the preservation of the fishery, or of oil and gas fields.

In each of these examples, the case for the legal transition rested on the fact that substantial allocative gains warranted the increased administrative costs. Indeed, only if the marginal benefits from each step in the legal transition are greater than the marginal costs of such a transition, should it be implemented. By this logic, the case for hastening legal transitions becomes more compelling when the changes in question simplify the operation of the legal system, because then the administrative costs of such a system decrease. Thus, the repeal of a price control or a rent control statute will surely cause some dislocations by those who have made investments in reliance on the continuation of the legal scheme (just as it deterred many investments by others), but the relaxation of the massive set of legal restraints should on average work so great an improvement that these costs should be borne with relative equanimity. The same can be said for the dismantling of many other types of legal regimes, such as tariffs on trade or labor regulation.

Unfortunately, most modern legal transitions have moved matters in the opposite direction, and have dramatically increased the administrative costs of legal rules. In these cases, legal transitions should in general be discouraged, and the rules on transitions should be organized in ways that reduce their frequency. For example, if the cost of the transition is put on the government entities and their supporters who wish to initiate

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5. This is in effect the dominant theme in Harold Demsetz, Toward a Theory of Property Rights, 57 Am. Econ. Rev. 347 (Pap. & Proc. 1967). For the Japanese illustration, see Mark Ramseyer, Water Law in Imperial Japan: Public Goods, Private Claims, and Legal Convergence, 18 J. Legal Stud. 51, 63 (1989). For an American instance, where “imperative necessity” was found to justify the transition in legal rules, see Coffin v. Left Hand Ditch Co., 6 Colo. 443, 449 (1882).
the change, they will be less likely to go forward with it. One obvious reason for this anti-transition bias is that transitions are costly even when perfectly done. The time, expense, and uncertainty created by the development and implementation of new legal rules should always tilt the scale in favor of the status quo. In many cases, moreover, the new transitions that promise justice or efficiency are fraught with hidden perils that overwhelm programs that have broad levels of social support. The massive developments with the Telecommunications Act of 1996 have followed paths that no one predicted, and which have caused serious dislocations within the industry.\(^6\) The adoption of Title IX to deal with sex discrimination in educational institutions that receive support from the federal government has also generated massive dislocations by the imposition of the proportionality by sex requirement for intercollegiate athletics.\(^7\) In both these cases, statutes that purported to have relatively modest objectives were expanded in their scope and impact by administrative decision so that the final resting point seemed far removed from the initial statutory objectives. Even the most well-meaning transitions carry with them this danger of overshooting the mark—assuming that they were headed in the right direction in the first place. The once popular aphorism—an old tax is a good tax—carries with it a fair bit of wisdom. It is not that individuals and firms are incapable of making adjustments to changes in their legal environment. Rather, it is that they are required to incur the costs of so doing. Given that somber reality, the initial premise ought to be that the residual risks of change, whether or not anticipated, ought to be borne in the first instance by those who champion or initiate the change, and not those who are asked to respond to it. Both justice and efficiency point in this direction.

In making any global assessment of the equitable distribution of the costs associated with transitions, much depends on our views of the expected value of legal transitions. In particular, the threshold question is whether we regard government actors as purposive agents for good, or as necessary evils that we first select and then tolerate because we fear the greater chaos that will arise in their absence. The first of these views treats governments as honest agents of the public interest. The second registers substantial doubts on that proposition.

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6. For an account of the political infighting that led to critical decisions under the act, see Peter Huber, Telecom Undone—A Cautionary Tale, Commentary 34 (2003).
7. 20 U.S.C.A. § 1681 (2000). The appropriate response here is to abolish Title IX. The transition costs of that change are close to zero. For my latest plea in that direction, see Richard A. Epstein, Just Do It!: Title IX as a Threat to University Autonomy, 102 Mich. L. Rev. (forthcoming 2003).
Ideally, the system could be organized so that all legal changes were Pareto efficient to the extent that government could make them so. First, we would introduce only changes in laws that by our best collective estimates improved the overall size of the social pie. Next, we would arrange side payments to compensate the losers from the legal changes in question. Each transaction would be a self-contained deal that would produce overall improvements. Indeed, in many cases the gains could be made proportionate to the initial investments so that the surplus is allocated in a fashion that allows each person to receive the same rate of return on his private investments to the common good. In the private sector, this result is achieved by investment in partnerships and corporations, all of which have that feature built in on the ground floor.

Alternatively, we could relent on the Pareto test and count on our virtuous government enacting those changes that produce larger benefits to winners than the losses it imposed on losers. The use of this Kaldor-Hicks formulation would not make all transitions win/win across the board, but it would rule out at the front end any negative sum government projects in which the gains of the winners are not sufficient to compensate the losers, while leaving those winners better off as well. The distributional consequences might be unpleasant in any individual case, but even that unhappiness would tend to even itself out over the long-haul; the virtuous government does not target insular and isolated minorities, but rather treats the welfare of all its citizens equally. In so doing, the constant procession of sound overall legal innovations will leave, after the dust settles, few if any losers behind. The basic point is that over large numbers of events with virtuous governments, the Pareto test and the Kaldor-Hicks test converge, with (ironically) the slight edge to the latter insofar as it eliminates the costs needed to calculate compensation on a piecemeal basis for each and every social reform precisely because virtuous governments only generate net advantages. The virtuous government will be hampered in its quest for good deeds by a constitutional or political restraint on its ability to implement its preferred programs.

There is, however, a very different view of government that supports a very different view of legal transitions. The public choice position, somewhat oversimplified, says that public officials, even when bound by the oaths of office, do not gravitate toward legislative programs that are always calculated to advance the common good in either of the two senses mentioned above. Self-interest is a strong driver of individual behavior outside of political institutions, and people do not check their
personal passions and inclinations at the door when they assume public office. Much of constitutional law in the United States is directed to the proposition that legislatures will often take advantage of discrete and insular minorities, to use the famous phrase of the *Carolene Products* decision.\(^8\) The result is that an unconstrained legislature has no particular institutional incentives to approve only those changes that are either Pareto or Kaldor-Hicks efficient. Rather, it will initiate and ratify changes that in many cases will lead to net losses, factional gains and bureaucratic bloat. In some cases it will do this directly; in others, as with telecommunications and Title IX, it will delegate power to administrative agencies staffed by individuals with partisan agendas. Accordingly, a presumptive case can be made out for judicial intervention that in some ways will improve the odds that legislation will only take the form of introducing socially desirable changes.

The case is at best presumptive, alas, because there is no bullet-proof institution that can determine which legal transitions count as social improvements and which ones do not. Try as we may, the only force that human ingenuity has been able to devise to counteract the forces of partisan politics is the judicial intervention of judges, who by design bear little or no forms of political accountability. In the end, therefore, we find that the question of institutional arrangements is always a question of toting up alternative imperfections. Do we think that unaccountable judges offer an effective counterweight to legislative bodies that are subject to democratic pressures that routinely vary from enlightened to demagogic?

In this debate, I have long championed the view that a heightened level of judicial intervention does make sense, at least under a constitution that regards its primary missions as the preservation of liberty and property.\(^9\) Common law rules of property, contract and tort provide a serviceable backdrop for social interaction, so that it becomes appropriate to treat them as a baseline by which we judge the soundness of any general rule. Where a law works in particular fashion, as to condemn the land of a given individual, we make up the shortfall by direct compensation. Where the law works in general form, it becomes impossible to use specific mechanisms of compensation to see that its benefits and burdens fall equally across the population at large.\(^10\)

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10. See, e.g., Armstrong v. United States, 364 U.S. 40, 49 (1960) ("The Fifth Amendment's guarantee that private property shall not be taken for a public use without just compensation was designed to bar Government from forcing some people alone to bear
test of proportionate impact does not rule out democratic decisions on what changes should be made; rather, it gives individual legislators an incentive to vote in ways that are socially responsible. If each person gets “n” percent of the gain and bears “n” percent of the loss from any government program, the only way that he can vote to maximize his own welfare is to maximize that of his fellow citizens. The proportionate impact rule tends to be incentive compatible in that it makes people “show their cards,” revealing their true preferences as to whether any piece of legislation works to their own benefit. In so doing, the rule usually leads to decisions that are socially optimal, because the only way that one person can advance his own interest is to advance the interest of his fellow citizens at the same time. The system is far from foolproof, and there are many cases in which the harms and benefits are not quite in sync across the population as a whole. A uniform tax of fuel, for example, might impact individuals who drive SUVs more heavily than those who drive compact cars, resulting in a wealth shift between them. But in these cases it is in general not a good idea to push to hard on the takings requirement because it is unclear just what tax is ideal for the purposes. As long as the level of incidence is small per unit, and the number of units very large, it becomes foolhardy to impose a compensation requirement. However, as the number of targets is reduced and the net redistribution increases, that passive option becomes far less attractive. Yet, we are always required to draw some line, and the heightened judicial intervention rule remains our most attractive option because the added cost of a dual mechanism will on balance be less than the benefits of this rule in imposing procedural and popular restraints against various forms of partisan abuse. It would not make sense to allow, without compensation, a rule that prohibited further construction in a given city region when all owners except one have built-out their properties, such that they benefit from a restriction that has a single concentrated loser.11 Similarly, it would not make sense to allow a rule that forced people who had not built on their property and did not participate in the democratic process to pay for the pollution caused by people who had already built and thus were in a position to shape the local rules to their advantage through the political process.12

public burdens which, in all fairness and justice, should be borne by the public as a whole.”).  
11. See, e.g., Haas v. San Francisco, 605 F.2d 1117 (9th Cir. 1979) (wrongly sustaining such a restriction without compensation.).  
12. See, e.g., Tahoe Sierra Pres. Council, Inc. v. Tahoe Reg’l Planning Agency,
The choice of attitudes regarding the government virtue maps closely onto the questions of legal transitions. If we start with a virtuous view of government writ large, there is little reason to oppose legal transitions. The legislature will move from good to better; the courts will do the same. With this view of the world, individuals who plan their actions at T1 should be aware of social changes that will be made at T2 and take into account that their conduct may in the end be judged under standards that were not in place at the time they made their original decisions. The upshot is that individuals will behave in a more responsible fashion even before the legislature or court has made the appropriate adjustments to existing law. The coordination game thus has a corner solution: the maker of the legal rule has perfect freedom; the private party is duty-bound to anticipate its changes, which as a rational agent it will do.

That solution, however, makes little sense in a world in which the legislatures and courts are themselves imperfect institutions whose changes are as likely to introduce mischief as social improvement. At this point, the private parties are now asked to bear the risk of changes that are socially destructive, and to organize their operations and investments in ways that resist the silliness of government initiatives and programs. This anticipation is all the more difficult when individuals have to foresee not only beneficial changes, but also unpredictable changes bought by lobbying interests groups. The far superior solution in this case is one that places some restraint on the power of governments at all levels to so act. Compensation for losses induced by legal changes is one possible alternative, which is, however, very difficult to implement with respect to general changes in the legal rule. Another alternative is a limited form of grandfathering to protect the reliance interests of those who acted under the previous regime. Still a third possibility is just to strike down the changes to begin with, which offers some hope in those cases where courts negate legislative changes under their power of judicial review. But this last measure works, to say the least, far less effectively when courts are asked to constrain the unwise initiatives that they (or other courts) have initiated. At one level, therefore, the point of this argument is to caution all decisionmakers against the initiation of legal transitions, especially those that deviate from traditional common law rules. At another level, it is to examine whether some legal test can be applied to distinguish, case-by-case, those changes that are social improvements from those that are not.

In order to carry out this program, I shall look at three cases in which it has been urged that the government be given broad powers to initiate

legal changes without any constraints of the sort mentioned above. The first of these involves the introduction of retroactive changes in taxation. The second involves the refusal to make compensation (at least in full) when the government takes buildings and other improvements to real estate. The third involves retroactive changes in product liability law.

Retroactive Taxation. One common element of the traditional natural justice view of taxation takes a deeply suspicious attitude towards retroactive changes in the law. Individuals have a right to rely on the law as it is stated and should not be penalized after the fact for actions that were legal when made. Just this theme of fair notice of the rule is impounded, for example, in Lon Fuller’s conditions as to what counts as a good law.13 Further, the requirement of notice and fair hearing is similarly impounded into much administrative law under the due process clause, on grounds of fundamental fairness. The intuition is that limitations on the power of the government to reverse field are one strong way in which to limit the scope of government abuse, a paramount concern of the public choice view of the world.

That set of concerns is said to vanish once we think that government policies are revised with only the public good in mind. Under this view, rational investors could foresee the risk of changes in the law that are adverse to them, just as they can foresee the possibility of legal changes that work to their advantage. In dealing with their decisions, they can impound both forms of uncertainty into the price, so that it becomes a form of double compensation to award them compensation after the fact for risks that they had assumed before the fact. The argument continues that these investors do not have to make any returns to the government for legal changes that cut in their favor, to which the prohibition against retroactive changes does not apply. The net effect, therefore, is some form of double-compensation for risk.14 Consequently, the more economically-minded authors have come out against compensation for any form of protection against retroactive changes in the tax law.15 As a practical matter, these results have borne fruit in the decided cases, many of which offer lip service to the idea that the government should be forced

not to introduce retroactive regimes. However, they allow just these sorts of changes because ordinary individuals are in a position to foresee that the government might have good and valid reasons to change the legal regime under which taxation has taken place.\(^\text{16}\)

I remain deeply suspicious of these findings precisely because I see no reason to think that the new government regimes will on balance be better than the ones that they replace. The point is not the cynical view that all changes in taxation are always worse than the regime that they displace; it is rather than the changes in question have equal chances of being good or bad, so that carte blanche with respect to future changes is likely to do as much harm as good. The necessary question, therefore, is whether there is some way in which we can seek to improve on the carte blanche rule. In this regard, it is instructive to look first at one case demonstrating the sorry state at which matters can fall under the Internal Revenue Code.

In *United States v Carlton*,\(^\text{17}\) the Court held that there was no due process violation from a retroactive repeal of an estate tax provision on which the petitioner had explicitly relied, so long as Congress acted promptly and advanced a legitimate state interest. The Court further held that the state had such a legitimate interest in the protection of revenue against an excessive use of an estate tax deduction, in this instance then new Section 2057(a). This section allowed an estate tax deduction equal to one half the market value of company shares sold by the estate to its employee stock ownership plan ("ESOP"). The taxpayer had purchased shares of MCI Communications in the open market for over $11 million and resold them two days later to the MCI ESOP, suffering an economic loss of around $630,000, but claiming a deduction of over $5 million. In 1987, after the transaction had been completed, Congress repealed Section 2057(a), both prospectively and retroactively. The original idea behind Section 2057 was to allow individuals who already held stock in a company before death to sell it to an ESOP to claim the deduction. Congress did not anticipate that others would *buy* stock in the open market after death to take advantage of the provision, which increased revenue losses from an anticipated $300 million (over a five year period) to $7 billion for that same period.

The obvious question is how best to sort out this unseemly mess. First, it is peculiar why this particular provision of the estate tax was passed at all, since it looks like the type of gimmick that is utterly

\(^{16}\) See Pension Guaranty Corp. v. R.A. Gray & Co., 467 U.S. 717, 729 (1984) ("[T]he strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively.").

\(^{17}\) 512 U.S. 26 (1994).
inconsistent with any sensible scheme of taxation. At this point, we can see evidence of the asymmetry illustrated by Graetz and others: a special interest loophole that looks indefensible on its own terms even if the taxpayer had owned the shares of MCI at the time of death. Yet, under the American constitutional system, it is much harder to challenge giveaways from government than it is to challenge government exactions. The latter situation is one for which the taking challenges are in principle available. The former has to be based on some nebulous version of the public trust doctrine, which provides “nor shall public property be given for private use, without just compensation,” for which it is very difficult to find in the Constitution a viable doctrinal home.

In a first-best world, however, we should initially ask the question as to whether some individuals should be allowed to challenge these giveaways. The answer should be in the affirmative, as it has been in cases under the establishment clause that (haltingly) allows citizen-standing against public giveaways to religious institutions. At this point, some eager interest group will challenge the giveaway, so that the entire sequence of events will never take place at all. At the very least, the taxpayer now has explicit notice that the provision under which he wishes to proceed is at risk. The next question is whether that taxpayer challenge should succeed. The answer to that question is also yes, assuming that the estate tax itself is constitutional. The overall concern with public choice issues immediately singles out any gimmick that is available to some and not to all, in light of its disproportionate impact. The net effect is that we do not have to face Carlton’s sorry tale of back and forth government at all. The gist of the argument is that stronger, not weaker, forms of judicial supervision are the appropriate way to deal with taxpayer efforts to lobby a fast one through the government. In contrast, the implicit theme of Graetz, Kaplow and their followers is that lower levels of judicial supervision should be allowed in order to permit the correction of abuses once they occur. This view is incorrect because higher levels of scrutiny that go both ways stop the abuses from occurring in the first place. Yet today, all efforts to stop government giveaways on constitutional grounds seem to have come to a dead-end

after the Supreme Court used in essence a rational basis test to sustain a grand legislative giveaway under the Copyright Term Act Extension Act.\textsuperscript{20} It is no coincidence that the rhetoric of deference that greased the decisions in favor of retroactive government regulation also greased them for copyright giveaways that dry up the public domain.

Now that two-sided judicial intervention looks dead, we have to recognize that the Carlton situation necessarily involves a second-best problem of deciding whether Congress is within its rights of knocking out a tax advantage retroactively that it should never have passed in the first place. One argument is, of course, that Carlton-like changes to the tax code prevent a massive erosion of the public’s fiscal health. Once again, however, this argument is indeterminate because it could be said just as easily that Congress would exercise greater care to avoid the creation of loopholes once it knew that it could not reinstate the tax (or deny the deduction) on the transactions that had been consummated before any future repeal. Financial losses to the state create strong incentives for it to control the dispensation of benefits in the first place. It is at best idle speculation to guess from a social welfare perspective how the two scenarios play out, but one argument in favor of allowing this taxpayer to get away with the scam is that it will knock down the number of loopholes the legislature will pass initially. That alternative has to be preferred to the current situation. After all, it was at least a possibility that this particular loophole might have survived longer than it did, which means that the next tax gimmick might work after all. If so, the choice of the tough taxpayer rule may work wonders in the individual case, but lead to the proliferation of greater efforts to obtain loopholes in the first instance and to defend them to the last breathe thereafter.

At this point, it should be possible to gain a clearer sense of how tax legislation should work. The central problem for the government is to raise the revenue needed to run its public programs. Any constitutional provision that sought to limit the amount of taxes as, say, a percentage of the gross domestic product, runs into the obvious objection that government revenue needs are, at the very least, vastly different in peace and war. Yet at the same time, it is important to develop a rule that eliminates the endless game playing of the sort that was so evident in Carlton. The best way to achieve both objectives is to start with the top-to-bottom flat tax that removes the gameplaying with respect to brackets.\textsuperscript{21} At this point, investors still have to deal with the changes in rates in calculating whether or not to go forward, but on that score they

\textsuperscript{20} See Eldred v Ashcroft, 123 S. Ct. 769 (2003).
\textsuperscript{21} For my defense, see Richard A. Epstein, Can Anyone Beat the Flat Tax?, 19 SOC. PHILO. & POL. 140 (2002).
know that they cannot be singled out for special treatment further down the road so that their calculations are made easier and more reliable. It is commonly said that changes in legal regimes are just another form of uncertainty, and while that is true (the moral hazard issue of government misbehavior to one side), it hardly follows that we should ever introduce any unnecessary dimension of uncertainty if a strong structural solution is available in advance.

There are of course many tax decisions that do not have one right answer, so it becomes incumbent to figure out how to deal with these. The most acute problems are those with respect to expenditures that are made on projects that last for multiple periods. The key rules are those governing the depreciation of these investments. Here again as a matter of first principle, the ideal rates of depreciation should exactly mirror the economic losses associated with the project. In principle, therefore, even a system of straight-line depreciation results in an implicit form of tax subsidy. An economic asset that has a 20 year life loses its last year of value in the first year of use, because it is still a 19 year asset. That amount of loss is reflected better by an amortization table, which clocks in at far less than the five-year period of depreciation allowed under the straight-line rule. Matters are, of course, more complicated than this simple example, as some assets (e.g. movies, cars) may lose huge portions of their value in the initial period. However, with standard assets, it follows that the various forms of accelerated depreciation allowed under the Internal Revenue Code only compound the dangers. Theses changes are at this point beyond the scope of judicial review in part because it is so difficult to figure out what the accurate measure of depreciation should be in many contexts. But now that there is no constitutional intervention at the initial level, the question is what should be the appropriate judicial response to the second-best question of changes in tax regimes.

The first point to note on this second best question is that the key decisions are usually made on the strength of the tax regime in place at the time, and it will certainly improve the ability of investors to make their estimations if they have confidence that this legal regime will remain in place for the expected life of the investment. At this point, the concern is with the both ways test, and the proper response is that the

22. See, e.g., Kaplow, supra note 15, at 520.
initial depreciation schedules available at the time of passage should remain in place for the duration of that asset. All other changes should be made on a going-forward basis, whether they benefit the taxpayer or work against his interest. Blocking both-ways changes is necessary to prevent the gaming of the system by taxpayers, who now have less incentive to lobby for greater tax breaks since they will no longer be able to obtain them.

The depreciation deduction only determines the rate of taxable income within the particular period, and every taxpayer has to take the same risk of changes, up or down in general rates under, ideally, a flat tax system. Once again, the government gets its discretion over revenue, while property owners are protected under the general rate structure against being singled out by a retroactive change in the depreciation rules that cover the future periods for past losses. On balance this system is respected under the Internal Revenue Code where the legislature announces that various rules apply to projects begun on different dates. In this system, the individual taxpayer could protest the loss of a depreciation deduction allowed at the time of construction, while the general taxpayer (with standing, of course) could protest any additional advantage conferred on that taxpayer. By constraining the political dimension, it should be possible to improve both investment decisions and tax decisions simultaneously under a test that only requires a court to monitor the backward imposition of changes, without having to make wild judgments as to the allocative efficiency of this or that tax. That alternative system seems to dominate the two-sided game playing that is encouraged by a regime that allows tax breaks and tax penalties to be adopted with abandon. The traditional principle against retroactive changes makes sense, so long as it is applied relentlessly in both directions.

Takings. Another set of issues that gives rise to the question of legal transitions involves the appropriate rules for the taking of private property. On this issue, I have often taken a strong position that every change in regulation, in taxation and liability constitutes a prima facie taking for which compensation is required unless some justification is advanced.24 The strong program recognizes that no compensation is in fact required in cash for those cases in which it has been provided in kind, and it also recognizes that certain losses in value are justified on the grounds that they prevent present and future nuisances, both certain and uncertain. Those justifications, however, do not reach a case that

has been much discussed in the literature, in which it is thought that parties will have excessive incentives to build if they receive full compensation for the losses caused by subsequent government programs requiring the destruction of property. This literature argues that the social losses and the private losses are thrown out of alignment if compensation is paid.

The stock example to illustrate this proposition runs as follows. Assume that a landowner has to decide to build a hotel near to the shore at a location that will be flooded if the government thereafter decides to build a dam. The public decision on the dam will depend on the price of oil in world markets, so that the decision to build will only be made when that price exceeds a certain amount. Here the decision to compensate the landowner means that he gets the same rate of return in all states of the world, that is, whether or not the dam is built. That hotel, however, will have value only in those states of the world where the dam is not constructed. The ideal social decision therefore requires the hotel owner to take into account this possibility, which he will ignore if compensated ex post when the hotel is razed. The upshot is that the denial of compensation is said to be justified because it aligns the private with the social incentives, once notice is given of the government project. The reliance interest of the landowner has to yield to his ability to anticipate the government action in question. The argument, moreover, has no obvious limitations, because it could easily be extended to cover all cases of the condemnation of improvements, even when no specific announcement is made. The paradigmatic case of condemnation now becomes questionable under this new analysis. For instance, this logic allows the government broadly to proclaim that it will no longer compensate for its takings, so that once everyone is on notice, then nobody would ever receive compensation, notwithstanding the Fifth Amendment.

This argument has had its influence on judicial thinking even in cases to which it does not apply: that is, to ex ante restrictions on new construction which diminish the value of land. In these cases, any


26. See, e.g., Lucas v. South Carolina Coastal Comm’n, 505 U.S. 1003, 1070 n.5
diminution in land value attributable to the regulation cannot be laid at the doorstep of improper landowner behavior. But how then should the principle apply in those cases where the construction has taken place? The critical point is to again recognize that the potential for abuse could well operate on both sides of the relationship. Much depends on the way the particular program of the government is described. In the original version of the problem, the decision whether to build the dam depended exclusively on objective factors totally outside the control of the government agency: let the price of oil on the spot market rise above $X and the dam shall forthwith be built. Just that assumption is built into Fischel and Shapiro’s model, for they write that “everyone knows that when oil prices exceed a certain level, the government will build the dam. The government cannot be swayed from this decision by any political activity or legal manipulations.” This convenient stipulation removes all reason to constrain the operation of the state officials because they have already been deprived of all discretion. The only remaining need is to constrain the individual, who might overbuild in the face of the government policy.

Yet this point invites two rejoinders. First, the government may have been motivated by strategic purposes in announcing the future plans, which it could then abandon or delay opportunistically once the landowner chooses not to build on the site. Next, if the situation is as stated, the state should be required to purchase an option contract to condemn, free of obligation for the improvement, if the stated conditions come to pass, precisely because the trigger events fall wholly outside government control. At this point we have the best of both worlds. There are both constraints on the government decision to announce these policies, and the landowner investment decisions that take these risks into account.

In response, it could be argued that the option market could not work because deciding whether to build the dam in an age of deep environmental

(Stevens, J., dissenting), where Justice Stevens invoked this argument to attack the decision to allow compensation when a landowner was not allowed the right to build any structure on his beachfront lot.

Even measured in terms of efficiency, the Court’s rule is unsound. The Court today effectively establishes a form of insurance against certain changes in land-use regulations. Like other forms of insurance, the Court’s rule creates a “moral hazard” and inefficiencies: In the face of uncertainty about changes in the law, developers will overinvest, safe in the knowledge that if the law changes adversely, they will be entitled to compensation.


27. Fischel & Shapiro, supra note 25.
concern always depends on unidentified factors that occur or become evident only after the government makes its general declaration of interest. However, the terms and conditions of the state option—we shall build the dam when energy needs so require—do nothing to constrain state actors from acting strategically: announce that certain new construction might be forthcoming in order to forestall unwanted development without paying compensation.

The inability to temporize with options forces the all or nothing choice, in which the main question is whether private or official excesses turn out to pose the greater risk. The risks of public misbehavior are clearly larger because there is no independent way to limit the use of options. Absent any form of constraint, the state could just announce that several locations are under consideration for the new dam so that all owners should take care. There are no comparable risks on the other side. Even if compensation is allowed in full, the individual landowner will only recover the fair value of his project, so that if it goes down in value he will sustain a loss whether or not the condemnation takes place. No one will rush to build foolish projects under the circumstances. In addition, the rules for compensation in cases of actual takeover are woefully insufficient.28 There is no allowance for the costs of fighting the condemnation, for contesting the appraisals offered by the government, for reimbursing moving costs, or for the loss of good will. It is no accident that every single rule of compensation for land, existing structures and established businesses understates the government obligation to compensate. Any moral hazard on the part of the landowner is therefore effectively countered by the puny rules for actual compensation that never leave any owner indifferent between the property interest that he possessed and the compensation that he received in exchange. Although this factor is much discussed in the literature, there is most likely no real world

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28. See, e.g., Kimball Laundry Co. v. United States, 338 U.S. 1, 5 (1949) (Frankfurter, J.) (“In view, however, of the liability of all property to condemnation for the common good, loss to the owner of nontransferable values deriving from his unique need for property or idiosyncratic attachment to it, like loss due to an exercise of the police power, is properly treated as part of the burden of common citizenship.”). The passage would make sense if all landowners were equally subjected to the risk of condemnation, but is far less attractive when the state can decide which businesses or land to condemn for its own use. For a powerful demonstration of the shortfall of the current compensation rules for land, see Gideon Kanner, When is “Property” Not “Property Itself”: A Critical Examination of the Bases of Denial of Compensation for the Loss of Goodwill in Eminent Domain,” 6 CAL. W. L. REV. 57 (1969).
situation in which the rush to construction risk will prove to be important. The overwhelming bias of the eminent domain law works against that of the owner in possession. The state, if it truly cares about the risk of overcompensation, can purchase the property before construction and sell or lease it out on whatever terms and conditions that it sees fit. When two kinds of error are present, even of equal magnitude, place the burden of action on the party that has the greater number of options, which is the state in this case. The risks and magnitude of error are anything but equal in this case.

Product Liability. A similar set of considerations applies to transformations in tort law, especially in product liability cases. These cases cover those situations where a manufacturer or other seller introduces a product into the stream of commerce, and it causes harm to some user, consumer or bystander. In practice many product liability cases, e.g. those involving foodstuffs, take place within a relatively short time frame so that the issue of legal transitions never surges to the fore. But in major classes of cases, many years may pass between the time that the product leaves the hands of the manufacturer and the occurrence or manifestation of injury. Machine tools may be in service for years before they harm some user. Pharmaceuticals may produce adverse consequences only after long periods of use. Toxic substances may well cause injuries only years after they are released into the environment (e.g. Agent Orange) or inhaled (e.g. asbestos) in industrial settings. With these cases, the question arises what legal rule should apply when the law has changed between the time of manufacture and initial sale, and the time of injury.

This question differs from that of retroactive taxation and eminent domain law in that we are dealing typically with the incremental developments at common law. In this area, however, the period between 1965 and 1978 counts as the watershed period, which started with the (relatively unimportant) shift from negligence to strict liability under section 402A of the Restatement (Second) of Torts. In addition, the early cases allowed defenses for products that were subject to inspection before being put to their normal and proper use. In contrast, the latter cases held the manufacturer responsible after the product was altered by third parties and used in a way that was neither normal nor proper, but foreseeable to the manufacturer. The earlier law held that once a condition

29. See Restatement (Third) Torts—Products Liability § 1 (1998); Restatement (Second) Torts § 402A (1965).
was open and obvious, the user could make a choice to use the product in its current condition, or to refuse to do so. The latter law has held that if the jury thinks that some precaution was cost effective, the injured party could recover either in whole or in part for an improper use that took place with knowledge of the known danger, thereby knocking out one pillar of the standard product liability defenses. Under the earlier versions of the law, the only defective cigarettes were those containing contaminants. Under the modern view, a cigarette may be found defective if it contains tobacco. These are not small shifts in doctrine, and they hit most hard against those companies that have remained in business throughout the entire cycle of change.

My basic sentiment is to be deeply suspicious of imposing liability on parties based on a set of rules that were not in place at the time the products were sold. The now-regnant position tends to be the opposite view holding that with product liability, as with taxation, the imposition of liability should be anticipated by the manufacturer before the law is changed. The stated justification for this position is that it is more important that manufacturers and others efficiently respond to change than be permitted to act in reliance on the legal rules in place at the time they made their marketing decisions. Adopting this stance encourages manufacturers to stay one step ahead of the power curve.

One implicit assumption in this argument is that the new rules are actually better than the old. But that is hardly the case. One of the hidden rationales for the expansion of product liability law is that it allows for the spreading of loss among product users. However, this insurance rationale makes little sense. As was dimly understood by the earlier writers, a manufacturer is a poor organization around which to organize the insurance function. The manufacturer of a product has little control over the skills of the individuals who use the products sold, whether he sells direct to the customer or through distributors and retailers. It cannot price discriminate, and is, therefore, constrained to charge a single price for all customers no matter how great the variation in the risks they pose. One premium has to serve for the amateur who attempts dangerous jobs and for the skilled person who works well

33. See, e.g., Huset v. J.I. Case, 120 F. 865, 867 (8th Cir. 1903) (noting the dangers of requiring the manufacturer to insure the skilled and incompetent at a single price). For a more systematic development of this theme, see Richard A. Epstein, Products Liability as An Insurance Market, 14 J. LEGAL STUD. 645 (1985).
within his limits. The insurance, moreover, comes with a heavy administrative load given the need to establish some form of defect, to trace intermediate modifications and uses of the product, and to take into account the plaintiff's own use, all of which are factors that land in the lap of a jury. The older rules that limited recovery to products that contained latent defects in their original condition that caused harm to the customer in their ordinary use were a perfectly sensible response to the difficulties in holding liable a party for defective products, whose possession and use was with the plaintiff or some other third party. There is little doubt that the case for liability, be it strict or negligence only, is much weaker here than it is in cases of dangerous instruments that remain in control of the defendant immediately before the occurrence of injury, as happens with harms caused by such "abnormally dangerous activities" as blasting, fumigating, or drilling.  

If this analysis is correct, it is no longer possible to assert that the anticipated changes in liability rules count as social improvements. If so, what is the gain in question from asking manufacturers of 1940 to anticipate the standards that will be in place in 1970 or 1980? The ostensible hope is that they will build products that meet these more onerous rules, but the effects are likely to be counterproductive. One of the watershed cases in the modern product liability wars is *Barker v Lull Manufacturing Co.*, 35 in which an inexperienced substitute operator of a loader used it on uneven terrain for which it was neither designed nor suited. The question of whether the loader was defective was held properly to belong to a jury, which was free to invoke a broad cost benefit test to decide the issue. The earlier rules, in effect when the loader was made, would have ruled this case unsustainable because of the obviously improper use of the equipment by the wrong person in the wrong place. The great advantage of the older rule is that it allows manufacturers to offer a full array of equipment. Cheaper equipment that is easier to operate can be used in some locations, while more expensive equipment that is harder to operate can be used for more dangerous locales. That separation should reduce the costs of various operations, and encourage downstream owners of the equipment (who are typically subject to worker's compensation obligations) to exercise more care in the selection and training of workers for various jobs, a task that no remote manufacturer can hope to accomplish. In turn, the newer rule will price many consumers out of the market, as the cheaper equipment will no longer be available for sale.

35. 573 P.2d 443 (Cal. 1978).
In asking the manufacturer to anticipate the change in rules is to insist that it shelve sensible low-cost standard products today out of fear of future liability. In practice, the better business strategy might well be to sell the equipment that is currently demanded and then liquidate the business down the road in order to avoid the sting of future liability, even at the cost of practical wisdom and going-concern value. The shift in legal rules, therefore, exacerbates the problem of remaining in business, and it surely complicates the task of selling off an established business with strong brand identification to a new purchaser who is on the line for all the losses of the earlier business. Indeed, if it merges the old corporation into its own operations, all its assets, whatever their source, remain on the hook for these losses. The power of anticipation could easily lead firms to take counterproductive effects. Asking people to anticipate changes in the law in the next generation makes no more sense than pushing on a string.

What then ought to be the appropriate social response to the changes in legal position? The best approach is one that I worked on a generation ago when I was a consultant for the American Insurance Association. This approach is designed to insulate older suppliers from the corrosive effects of new laws. It is the so-called statute of repose that insulates defendants from any liability for the harms that their products cause in their original condition 10 or 12 years after they part with possession. That statute of limitations does not apply to actions that take place after the product is sold, such as the issuance of subsequent warnings or bulletins about newly discovered product flaws, subsequent repairs or modifications. Further, the rule could be modified to allow for actions in the event that a product with a known and concealed defect was sold, which would catch perhaps some asbestos suppliers, but surely not the raft of premise occupiers that are now routinely charged in the last round of asbestos litigation.

In one sense, this statute of repose is overbroad for the purposes at hand, in that it not only freezes liability at the level it was when the product was sold, but totally insulates the manufacturer from liability under any and all theories. The extent of the overbreadth is still less than might be supposed however, for few if any of the products sold would be subject to any form of liability whatsoever in the formative conditions.

36. For the ins and outs on the subject, see Michael D. Green, Successor Liability: The Superiority of Statutory Reform to Protect Products Liability Claimants, 72 CORNELL L. REV. 17 (1986).
years. In addition, the rule has the desirable feature of forcing product supervision, maintenance, repair and use on the parties downstream of the parties who are now in possession of the goods in question. These parties are likely to do more to prevent injury if they know that they have no recourse whatsoever against the original manufacturer (not to say distributor or retailer, who often are inappropriate targets at any time). At this point, the only people who have to anticipate that their liability or exposure will be increased are the present owners and users. But if the standard theory is correct, that anticipation is the critical variable, and there is no reason to demand impossible foresight of manufacturers while allowing current possessors and users to ignore the perils that stare them in the face. The theory of transitions should not be directed at only one link in the chain of distribution. It should be applied to parties who are in the best position to do something about the losses in question.

The great advantage of the statute of repose is that it peels off remote layers of defendants in an orderly fashion and, thus, shortens the chains of liability to manageable proportions. This protection of the reliance interest works to increase current safety far better than any rule of anticipation. Ideally, there was no reason to incur the massive costs of legal transition in the first instance. But if those bold and misguided innovations are appropriate, someone should find out ways to insulate prior actors from the consequences of these great transformations. The stability of possession is a Humean virtue that goes unappreciated in modern times.

Conclusion. The matter of legal transitions is one that has been with us for a long time, and one that will not disappear from view in the immediate future. Much of the difficulty in this area stems from the common mistake that new changes in social behaviors and technological advances require parallel changes in the legal system. Yet often exactly the opposite is true. The stability of the legal regime makes it easier for entrepreneurs, consumers and workers to respond to these changes, without having to factor uncertain changes in the legal regime as well. The full measure of complexity, moreover, is often concealed from view when we examine each proposed legal change as though it existed in isolation. In reality, if the pace of new regulation continues, the interactive features of the various systems will create negative synergies. One implicit assumption of product liability rules is that firms are able to respond quickly to incentives. Yet that assumption is necessarily called into question if movements in employment law hamper the ability of the firm to hire, promote and, yes, fire at will. Once we are aware of the manifold difficulties that lie in the path of successful regulatory
initiatives, we should no longer give each bright-eyed scheme our implicit collective endorsements. We should instead remember the old injunction of laissez-faire, which is to view each form of state regulation under a presumption of error. Private actors are already powerfully constrained. The task now is to thin out the forests of legal regulations in the hope that we can make an effective transition to a situation in which, of course, simple rules provide guidance to a complex world.