Chapter 5
Bad Economics, Good Law: The Concept of Externality

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Abstract The term "externality" is pervasive in modern economics. Most microeconomic theory textbooks have a chapter devoted to the topic as do texts covering public economics. This chapter argues that law deals with the matter of externality in an economically efficient manner. Courts largely ignore the term externality despite its common use in economics and, more importantly, law has changed little to incorporate the now-common economic meaning of externality. Law, especially tort law, often deals with what economists would call relevant externalities. Economists often fail to understand what constitutes a relevant externality, resulting in the term being operationally meaningless.

5.1 Introduction

The term "externality" is pervasive in modern economics. For decades, beginning at the principles level, most microeconomic theory textbooks have a chapter devoted to the topic, as do texts covering public sector economics. In general, externality means the imposition of a cost on another party without consent, or the provision of a benefit without prior agreement.[1] It is the basis of a huge literature in economics, especially in the environmental area, that is used to justify a wide range of policy proposals to correct alleged defects in market-based arrangements that do not account for such costs.

This chapter argues that law deals with the matter of externality in an economically efficient manner. Courts largely ignore the term externality despite its common use in economics and, more importantly, law has changed little to incorporate the now-common economic meaning of externality. Law, especially tort law, often deals with what economists would call relevant externalities. As will be discussed, economists

[1] The latter is rarely of concern even though it is common. Details of the economic definition of externality will be reviewed later in the chapter.

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often fail to understand what constitutes a relevant externality, resulting in the term being operationally meaningless in much discussion in economics. It has become a straw man that justifies nearly any policy prescription one wishes to advocate. Economic theory has gone astray, but law has not.

This chapter reviews the use of the term externality in law from its first appearance in a reported case up through 2012. We begin with a review of older cases, where the meaning of the term was not much related to its modern economic and policy use. We then look at its usage in the more modern content as it appears in case law. Then we turn to economic theory and contrast how externality is often presented to how law deals with relevant externalities.

5.2 First References in Law to Externality

The first published decision using the word externality was by the Supreme Court of Vermont in 1928. The court noted that Justice Holmes wrote that the words used in a will should be taken in the sense in which they would have been used by the testator in usual circumstances: "The normal speaker of English is merely a special variety, in literary form, so to speak, of our old friend the prudent man. He is external to the particular writer, and reference to him as the criterion is simply another instance of the externality of the law."[2] What Holmes meant was elaborated by the Mississippi high court several decades later.[3] If there is conflict about the presumed "internal" meaning of words, such as those in a will or a contract, one should look to the "external" or common meaning of the words in their normal context, not divine some peculiar construction. As we will see, this usage will appear in some cases in recent years.

The first use to the word externality in a reported federal case involved a land dispute by the Seneca Nation and the City of Salamanca, New York, when the Second Circuit noted, in 1942, that the law in medieval Germany suffered from "a multitude of unimportant externalities" meaning extreme formalism or "form-rigorism."[4] Judge Frank must have been enamored with the term as he used it again the next year in a contracts case. In discussing mutual assent in contracts, the court said: "We now speak

[2] *Middlebury College v. Central Power Corp. of Vermont*, 143 A. 384, 390 (Sup. Ct., Vt. 1928), citing Holmes (1899).

[3] In a contested will, the court looked to effectuate the textratrix's intention. "The criterion designated by Mr. Justice Holmes as 'the externality of the law' simply reflects that we must ask what the words used in the instrument would mean 'in the mouth of a normal speaker of English using them in the circumstances in which they were used…' (Holmes 1899, p. 417)" *Hemphill v. Mississippi State Highway Comm.*, 145 So.2d 455, 459 (Sup. Ct., Miss. 1962). The same court used the word in that context a few years later in *Yates v. State*, 189 So.2d 917 (Sup. Ct., Miss. 1966), stating, at 921, "The infeasibility of getting into the mind of a person to determine what he thought or believed is a sound reason for the principle of externality that requires judgments be based on something more than subjective statements of what one believes or thinks."

[4] *U.S. v. Forness*, 125 F.2d 928, 935 (2nd Cir. 1942).

of ‘externality,’ insisting on judicial consideration of only those manifestations of intention which are public (‘open to the scrutiny and knowledge of the community’) and not private (‘secreted in the heart’ of a person).”[5] Perhaps because the Supreme Court reversed that decision in one terse paragraph,[6] although for reasons not related to externality, the term did not reappear in a reported federal case for almost three decades.[7]

The term appears in a few other state court decisions. In a child custody dispute, the court said that the religious training given a child was one of the externalities (outside influences) that impacted the child.[8] In an insurance death benefits case, the issue was whether the cause of death was “external, violent and accidental,” which the court refers to as an “externality,” as opposed to death from an internal cause such as disease.[9] In a shareholder derivative suit, the court noted that when it stripped “the matter of all externalities” and just considered “the fundamental aspects of the transaction” the essence of the dispute was clear.[10]

For our discussion the cutoff point for “old cases” is 1972. The nine cases prior to 1973 used the term externality in a non-economic sense. After 1972 the term is used in a non-economic sense at times, but more commonly it is used in some economic sense. Sometimes the term is used carelessly, but generally it is used with a particular meaning. As we will see, in some areas of law, the term has come to have a particular meaning, hence the little areas of concentrations in the reporting of cases here.

Beginning in 1973, when the term began to be used in its modern sense, it appeared 225 times in reported decisions over 40 years (through 2012), for an average of about 5.5 uses per year in federal and state cases. Again, some of the uses are not in an economic sense, which would reduce the count further if our interest is in the economic meaning and application of externality. The usage in all cases is categorized by area of law in Table 5.1. The areas were chosen because of the number of times the term appeared. Areas of law with few references to externality, such as child custody and litigation procedure, are lumped together as “random.”

The non-economic sense of externality is, as Justice Holmes (1899) explained, events or definitions that are external to the immediate legal issues or documents. There is no economic cost issue implied in such uses. When the term is used in an economic sense, meaning costs (or benefits) not accounted for by the decision maker, the usage is correct in most cases, but not all, as will be discussed. However, overall courts use the term judiciously. We review the use of externality in many cases to understand better how the concept is employed in law.

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[5] *Zell v. American Seating Co.*, 138 F.2d 641, 646 (2nd Cir. 1943). The court noted in footnote 20a accompanying that sentence that Williston and Wigmore may not always agree with its interpretation.

[6] *American Seating Co. v. Zell*, 322 U.S. 709, 64 S.Ct. 1053 (1944).

[7] *City of Burlington v. Turner*, 356 F.Supp. 594 (S.D. Iowa 1972). The court discussed “external costs” of a bridge, meaning costs related to operating, as opposed to constructing, a bridge, at 608.

[8] *Boerger v. Boerger*, 97 A.2d 419 (Super. Ct., Chan. Div., N.J. 1953).

[9] *Towner v. Prudential Insurance Company of America*, 137 So.2d 449, 451 (Ct. App., La. 1962).

[10] *Urnest v. Forged Tooth Gear Co.*, 243 N.E.2d 596, 601. (Ct. App., Ill., 1968).

Table 5.1 Number of cases in which "Externality" appears through 2012

Classification		Number
Old cases (pre-1973)		9
Antitrust		17
Bankruptcy		9
Constitutional		16
Contracts		6
Crime		13
Environmental		
	NEPA	2
	Air	11
	Land	11
	Water	6
FCC, ICC, and PUC		10
Intellectual property		14
Labor		16
Takings		9
Tax		14
Torts		19
Zoning		25
Random		27
Total		234

Notes: Search also includes "externalities" and is limited to reported decisions

5.3 Antitrust

The first "externality case" post-1972 was an antitrust suit by the state of California contending that the automakers conspired to eliminate competition in research and development of air pollution equipment. The appeals court noted that the automakers considered antipollution devices to be "externalities, whose development would increase price without concomitant spur to consumer interest."[11] The use is vague; the court seemed to be saying that the automakers did not care for the costs they incurred by having to invest in pollution control devices, especially because consumers were not interested in paying for such devices. Not liking the fact of a cost does not make it an externality in the formal economic sense, but the intended use appears to be economic. The next antitrust case also used the term in the sense of an external force that impacted the market.[12] That is a common way in which courts use the term in decisions.

[11] *In re Multidistrict Vehicle Air Pollution*, 481 F.2d 122, 124 (9th Cir. 1973).

[12] *Knutson v. Daily Review, Inc.*, 383 F.Supp. 1346 (N.D. Calif., 1974), the court noted that a restriction on maximum resale prices were "an externality" imposed on the market (at 1383), meaning an external force that impacted the market.

The concept of network externality has been mentioned in several antitrust cases. This comes from the notion of network effects, a reference to the fact that when many people use the same "network," such as the telephone or Internet, it will become more useful. Network externality derives from network effects, meaning the change in benefits from a good or service that one derives when others are consuming the same good (Liebowitz and Margolis 1998; Metcalfe 2007). The decisions of users are made independently, but benefits are mutual. Those may include cost savings by sharing network costs among a group and the informational or use benefits that arise from an expanded network. External costs imposed by other network participants may include clogging the system (hogging bandwidth) and imposing junk (spam) seen as a bad by most participants.

Network externality first appeared in a decision in 1996. The operator of an ATM network challenged an order by the Federal Reserve System allowing a merger of several ATM systems. Upholding the decision, the court quoted the Board of Governors, which said "Network externalities… tend to promote the consolidation of regional ATM networks."[13] That is, ATM systems are more efficient when in larger networks.

Some see benefits from larger networks, others see threats to monopolization by a dominant network, including dominant software. Hence the issue of network effects has arisen in some antitrust suits claiming network effects tended to lead to monopolies, a view rejected in most decisions.[14]

Externality has appeared in a few other antitrust cases. One concerned alleged monopolization of the broadcast of scores from golf tournaments. Plaintiff argued that release of the scores was a "positive externality" that benefited all who wanted to know the scores. The court agreed, but held that the Professional Golf Association has a valid business reason for restricting access to proprietary score information.[15] In a suit involving tortilla makers paying for shelf space, the court discussed "market realities and other externalities," seeming to mean external effects in general.[16] In another case, the court rejected a monopolization claim made against a college by a fraternity. The court noted that efforts by a college to enroll the "best" students make a school more attractive, which is a "positive externality."[17] In sum, the use of

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[13] *Money Station, Inc. v. Board of Governors of the Federal Reserve System*, 81 F.3d 1128, 1133 (D.C. Cir. 1996).

[14] For specific references to network externalities see *U.S. v. Microsoft Corp.*, 147 F.3d 935, (D.C. Cir. 1998); *California Dental Assn. v. F.T.C.*, 224 F.3d 942 (9th Cir. 2000); *U.S. v. Microsoft Corp.*, 253 F.3d 34 (D.C. Cir., 2001); *Freeman v. San Diego Association of Realtors*, 321 F.3d 1133 (9th Cir. 2003) where Judge Kozinski noted, at 1153 fn. 28, that those who worry about the anti-competitive consequences of network externalities have made it the market "*defect du jour;*" *Broadcom Corp. v. Qualcomm, Inc.*, 501 F.3d 297 (3rd Cir. 2007); *Novell, Inc. v. Microsoft Corp.*, 505 F.3d (4th Cir. 2007); *Sprint Nextel Corp. v. AT&T, Inc.*, 821 F.Supp.2d 308 (2011).

[15] *Morris Communications Corp. v. PGA Tour, Inc.*, 235 F.Supp.2d 1269, 1280 (M.D. Fla. 2002).

[16] *El Aguila Food Products, Inc. v. Gruma Corp.*, 301 F.Supp.2d 612 (S.D. Tex. 2003).

[17] *Delta Kappa Epsilon (DKE) Alumni Corp. v. Colgate University*, 492 F.Supp.2d 106, 110 (N.D. N.Y. 2007), citing the expert testimony of Prof. Jerry A. Hausman from the economics department at MIT.

externality in reported antitrust cases is consistent with common economic usage. A decision is made by a party that has a cost impact on other parties.

5.4 Bankruptcy

In two cases externality is used in the sense from Justice Holmes, referring to external meanings of words and the law.[18] Another case has a nearly incomprehensible discussion of "externality-creating religious conduct" and "free exercise externalities" that appear to mean external factors in determining if a religion qualifies as a valid charity.[19] It is not an economic use of the term.

Other cases refer to events outside (external) to a business that impacted the business.[20] That is, bad economic conditions, which are external to the firm, may help drive it into bankruptcy. One case clearly attempts to use externality in an economic sense. It discusses the problem of debtors or creditors trying to shift costs to other parties.[21] While it is true that can be a costly exercise, it is not a proper economic use of the term. Such cost shifting, if legal, would not qualify as an externality in its economic sense because it would be a cost that should or should not be borne by a party to the transaction. It is presumed in economics that one role of law is for judges to resolve liability disputes. Hence most bankruptcy cases do not use externality in an economic sense but in a more general sense of events outside the firm that impacted it.

5.5 Constitutional Law

Externality appears in cases that deal primarily with a constitutional issue. In most, the intent was to use the term in its economic sense. The first case involved the striking down of an Illinois statute intended to force coal-fired utilities to use more Illinois coal.[22] The State made the argument that the use of Illinois coal was an economic benefit to Illinois because it forced expenditures inside the state and that the state would suffer an externality (economic loss) if utilities were allowed to buy non-Illinois coal. Striking down the statute as a violation of the Commerce Clause, the

[18] *Matter of Sinclair*, 870 F.2d 1340 (7th Cir. 1989) and *In re Walsh*, 260 B.R. 142 (Bkrtcy. D. Minn. 2001).

[19] *In re Saunders*, 215 B.R. 800, 804 (Bkrtcy. D. Mass. 1997). The usage seems to mean that certain religious activities can impose costs on others outside of the religion.

[20] For example, *In re 523 East Fifth Street Housing Preservation Development Fund Corp.*, 79 B.R. 568 (Bkrtcy. D.D. N.Y. 1987).

[21] *In re An-Tze Cheng*, 308 B.R. 448 (9th Cir. BAP 2004).

[22] *Alliance for Clean Coal v. Miller*, 44 F.3d 591 (7th Cir. 1995).

concurring opinion noted that the external damage suffered by Illinois coal producers was offset by the external benefits of being part of a free-trade nation.[23] The fact that the law does not recognize the kind of externality costs argued by Illinois is consistent with the economic concept of pecuniary externalities not being relevant. That is, if a Caribou Coffee opens a store across the street from a Starbucks, thereby causing the Starbucks to lose revenue, the Starbucks has incurred a real cost imposed upon it by the decision of Caribou. The fact that income shifts due to changes in competitive conditions is beneficial to society as a whole. The economic view of pecuniary externalities, like the rule of law explained in the opinion, is that such costs are irrelevant or will be ignored.

Some cases used externality in its economic sense as a technical externality, where a cost is involuntarily imposed that may be worthy of legal consideration so as to improve market efficiency. In one case, the court explained that health benefits for coal workers were an attempt by Congress to force the employers of miners to include health costs in the production equation.[24] This is a common economic view, that there is some sort of defect or negative externality in the market (miners are underpaid) that can be addressed by legislative action. Similarly, plaintiffs in another case argued that certain expenditures on public health programs are justified as producing a positive externality for society at large by reducing the spread of disease and reducing the cost of treatment.[25]

Other cases were challenges to statutes in New Jersey and Pennsylvania that required candidates for local office or public-sector employees to have resided in a specific local jurisdiction for at least one year before eligible for office or for employment. In the New Jersey case the court held that the election-qualification statute imposed an unconstitutional burden on the right to intrastate travel.[26] It noted that the state argued in favor of the statute as a way to reduce externalities. If office holders were required to live in the jurisdiction in which they wished to hold office, then they would incur the impact of taxes imposed.[27] The subsequent case upheld the right of jurisdictions to impose residency requirements on prospective employees; it cited the previous case discussion of supposed externalities as being in favor of such a rule.[28]

Other cases apply externality in what is intended to be a conventional economic sense, contending that certain restrictions have the benefit of reducing externalities

[23] *Id.* at 598.

[24] *Unity Real Estate Co. v. Hudson*, 889 F.Supp. 818 (W.D. Pa. 1995).

[25] *Reynolds v. Wagner*, 128 F.3d 166 (3rd Cir. 1997).

[26] *Callaway v. Samson*, 193 F.Supp.2d 783 (D. N.J. 2002).

[27] *Id.* at 788. This is not a proper economic application of the notion. Public servants need not be taxpayers of specific jurisdictions any more than company employees must consume products made by their employer for them to be able to provide good value in employment. The argument is political, not economic.

[28] *McCool v. City of Philadelphia*, 494 F.Supp.2d 307 (E.D. Pa. 2007).

suffered by other due to the actions of certain parties. In one case, concerning regulations that restrict placement of the Confederate flag, a dissenting judge argued that such time, place, and manner restrictions deal with "a negative externality of what otherwise may be protected symbolic speech."[29] That is, seeing the flag imposes a cost on some observers, so restrictions would reduce such costs. The judge ignored the similar costs borne by those who are denied the possibility of seeing the flag in a particular location.

More importantly, it is generally presumed that constitutional rights are not distributed based on a weighing of the costs and benefits of certain parties holding certain rights in contrast to other parties. Markets will function under whatever set of rights have been established. In another case, a First Amendment claim against restrictions on sexually-oriented businesses was rejected. Such businesses impose "negative externalities" on neighbors, so limitations are permissible.[30] Similarly, certain Rhode Island liquor regulations were upheld. The court cited a law review article to the effect that states may impose laws to correct for problems, including externalities.[31]

The term was raised in cases challenging the constitutionality of the Affordable Care Act (ACA) (aka Obamacare). One dissenting judge, arguing for the constitutionality of a challenged provision of the Act, said that it corrected "a massive market failure caused by tremendous negative externalities" (i.e., the lack of health insurance for some, which justified a policy that requires obtaining insurance).[32] In another case that found a portion of the ACA to be unconstitutional, the appeals court noted that "under the government's theory, Congress can enlarge its own powers under the Commerce Clause by legislating a market externality into existence, and then claiming an extra-constitutional fix is required."[33]

In sum, in most cases judges intend to use externalities in its economic sense of a cost visited upon other parties. The courts simply recognized the fact of costs being involved. Costs were never quantified, just recognized as a fact.

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[29] *Sons of Confederate Veterans, Inc. v. Commissioner of the Virginia Dept. of Motor Vehicles*, 305 F.3d 241, 252 (4th Cir. 2002).

[30] *Center for Fair Public Policy v. Maricopa County, Ariz.*, 336 F.3d 1153, 1162 (9th Cir. 2003). Other courts have ruled similarly, holding that regulation of "adult" business, such as strip clubs, is a permissible activity for the state as it protects parties from external effects created by the presence of such businesses; see *Entertainment Productions, Inc. v. Shelby County, Tenn.*, 588 F.3d 372 (6th Cir., 2009).

[31] *Wine and Spirits Retailers, Inc. v. Rhode Island*, 418 F.3d 36 (1st Cir. 2005).

[32] *Liberty University, Inc. v. Geithner*, 671 F.3d 391 (4th Cir. 2011). The discussion by the judge seems misplaced; if people do not buy insurance it may not be due to a market failure but due to low income or lack of interest in the product.

[33] *Florida v. U.S. Dept. of Health and Human Services*, 648 F.3d 1235 (11th Cir. 2011) at fn. 101. That is, the court said Congress declared the fact that some persons do not have health insurance to be a market defect that gives it the constitutional basis for correcting a market defect. No doubt the supporters of the ACA see it that way.

5.6 Contracts

Six contract cases have used the e-word. Five cases use the word in a Holmes sense in reference to external events.[34] For example, concerning payment of property insurance benefits, a dissenting judge argued that the collateral source rule should apply in contract cases to avoid allowing parties to double collect in some instances, in which case they can profit from "externalities," an unfortunate external event such as, in this case, a hurricane.[35]

The sixth case, a dealership dispute, noted: "Not every conferral of a benefit creates an implied contract (consider gifts, third-party beneficiaries, parent-child relationships and the vast array of indirect benefits the economists call positive externalities). Nor do such benefits automatically give rise to claims for unjust enrichment."[36] This is an economically consistent and disciplined use of the concept. The world is full of externalities-costs and benefits we visit upon each other-but most are not relevant legally or we would all live in courtrooms.

5.7 Criminal Law

Criminal law cases often use externalities to refer to factors outside of the evidence-external events or facts.[37] A few cases use it in an economic context. One refers to "interstate externalities" that may justify federal criminal jurisdiction in what might normally be thought of as a matter for state concern.[38] Judge Posners *Economic Analysis of the Law* is cited for that proposition at that point (Posner 1992). While this is not incorrect usage of the term, it is part of the *carte blanche* problem of externality-it is a concept that can be used to justify nearly any interference since costs are ubiquitous.

Taking the other tack based on the same generic notion of externality was a case in which the court struck down a requirement that a certain party must provide a DNA sample to go into the national DNA database. The government argued that such databases create "positive externalities" as they help reduce crime.[39] The judge noted that there were benefits from such things but that did not justify a violation

[34] *Superior Oil Co. v. Western Slope Gas Co.*, 604 F.2d 1281 (Ct. App. Colo. 1979); *Court Street Steak House, Inc. v. County of Tazewell*, 643 N.E.2d 781 (Sup. Ct. Ill. 1994); *Smelkinson Sysco v. Harrell*, 875 A.2d 188 (Ct. Spec. App. Mary. 2003); *Willard Packaging Company, Inc. v. Javier*, 899 A.2d 940 (Ct. Spec. App. Mary. 2006).

[35] *Citizens Property Ins, Corp. v. Ashe*, 50 So.3d 645, 658 (Fla. App., 1 Dist., 2010).

[36] *Motorsport Engineering, Inc. v. Maserati SPA*, 316 F.3d 26, 31 (1st Cir., 2002).

[37] For example, *People v. Pate*, 310 N.W.2d 883 (Ct. App., Mich. 1981); *Zettlemoyer v. Fulcomer*, 923 F.2d 284 (dissent) (3rd Cir. 1991); *U.S. v. Meyers*, 906 F.Supp. 1494 (D. Wyo. 1995); *U.S. v. Bin Laden*, 132 F.Supp.2d 168 (S.D. N.Y. 2001); *People v. Huston*, 802 N.W.2d 261 (Mich. S.Ct., 2011).

[38] *U.S. v. Lipscomb*, 299 F.3d 303, 332 (5th Cir. 2002).

[39] *U.S. v. Miles*, 228 F.Supp.2d 1130, 1139 (E.D. Cal. 2002.

of Fourth Amendment rights as part of a broader criminal matter. Another case also used externality in a generic cost sense, discussing "negative externalities" that would result from two parents being in prison at the same time away from their children.[40] Again, this is not a market transaction; it is a matter to be determined by the rule of law, not some judicial weighing of costs and benefits that cannot be measured.

5.8 Environmental Law

To economists, the word externality is most commonly linked to environmental problems. Most textbooks use pollution as examples to explain the concept. Polluters do not bear all costs of production when they do not prevent waste from being strewn, thereby imposing costs on other people. Those who bear the cost of pollution subsidize the producer. In case law we find externality used a bit more frequently in this area of law than any other area, but they are only about 13 % of the cases. Most of the cases are under various statutes, but some are common law; we first cover National Environmental Policy Act (NEPA) cases, then air, land and water.

5.8.1 NEPA

Two cases involved a claim that an agency violated the National Environmental Policy Act. The first asserted that the ICC had failed to require a ferry service provider from Long Island to provide an environmental impact statement as part of rate deregulation.[41] The court held that under NEPA, Congress requires agencies to include environmental considerations, including "the full range of possible externalities, including environmental costs and benefits," but the court asserted NEPA did not apply to a decision to exempt ferry service from ICC rate regulation.[42]

A later case challenged the adequacy of an Environmental Impact Statement prepared by the Army Corps in its decision to dredge the shipping channel in the Columbia River. The appeals court affirmed summary judgment for the government, dismissing the plaintiff's claim that "the agency understated the costs associated with the project by failing to consider environmental externalities associated with channel deepening…."[43] The court held that the Corps satisfied NEPA by conducting

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[40] *Smith v. U.S.*, 277 F.Supp.2d 100, 114 (D. D.C. 2003).

[41] *Cross-Sound Ferry Services, Inc. v. Interstate Commerce Comm.*, 934 F.3d 327 (D.C. Cir. 1991).

[42] *Id.* at 333; Judge Clarence Thomas, in a concurring opinion, said the Transportation Act of 1940 "did not mean to give the ICC power to regulate ferries in order to promote ecological consciousness-raisingor any other 'externalities' unconnected to [the narrow focus on transportation]." At 338.

[43] *Northwest Environmental Advocates v. National Marine Fisheries Service*, 460 F.3d 1125, 1147 (9th Cir. 2006).

extensive economic and environmental analyses. So both NEPA cases use externality in the environmental economic sense.

5.8.2 Air Pollution

The first federal case to use the term externality for environmental damage was in 1980. The case was one in a 20-year marathon involving aluminum smelters in Oregon along the Columbia River.[44] The court awarded compensatory and punitive damages to an orchard owner who suffered crop damage from fluoride emissions from a smelter. "Our society has not demanded that such externalized costs of production be completely eliminated. Instead, we tolerate externalities such as pollution as long as the enterprise remains productive: that is, producing greater value than the total of its internalized and externalized costs of production."[45]

The other air cases that mention externality were statute based. For example, when a challenge arose to the issuance of a permit for a new coal-fired electric generation plant in Alaska, the state high court, upholding the Alaska Public Utility Commission (APUC) decision, noted that the definition of externalities was unclear.[46] "The Federation [the group opposing the permit] uses the term 'environmental externalities' interchangeably with the terms 'environmental impacts' and 'environmental costs.' GVEA [the permit holder] argues that 'environmental externalities' are not the equivalent of 'environmental costs' and 'impacts.' It contends that environmental externalities encompass only environmental impacts that are 'not internalized elsewhere in the permitting process.'"[47] It claimed that definition was consistent with NEPA procedure. The court noted that the APUC "defines 'environmental externalities' as those impacts on the environment caused by the production of electricity 'which have not historically been reflected in the costs of electricity.' We find APUC's definition the most accurate."[48] Having approved an expansive definition of the term, the court held that "APUC is not required to consider costs associated with environmental externalities… in its inquiry concerning whether a service is required for the public convenience and necessity" and if the applicant is "fit, willing and able."[49] The dissenters protested on that point, contending that part of being fit to provide service meant being able to provide an explanation of "environmental externalities" that

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[44]The first suit was filed in 1961; see *Renken v. Harvey Aluminum, Inc.*, 226 F.Supp. 169 (D. Ore. 1963). It did not use the term externality.

[45]*Orchard View Farms, Inc. v. Martin Marietta Aluminum, Inc.*, 500 F.Supp. 984, 989 (D. Ore. 1980).

[46]*Alaska Federation for Community Self-Reliance v. Alaska Public Utilities Comm.*, 879 P.2d 1015 (Sup. Ct. Alak. 1994).

[47]*Id.* at 1018, fn. 2.

[48]Id. at 1018.

[49]*Id.* at 1022.

APUC should evaluate.[50] Both opinions indicate an understanding of the economic meaning of externality in an environmental context, but there was no discussion of specifically how such costs should be addressed, the issue was to follow procedure properly.

The same year a similar case was decided by the Massachusetts high court. The Department of Public Utilities (DPU) ruled that electric utilities must consider environmental externalities when planning facilities. As the court explained: "The department recognized 'that including environmental externalities in resource selection decisions may result in some higher direct costs in the short-term' but that 'environmental externalities are real costs borne by ratepayers and the rest of society in the form of increased health care expenses, economic impacts on material and agricultural resources, and a reduced quality of life.'"[51] To measure externalities, the DPU looked at "the implied valuation method" as a "proxy" for damages that reflect "what society as a whole is willing to pay to avoid damages from pollutant emissions."[52]

The court held that the DPU could consider a utility's pollution and consider mitigation costs against long-term economic benefits. "Where we disagree with the department (as a matter of legal principle, but not as a matter of environmental policy) is in the department's conclusion that increased costs (and hence higher rates) are justified solely because of the potential or real effect of pollution on other than ratepayers [i.e., society as a whole]…. These are important subjects, but they lie in the jurisdiction of legislatures…."[53] DPU was not allowed to impose expansive economic measures of environmental costs.

Some cases are more mundane in that they use externality to refer generically to problems imposed by air pollution and regulations adopted to deal with the problems, but there were no unusual legal issues concerning how costs might be determined.[54] Two cases were more contentious. In one, the Washington state high court was "asked to decide whether a municipal utility may mitigate the effects of its greenhouse gas emissions by paying public and private entities to reduce those entities' emissions. We hold that combating global warming is a general government purpose, albeit a meritorious one, and not a proprietary utility purpose."[55] The four dissenting justices would have permitted the expenses, asserting that "GHGs and anthropogenic climate change are externalities of electricity generation-they are costs borne from the activity

[50] *Id.* at 1024.

[51] *Massachusetts Electric Co. v. Dept. of Public Utilities*, 643 N.E.2d 1029, 1032 (Sup. Jud. Ct. Mass. 1994).

[52] Id. at 1032.

[53] *Id.* at 1034.

[54] *Alliance for Clean Coal v. Miller*, 44 F.3d 591 (7th Cir. 1995); *U.S. v. Marine Shale Processors*, 81 F.3d 1329 (5th Cir. 1996); *LaFleur v. Whitman*, 300 F.3d 256 (2nd Cir. 2002); *Glustrom v. Colorado Public Utilities Comn.*, 280 P.3d 662 (Colo. S.Ct., 2012); *American Coatings Assn., Inc. v. South Coast Air Quality Dist.*, 278 P.3d 838 (Calif. S.Ct., 2012).

[55] *Okeson v. City of Seattle*, 150 P.3d 556, 558 (Sup. Ct. Wash. 2007). For example, the utility paid for buses and ferries to burn cleaner fuels and paid DuPont $650,000 to buy 300,000 tons of emission offsets from a DuPont plant in Kentucky.

which are not reflected in electricity rates."[56] In another case, states and public interest organizations petitioned for review of the National Highway Traffic Safety Administration (NHTSA) rule regarding corporate average fuel economy (CAFE) standards for light trucks. The Ninth Circuit struck the regulations because the agency was arbitrary and capricious for failing to monetize the benefits of greenhouse gas emissions.[57] The court noted that a committee of the National Academy of Sciences "found 'externalities of about $0.30/gal of gasoline associated with the combined impacts of fuel consumption on greenhouse gas emissions and on world oil market conditions.'"[58] NHTSA's contended that this number was too speculative, unlike other externality costs associated with driving, such as emissions from gasoline refining and noise from driving. The agency claimed that the "value of reducing emissions of CO2 and other greenhouse gases [is] too uncertain to support their explicit valuation and inclusion among the saving in environmental externalities from reducing gasoline production and use."[59] The court rejected that position, thereby highlighting a key issue in the economic concept of policies that can be justified based on the notion of externality.

In sum, the economic concept of externality appeared not to be central to most decisions that recognize the authority of regulators, under statutes, to impose regulations. In the Alaska and Massachusetts cases the economic notion of external costs played a large role as the courts discussed which costs could be "internalized" in the regulatory process. The courts stuck with the legislatively defined parameters. In the last two cases noted, the economic cost concept of externalities played a large role, with the dissenters in the Washington state case arguing that the costs provided justification for greenhouse gas emission side payments and with the Ninth Circuit stating that NHTSA must monetize externalities in its fuel economy standards. These positions come close to what is often called judicial activism, but one was a minority view and the other is a view commonly adopted in air pollution regulatory matters in recent years-monetizing non-market environmental costs.

5.8.3 Land Pollution

Of the eleven land pollution cases that use the term externality, four were common law actions. The first was a nuisance suit against a feedlot; the court held that its ruling for plaintiffs was based "not simply upon general notions of fairness; it is also grounded in economics... the problems of 'externalities'..."[60] The two cases

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[56] *Id.* at 566. The dissenters also argued that the "program internalizes the externalities associated with electricity generation in the most efficient manner, thus benefiting the ratepayers."

[57] *Center for Biological Diversity v. National Highway Traffic Safety Admin.*, 508 F.3rd 508 (9th Cir. 2007).

[58] *Id.* at 517.

[59] *Id.* at 524.

[60] *Carpenter v. Double R Cattle Co.*, 669 P.2d 643, 653 (Ct. App. Idaho 1983). "Externalities distort the price signals essential to the proper functioning of the market." The court cited Coase (1960),

were for contamination of property that spilled over to neighboring property; one was a nuisance action; the later one billed as a toxic tort matter.[61] The last case was a successful nuisance action against a hog operation.[62]

Most of the other land contamination cases, in which externality is mentioned, were scraps about remediation costs under the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA; aka Superfund). The discussion of environmental externalities was perfunctory and the economic issues did not appear to be relevant to the decisions.[63] The other two cases were similar clean up cases, one under a Michigan statute, the other under the Energy Policy Act that requires uranium purchasers to contribute to remediation; the term externality was used in reference to costs spilling over on other parties.[64] In sum, of the eleven cases, externality was always used in reference to pollution costs spilling over on other parties. The discussion was brief except in the first case mentioned here, where the economic argument played a role in the Idaho courts adoption of the *Restatement* rule regarding nuisances that invade neighboring property.

5.8.4 Water Pollution

In one water pollution case, externality refers to external substances that caused contamination,[65] but in the other four cases it is used in the sense of environmental costs being imposed on other parties. In three cases, the mention is brief and it has no impact on the logic of the decision.[66] In another case, involving environmental standards for a mining operation, the court notes that "The externalities produced by

(Footnote 60 continued)
and argued that intervention was required because there are "impediments to changes of property" that might otherwise solve problems such as the one illustrated in this case.

[61] *Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303 (3rd. Cir. 1985); the court cited, at 314, an article with the word externalities in the title. *Cottle v. Superior Court*, 3 Cal.App.4th 1367 (Ct. App., 2 Dist., Cal. 1992); the court briefly discussed the divergence of private costs and social costs, citing an article on externality at 1402. In neither case did brief discussion of externality appear to have any effect on the outcome.

[62] *Tetzlaff v. Camp*, 715 N.W.2d 256 (Sup. Ct. Iowa 2006). The court noted at 261 that the property owner had to know of the externalities that flowed from the hog operation.

[63] *Lincoln v. Republic Ecology Corp.*, 765 F.Supp. 633 (C.D. Cal. 1991); *Transportation Leasing Co. v. State of California*, 861 F.Supp. 931 (C.D. Cal. 1993); *Louisiana Pacific Corp. v. Beazer Materials & Services, Inc.*, 842 F.Supp. 1243 (E.D. Cal. 1994); *Westfarm Associates LP. v. Washington Suburban Sanitary Comm.*, 66 F.3d 669 (4th Cir. 1995); *Acushnet Co. v. Coaters, Inc.*, 948 F.Supp. 128 (D. Mass. 1996).

[64] *Aetna Casualty & Surety Co. v. Dow Chemical Co.*, 28 F.Supp.2d 448 (E.D. Mich. 1998); *PSI Energy, Inc. v. U.S.*, 59 Fed.Cl. 590 (Fed. Cl. 2004).

[65] *U.S. v. Massachusetts Water Resources Authority*, 97 F.Supp.2d 155 (D. Mass. 2000).

[66] *McGowan v. Mississippi State Oil & Gas Bd.*, 604 So.2d 312 (Sup. Ct., Miss. 1992); *In re Water Use Permit Applications*, 9 P.3d 409 (Sup. Ct. Haw. 2000); *U.S. v. Wayne County, Mich.*, 369 F.3d 508 (6th Cir. 2004).

a mining operation including pollution, traffic, and the aesthetic harms created by having a large mining operation nearby-also affect the surrounding community."[67] This statement does not appear to have impacted the decision, it reflects the way environmental costs are commonly discussed.

One case marks the only Supreme Court decision in which externality is used in reference to environmental problems and is posited as a justification for federal intervention.[68] The Court held, 5–4, that abandoned gravel pits planned for use as dumps for non-hazardous solid waste disposal, were not under federal jurisdiction under the Clean Water Act because water in the pits was not navigable. In dissent, Stevens contended that migratory birds used the pits, which should be sufficient to create national issues. "In such situations, described by economists as involving 'externalities,' federal regulation is both appropriate and necessary."[69]

Stevens then cited an article (Revesz 1992) in support of this point, but mischaracterized its argument on this very point. What Revesz argued can be summarized by this line from the article: "the race-to-the-bottom hypothesis, though influential, lacks a sound theoretical basis." (Revesz 1992, p. 1244). That is, externality is a common argument made in favor of federal regulation, but that presumption must be taken carefully; competition among states tends to provide many protections for the environment. Further, market forces, under a rule of law, also works to resolve many problems. We do not end up in an environmental cesspool in the absence of federal regulations that are alleged to internalize all environmental externalities.

In sum, of the water cases that mention externality; only Stevens in dissent expressly found it to be an argument in favor of expanded regulatory control. The other cases used the term in its common meaning of an external cost imposed on others, now generally subject to regulatory controls.

5.9 FCC, ICC, and PUC Cases

Thirteen cases concern regulatory matters determined under Federal Communication Commission (FCC), Interstate Commerce Commission (ICC), or state Public Utility Commission (PUC) rules.[70] In most cases the issue was if an external cost could be internalized-that is, brought into the rate that could be charged by the regulated utility. In some cases the courts held that the cost matters were external to what they were allowed to consider. In other cases the courts held that firms could not be exempt from rate regulations or that certain costs that had previously been held to

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[67] *Hydro Resources, Inc. v. U.S. E.P.A.*, 608 F.3d 1131 (10th Cir., 2010).

[68] *Solid Waste Agency of Northern Cook Co. v. U.S. Army Corps of Engineers*, 531 U.S. 159, 121 S.Ct. 675 (2001).

[69] *Id.* as 195, 695.

[70] Public Utility Commissions have different names in different states; the term is generic here.

be external could be brought into the rate base.[71] This use of the term externality is economic but is a matter of statutory interpretation of what costs are costs legally. It is not a matter about which economic analysis has much to offer. In passing, a court mentioned network externalities.[72]

Two cases were claims by environmental groups that PUCs must take into account environmental externalities not considered in granting a permit to build a new generating plant[73] or not considered when electricity was purchased from out-of-state.[74] This would be the kind of external cost often discussed in economics. Environmental concerns have real value. But in both cases the courts remained within the statutory definitions of costs to be considered. The objections raised by outside groups were not, by law, to be considered, so were not relevant.

This did not mean the courts did not comprehend that real costs may be at issue. They treated environmental costs like any other cost petitioned for review. Under regulatory schemes, some costs are counted, some are not. Since the law is used to clarify the treatment of such costs, it allows parties to adjust to the rule. Those unhappy with the allocation of costs can appeal to the legislature for a revision of the law or can deal with the utility accused of polluting by offering payments to change or cease certain activities. The use of externality in all cases was straightforward and correct.

5.10 Intellectual Property

Most of the intellectual property cases are copyright cases that use externality use it in a non-economic sense. The first case in this area to use the term referred to "the externalities of the cotton market" referring to facts that cannot be captured in copyright.[75] The court cited *Plains Cotton* several years later, noting that *scenes a faire*, common knowledge or situations, such as the idea of a secret Swiss bank account used in a spy novel, cannot be captured by a copyright. That was one of

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[71] *Brae Corp. v. U.S.*, 740 F.2d 1023, 1057 (D.C. Cir. 1984); *Colorado Office of Consumer Counsel v. Public Utilities Comn.*, 786 P.2d 1086 (Sup. Ct. Colo. 1990); *CF&I Steel, L.P. v. Public Utilities Comm.*, 949 P.2d 577 (Sup. Ct. Colo. 1997); *GTE Southwest Inc. v. Public Utility Comm.*, 10 S.W.3d 7 (Ct. App. Tex. 1999); *New York State Electric & Gas Corp. v. Public Service Comm.*, 753 N.Y.S.2d 332 (Sup. Ct. N.Y. 2002); *Commonwealth Edison Co. v. Illinois Commerce Comn.*, 937 N.E.2d 685 (Ill. App., 2nd Dist., 2011); *People ex rel. Madigan v. Illinois Commerce Comn.*, 958 N.E.2d 405 (Ill. App., 1st Dist., 2011).

[72] *Rural Cellular Assn. v. F.C.C.*, 685 F.3d 1083 (D.C. Cir. 2012).

[73] *Texas Utilities Elec. Co. v. Public Citizen, Inc.*, 897 S.W.2d 443 (Ct. App. Tex. 1995).

[74] *In re Northern States Power Co.*, 676 N.W.2d 326 (Ct. App. Minn. 2004).

[75] *Plains Cotton Cooperative Assn. of Lubbock, Texas v. Goodpasture Computer Service, Inc.*, 807 F.2d 1256, 1262 (5th Cir. 1987).

several decisions that cite the word externality from Plains Cotton and use it in the same non-economic context.[76]

Other cases also used a non-economic meaning of externality. In one the court referred to the limited capacity of a computer as an externality a programmer would take into account.[77] Another case used what it called the "externalities doctrine" concerning *scenes a faire*.[78] In a patent case concerning an "externally mounted intercooler" the term externality was referring to the device.[79] The only copyright case in which externality was used in an economic sense was one that referred to network externalities-as a reason why copyright protection should not be too inclusive.[80] Hence, most intellectual property cases do not use externality in an economic meaning.

5.11 Labor Law

Most labor cases, which cover a wide variety of labor issues, use externality in a legal sense only. Whether ERISA benefits, workers' compensation benefits, a dispute over Davis-Bacon wages, collective bargaining agreements or Title VII application, the cases use externality in reference to external conditions of employment or matters external to the law itself.[81] There is an economic-type usage in a case concerning a

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[76]*Engineering Dynamics, Inc. v. Structural Software, Inc.*, 26 F.3d 1335 (5th Cir. 1994). See also *Autoskill, Inc. v. National Educational Support Systems Inc.*, 793 F.Supp. 1557 (D. N.M. 1992); *Kepner-Tregoe, Inc. v. Leadership Software, Inc.*, 12 F.3d 527 (5th Cir. 1994); *Mitel, Inc. v. Iqtel, Inc.*, 124 F.3d 1366 (10th Cir. 1997); *Torah Soft Ltd. v. Drosnin*, 136 F.Supp.2d 276 (S.D. N.Y. 2001). The *Mitel* case was cited, in the same externality context, in *Dun & Bradstreet Software Services, Inc. v. Grace Consulting, Inc.*, 307 F.3d 197 (10th Cir. 2002).

[77]*Computer Associates International, Inc. v. Altai, Inc.*, 982 F.2d 693 (2nd Cir. 1992). Similarly, another court referred to a network externality caused by too much demand on computer user bases; *Free FreeHand Corp. v. Adobe Systems Inc.*, 852 F.Supp.2d 1171 (N.D. Cal. 2012).

[78]*Control Data Systems, Inc. v. Infoware, Inc.*, 903 F.Supp. 1316, 1323 (D. Minn. 1995).

[79]*Rice v. U.S.*, 84 Fed.Cl. 575 (Ct. Fed. Cl. 2008).

[80]*Apple Computer, Inc. v. Microsoft Corp.*, 799 F.Supp. 1006 (N.D. Cal. 1992). Another case mentioned network externality in referring to a publication with the term in the title; *DocMagic, Inc. v. Ellie Mae, Inc.*, 745 F.Supp.2d 1119 (N.D. Cal. 2010).

[81]*DeArmond v. Sommer*, 348 N.E.2d 378 (Ct. App. Ohio 1975); *Dickerson v. U.S. Steel Corp.*, 472 F.Supp. 1304 (D.C. Pa. 1978); *Martin v. Sullivan*, 932 F.2d 1273 (9th Cir. 1991); *Westinghouse Hanford Co. v. Hanford Atomic Metal Trades Council*, 940 F.2d 513 (9th Cir. 1991); *Martin Marietta Corp. v. Lorenz*, 823 P.2d 100 (Sup. Ct. Colo. 1992); *Davis v. Portline Transportes Maritime Intl.*, 16 F.3d 532 (3rd Cir. 1994); *Northern California Drywall Contractors Assn. v. Dist. Council of Painters No. 8*, 879 F.Supp. 96 (N.D. Cal. 1995); *Carollo v. Cement and Concrete Workers Dist. Council Pension Plan*, 964 F.Supp. 677 (E.D. N.Y. 1997); *Collette v. St. Luke's Roosevelt Hospital*, 132 F.Supp.2d 256 (S.D. N.Y. 2001); *Melvin v. US Local 13 Pension Plan*, 202 F.Supp.2d 564 (W.D. N.Y. 2002); *City of Long Beach v. Dept. of Industrial Relations*, 1 Cal.Rptr.3d 837 (Ct. App. 2 Dist., Cal. 2003); *Keenan v. Director for Benefits Review Board*, 392 F.3d 1041 (9th Cir. 2004); *Committee of Concerned Midwest Flight Attendants for Fair and Equitable Seniority Integration v. International Broth. of Teamsters Airline Div.*, 662 F.3d 954 (7th Cir. 2011).

claim by public employees of violation of First Amendment rights.[82] The decision noted that the unconstitutional conditions doctrine can be justified as dealing with market failures, including negative externalities. This includes the problems that arise from having many government sector jobs subject to patronage.[83] In another case the court mentioned the "positive externality" that may arise from health insurance coverage that may obviate the need for worker's compensation.[84] That is, only three of sixteen cases used externality in any economic sense.

5.12 Takings

Takings cases are generally constitutional law cases but there were enough to put them in a separate category for our purposes. In the first takings case to use the term, a California court affirmed the constitutionality of the Coastal Conservation Act of 1972 that created the California Coastal Commission. Plaintiffs contended the law allowed the Commission to impose costs (externalities) on them. The court held that "it can be safely said that where [an] activity, whether municipal or private, is one which can affect persons… the state is empowered to 'prohibit or regulate the externalities.'"[85] This is an elastic view of externalities that could seemingly be used to justify most government actions because externalities are pervasive; most uses of the concept are not so expansive.

The next case was the first Supreme Court case in which the term externalities appeared. A cable television company attached a cable box to the exterior of rental property. That was done under a New York statute that allowed the cable attachment for payment of $1. The landlord sued, contending the cable company, with state backing, was engaged in a taking. The landlord demanded the cable company negotiate with her rather than take her property by attaching a box to the exterior of the building under a permit from the state. The New York courts upheld the New York law and the cable company action. Writing for the majority, Justice Marshall held the placement of the cable box to be an unconstitutional taking.[86]

In dissent, Justice Blackman, joined by Brennan and White, argued that a physical action should not be the basis for the definition of a taking. A small box attached to the exterior of a building, with state permit, was less invasive to the value of property than many regulations that restrict property usage but are not physically invasive. "Modern government regulation exudes intangible 'externalities' that may diminish

[82] *McCloud v. Testa*, 97 F.3d 1536 (6th Cir. 1996).

[83] *Id.* at 1551, citing Epstein (1987).

[84] *Joseph M. Still Burn Centers, Inc. v. AmFed Nat. Ins. Co.*, 702 F.Supp.2d 1371 (S.D., Ga. 2010). Similarly, in another worker's compensation case the court noted that payment from another source was an externality (a benefit to the worker); *In re Wadsworth's Case*, 935 NE.2d 333 (Mass. App. Ct. 2010).

[85] *Creed v. California Coastal Zone Conservation Comm.*, 118 Cal.Rptr. 315, 321 (Ct. App., 4th Dist., Cal., 1974), citing Sato (1972).

[86] *Loretto v. Teleprompter Manhattan CATV Corp.*, 458 U.S. 419, 102 S.Ct. 3164 (1982).

the value of private property far more than minor physical touchings."[87] The use of externality appears to be in the sense of government actions, such as zoning laws, that impact property value.

The issue next arose in a case in which a city denied a gas station owner permission to add a convenience store to his station. The property owner protested that this was a taking and the district court agreed: "the City may constitutionally 'tax' plaintiff to recoup the costs of the negative externalities that its increased business activities cause: Without a showing of such externalities, the condition which the City attached to building permits is simple extortion."[88] This use of externality is consistent with the economic use meaning costs being imposed involuntarily on others. The gas station would increase traffic that would impact neighbors.

The next case involved a federal government taking, by legislative action, of 550 acres of land next to the Manassas Battlefield Park that the owner planned to convert to housing and retail development. Before the development occurred, the government paid the owner for the property, but the county that expected economic benefits from the development sued for an uncompensated taking. The appeals court rejected the claim.[89] In its analysis, it cited economic analysis about externalities. The court noted, from the perspective of economic analysis, that there cannot be an externality if a right does not exist; that is, the county had no right to the future benefits it hoped to accrue from the planned development.[90] The county can claim it suffered an externality, but since it had no legal right to a gain that never came into existence, it was not actionable. This is much like court reasoning in many zoning cases.

Other cases mention externalities briefly, referring to some activity not liked by some people, or liked by some people.[91] The use of the term is in its normal economic meaning of spillovers incurred by some due to the actions of others. One case refers to externality in the legal sense of external events that courts should or should not take into account in triggering certain rights.[92] Hence, in most taking cases the discussion of externality was economic in nature. Some rather vague, others quite precise.

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[87] *Id.* at 447, 3182.

[88] *William J. (Jack) Jones Insurance Trust v. City of Fort Smith, Ark.*, 731 F.Supp. 912 (W.D. Ark. 1990).

[89] *Board of County Supervisors of Prince William County, Virginia v. U.S.*, 48 F.3d 520 (Fed. Cir. 1995).

[90] *Id.* at 525; the court cited an original economics paper on the role of transaction costs, externality, and property rights citepdemsetz1967.

[91] *Melillo v. City of New Haven*, 732 A.2d 133 (Sup. Ct. Conn. 1999), the court rejected that a takings occurred due to airport noise, which the plaintiff claimed to be externalities; *District Intown Properties LP v. Dist. Columbia*, 198 F.3d 874 (D.C. Cir. 1999), the concurring opinion asserted that historic preservation laws resulted in positive externalities by protecting old buildings that some people enjoy; *R&Y, Inc. v. Municipality of Anchorage*, 34 P.3d 289 (Sup. Ct. Alaska 2001), holding that a construction setback requirement was not a taking. Such land-use restrictions impose externalities no worse than the traffic suffered from increased commercial activity; it is non-actionable.

[92] *Cashman v. City of Cotati*, 374 F.3d 887 (9th Cir. 2004).

5.13 Taxes

Externalities as used in tax often refer to activities outside of a business-external factors that happen to affect business value-including the impact of weather on crops and changes in market conditions that impact values.[93] In two cases the courts refer to positive externalities that might be taken into consideration.[94] In an explicit use of the economic notion, three federal appeals court cases the courts noted that a tax may be imposed on those who create negative externalities to compensate those who suffer the costs.[95] In some cases the use was so imprecise as to be meaningless, although it appears refer to externalities in the economic sense.[96] In sum, most tax cases externality is intended to be economically meaningful and, in some, was used as partial justification for a tax.

5.14 Torts

The tort cases that refer to externality provide a good vehicle to explain the problem with the concept applied to law. What is an externality-and when it should be

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[93] *International-Stanley Corp. v. Dept. of Revenue*, 352 N.E.2d 272 (Ct. App. Ill. 1976); *Nunes Turfgrass, Inc. v. County of Kern*, 111 Cal.App.3d 855 (Ct. App. Cal. 1980); *Michigan Assn. of Counties v. Dept. of Management and Budget*, 345 N.W.2d 584 (Sup. Ct. Mich. 1984); *Chevron U.S.A., Inc. v. City of Perth Amboy*, 10 N.J.Tax 114 (Tax Ct. N.J. 1988); *Lampy Ready Mix, Inc. v. County of Otter Tail*, 1991 WL 44882 at 4 (Tax Ct. Minn. 1991); *Vermont Soc. of Assn. Executives v. Milne*, 779 A.2d 20 (Sup. Ct. Vt. 2001).

[94] *IHC Health Plans, Inc. v. Commissioner of Internal Revenue*, 325 F.3d 1188 (10th Cir. 2003), referring to the "positive externalities" generated by certain public goods; *PSI Energy, Inc. v. U.S.*, 59 Fed.Cl. 590 (Fed. Cl. 2004), referring to the "positive externality" received by free riders who get public benefits without paying for the benefits.

[95] In one case the court euphemistically called the taxes a "compensation charge" or "user fee" where property owners were assessed a fee when they demolished a residential building. The fee could be avoided if the property owner constructed "affordable" housing. The fee was to compensate other city residents for the impact of the demolition. *Kathrein v. City of Evanston, Ill.*, 636 F.3d 906 (7th Cir 2011); then cited in *Empress Casino Joliet Corp. v. Balmoral Racing Club, Inc.*, 651 F.3d 722 (7th Cir. 2011). In this case the court was not ruling on the constitutionality of the taxes but on the right to contest the taxes. In *Rincon Band of Luiseno Mission Indians of Rincon Reservation v. Schwarzenegger*, 602 F.3d 1019 (9th Cir. 2010), the court struck down a state tax on gambling on an Indian reservation but noted that in general gambling taxes may be imposed to help offset the negative externalities caused by gambling.

[96] *Holmdel Builders Assn. v. Township of Holmdel*, 583 A.2d 277 (Sup. Ct. N.J. 1990), referring to "unfettered non-residential development" that has caused externalities; *Burlington Northern Santa Fe Railroad Co. v. The Assiniboine and Sioux Tribes of the Fort Peck Reservation*, 323 F.3d 767 (9th Cir. 2003), referring to "nonmember activities that produce externalities for tribes but do not rise to the level [required for legal action or for compensation to be required]" as the tribes wanted to be paid for costs suffered by trains crossing the reservation; *Carter v. Carolina Tobacco Co.*, 873 N.E.2d 611 (Ct. App. Ind. 2007), regarding externalities asserted to exist, by a consultant to states' attorney generals for the Master Settlement Agreement on tobacco, if any tobacco sellers could avoid being part of the settlement.

actionable-can be in the mind of the beholder; the job of the courts is, regardless of what term is employed, to follow the rules of law. Externality could allow anything and everything to be actionable.

The first tort case to use the term externality was a wrong death suit based on failure to warn for a child killed by a B-B gun. The Pennsylvania high court agreed that the suit should be dismissed.[97] The dissent argued that "the trial court should direct the jury's attention to… physical properties as well as externalities such as marketing, promotional activities, labels, logo" that could affect how a consumer views a product.[98] Advertising materials can be relevant in tort suits, but the externality argument open the barn door to throw in anything that anyone would assert could be possibly relevant. Where should the line be drawn in law? The economic concept of externality as any cost imposed on, or suffered by, anyone gives no clue.

The next case was a claim of tortious interference with business relationships.[99] Affirming the denial of an injunction requested by a party, the court noted that judgments about matters in equity, like many other things, "can be arrived at only through a subjective quantification because of the subjective values, externalities, and effects on the public interest that may be involved in an injunction case."[100] That is, what is an externality is highly subjective. They are real, but hard to pin down and courts are normally wont to engage in such slippery relationships.

Another case concerned a defamation claim brought by an employee against his employing brokerage firm that would proceed to arbitration.[101] Discussing how the actions of some employees at the firm resulted in damage to the reputation of many other employees, the court noted that "any one member's reputation tends to reflect on the others; this externality gives each an interest in the other's standards of conduct."[102] That is, if a member of a firm acts badly and negative press follows, that impacts other employees who are tarnished by the bad actor. This is a real externality, but generally not one the law would recognize as giving rise to a cause of action. There would be no limits to such matters.

One court discussed the desirability of imposing liability on negligent parties who impose costs on innocent parties. A patient contracted AIDS from tainted blood he received during surgery. Allowing certain claims to proceed, the court explained defective products contain hidden costs or "what economists refer to as 'externalities.'"[103] The judge opined that if costs of externalities (defective products) were not imposed on manufacturers, then goods would be too inexpensive and members of society would be encouraged to buy more of the low-price goods, thereby suffering even more damage and imposing more costs on society. Absent strict liability "the

[97] *Sherk v. Daisy-Heddon, a Division of Victor Comptometer Corp.*, 450 A.2d 615 (Sup. Ct. Pa. 1982).

[98] *Id.* at 633.

[99] *Lawson Products, Inc. v. Avnet, Inc.*, 782 F.2d 1429 (7th Cir. 1986).

[100] *Id.* at 1434.

[101] *Pearce v. E.F. Hutton Group, Inc.*, 828 F.2d 826 (D.C. Cir. 1987).

[102] *Id.* at 830.

[103] *Doe v. Miles Laboratories, Inc.*, 675 F.Supp. 1466, 1471 (D. Md. 1987).

costs of externalities are thrust upon victims or upon society…."[104] Even if one takes the assertion as true, the judge gives no clue as to where to draw the line. Should the maker of the tainted blood have to compensate everyone who worries about the safety of transfusions?

The next case concerned injuries caused by use of a medical device used on a mother that caused her child, conceived after the medical procedure, to suffer injuries *in utero*. The appeals court affirmed dismissal of the suit, holding the negligent party in the accident had no obligation to an as-yet not conceived child.[105] The dissent quoted (Posner 1972, p. 47): "we want the total liability of negligent injurers to equal the total cost of their accidents."[106] Hence, the dissent argued, "In economic terms, all externalities must be internalized."[107] Liability might be endless in such a formulation.

The court in another decision recognized that problem. Suit was brought for misappropriation of likeness, violation of the false light doctrine, and related claims. The district court granted summary judgment for defendants. The appeals court affirmed.[108] It noted that protecting one's name or likeness "is socially beneficial because it encourages people to develop special skills, which then can be used for commercial advantage."[109] That is, when property rights are secure, there will be greater investment in the development of property. However, there are limits on rights. The claim here reached too far. Protection is not given to general incidents from a person's life or to material in the public record. The court stayed with the rules regarding what specific information is protected by the tort of misappropriation. The fact that the plaintiff felt wronged by an externality, a taking of value from him that went beyond what is protected by law, does not matter legally. The rule of law, not the personal beliefs of an individual as to what is valued, set the bounds of protected interests.

In the next case an insurer, Erie, was sued for denying it had a duty to defend an insured business, Alliance, accused of "advertising injury" inflicted on another company. Advertising injury was covered by the insurance policy. Alliance had been hired by LSC to review the quality of work performed by Sear. Alliance gave LSC a negative report about Sear's work. Sear then sued Alliance for defamation. Erie refused to defend Alliance as the policy did not cover defamation. The trial court and appeals court held for the insurer, saying that the negative information provided to LSC was not advertising.[110] Discussing the matter, the appeals court held: "We

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[104] *Id.*.

[105] *Hegyes v. Unjian Enterprises, Inc.*, 286 Cal.Rptr. 85 (Ct. App., 2 Dist., Cal. 1991).

[106] *Id.* at 111.

[107] *Id.*.

[108] *Matthews v. Wozencraft*, 15 F.3d 432 (5th Cir. 1994).

[109] *Id.* at 437. Posner (1992) is cited in support.

[110] *Erie Insurance Group v. Sear Corp.*, 102 F.3d 889 (7th Cir. 1996).

refuse to hold that every activity which produces the positive externality of increasing business, especially those activities requisite to basic job performance, constitutes 'advertising' as intended in the [policy here]."[111] That is, Alliance was required to report its findings to LSC as a part of its obligation. The fact that Alliance did a good job, presumably pleasing LSC, created positive spillovers or positive externalities. While good job performance is "good advertising" that may lead to more business, it does not qualify as advertising as it is generally understood. Actionable externalities are kept within the bounds of accepted definitions of actions; individual parties cannot expand the definition to suit their purpose or externalities are ever actionable.

Every loss may be called an externality by the person suffering the loss, but every loss is not actionable. For example, Monroe properly submitted his name to be a teacher for a school district. The district negligently left his name off the list, so he was not considered for employment. He sued but the appeals courts agreed with the trial court that Monroe had no cause of action.[112] "From an economic perspective, traditional common law judges decided that… purely intangible economic risks were matters that should be left as externalities borne by the party that experience them rather than as costs internalized into the social contract of safety."[113] The fact that some employee of the school board carelessly omitted a name did not give rise to a tort of negligence, regardless of the fact that Monroe may indeed have failed to obtain employment he otherwise may have had. No doubt he was aggrieved, but the externality he suffered is not actionable.

One court used the looseness of externality as a justification for allowing a novel cause of action to proceed. The Mayor of Cleveland sued various firearms makers for public nuisance, unreasonably dangerous design and unjust enrichment for making and selling firearms. The trial court rejected the motions to dismiss, holding that suit could proceed.[114] The court reasoned "that the City has paid for what may be called the Defendants' externalities-the costs of the harm caused by Defendants' failure to incorporate safety devices into their handguns and negligent marketing practices."[115] By this logic, automakers could be responsible for the clean up costs of car accidents that cities incur; everything is an externality as one cost is linked to another. As the next case illustrates, this can be so even if one voluntarily assumes the risk.

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[111] *Id.* at 895.

[112] *Monroe v. Sarasota County School Bd.*, 746 So.2d 530 (Ct. App., 2 Dist., Fla. 1999). This language was quoted later in *Virgilio v. Ryland Group, Inc.*, 695 F.Supp.2d 1276 (M.D. Fla., 2010). The court rejected a claim by homeowners that it was negligent for a developer not to reveal to them that the location of their homes had once been a bombing range used by the military.

[113] *Id.* at 535.

[114] *White v. Smith & Wesson Corp.*, 97 F.Supp.2d 816 (N.D. Ohio 2000). The decision has generally been ignored by other courts.

[115] *Id.* at 829.

A health insurer sued the tobacco companies for causing increased cost of medical services due to smoking. The jury awarded $17 million in compensatory damages.[116] The judge upheld the award: "leading commentators and economists accept the significant 'insurance externalities'-i.e., real world impacts-that result from the presence of first party insurance in consumer markets, and the tobacco market in particular."[117] Providing insurance to smokers, who presumably have revealed the fact of smoking to insurer, who adjusts premiums accordingly, is ordinarily presumed a matter of contract, but by employing the endless cost notion of externality, liability extends.

Similarly, a case involving voluntary sports activity may import liability by notions of externality. A guest at a resort was injured when he fell off a horse provided for a trail ride. The resort provided the novice rider with a gentle horse, but still the accident occurred. The guest had been briefed about the dangers of horseback riding and had signed a liability release, but the appeals court rejected that and allowed suit to proceed.[118] "The effect of the Release is to require society so subsidize Defendants' negligent operation of their business.... Nationwide...'Riding horses may involve greater risk of fatal injury than most other sports'.... There can be no doubt that equine activities expose substantial numbers of consumers to risks of serious physical harm."[119] So externality was cited as a basis for liability not only for costs unwillingly borne that are imposed by others, but for costs suffered in accidents from activities willingly undertaken.

Some tort cases used externality in passive ways not relevant to the outcome, so are not discussed.[120] Most cases discussed here indicate the sloppiness of the meaning of externality. It refers to costs, which are ubiquitous. As some court noted, not all costs are actionable because there is an externality, but some courts seem less sure. If all external costs are actionable, the law has no bounds. Some courts expressly recognize that the externality concept opens the door to unlimited liability. "The theory of using the law to internalize the externality of a business is a well-discussed idea among those who study law and economics. However, it is particularly difficult for a common law court to create a carefully tailored and limited theory of recovery for a special group... without creating more problems than it solves."[121]

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[116] *Blue Cross and Blue Shield of New Jersey, Inc. v. Philip Morris, Inc.*, 178 F.Supp.2d 198 (E.D. N.Y. 2001).

[117] *Id.* at 235. The decision cited several articles that argued that liability should be imposed on tobacco companies due to externalities.

[118] *Berlangieri v. Running Elk Corp.*, 48 P.3d 70 (Ct. App. N.M. 2002). The decision has not been cited favorably by any other court.

[119] *Id.* at 75. The court cited the *Miles Labs* case, *supra* n. 107 for the proposition that "the costs or externalities are thrust upon victims or upon society," at 1471.

[120] *LaFleur v. Shoney's, Inc.*, 83 S.W.3d 474 (Sup. Ct. Ky. 2002); *Travelers Casualty and Surety Co. v. United States Filter Corp.*, 870 N.E.2d 529 (Ct. App. Ind. 2007); *Bonewitz v. Parker*, 912 N.E.2d 378 (Ind. App. 2009); *Whitehouse v. Target Corp.*, 279 F.R.D. 285 (D. N.J. 2012); *Robbins v. Physicians for Women's Health, LLC*, 38 S.3d 142 (Conn. App. 2012).

[121] *Curd v. Mosaic Fertilizer, LLC*, 993 So.2d 1078 at 1085 (Fla. App. 2nd Dist., 2008).

5.15 Zoning

The first zoning case to use the term externality shows the common use for the term in similar suits.[122] The owner of an adult bookstore sued the state for violating equal protection. The appeals court upheld the states zoning practice: "The North Carolina law regulates adult establishments different from other bookstores and theaters because of the unique external costs of adult enterprises.... Special regulation of one commercial enterprise with particular externalities but not other enterprises lacking those secondary effects has long been recognized not to violate equal protection."[123]

This view has seen the term externality used in a number of cases that followed, all upholding zoning restrictions for dirty book stores, gravel pits, day care facility location, the number of unrelated adults who can live together in a house, restrictions on a homeless encampment built by a church, billboards, and the kind of structures that can be built in a particular area.[124] It is unlikely that the notion of externality made much difference in the law in this area since strong zoning authority goes back many years.[125] However, zoning rules may not infringe on other protected rights.[126]

The Supreme Court strengthened the use of externality in this regard when it supported restrictions on adult businesses and rejected the First Amendment violation they claimed inherent in restrictions. The court held that there were crime patterns correlated with location patterns of adult businesses, so they could be subject to specific rules.[127] Concurring in the decision, Justice Kennedy stated: "The calculus is a familiar one to city planners, for many enterprises other than adult businesses also cause undesirable externalities. Factories, for example, may cause pollution, so a city may seek to reduce the cost of that externality by restricting factories to areas far from

[122]Many zoning cases involve a constitutional law claim but there are enough of these to list them as a separate category.

[123]*Hart Book Stores, Inc. v. Edmisten*, 612 F.2d 821, 831 (4th Cir. 1979).

[124]*Basiardanes v. City of Galveston*, 514 F.Supp. 975 (S.D. Tex. 1981); *George Washington Univ. v. Dist. of Columbia Bd. of Zoning*, 429 A.2d 1342 (Ct. App. D.C. 1981); *City of Los Angeles v. State of California*, 138 Cal.App.3d 526 (Ct. App. Cal. 1982); *American Aggregates Corp. v. Highland Township*, 390 N.W.2d 192 (Ct. App. Mich. 1986); *City of Mandan v. Mi-Jon News, Inc.*, 381 N.W.2d 540 (Sup. Ct. N.D. 1986); *Giger v. City of Omaha*, 442 N.W.2d 182 (Sup. Ct. Neb. 1989); *Howard v. City of Garland*, 917 F.2d 898 (5th Cir. 1990); *France Stone Co. v. Charter Township of Monroe*, 802 F.Supp. 90 (E.D. Mich. 1992); *Dvorak v. City of Bloomington*, 702 N.E.2d 1121 (Ct. App. Ind. 1998); *Louhal Properties, Inc. v. Strada*, 751 N.Y.S.2d 810 (Sup. Ct. N.Y. 2002); *Scenic Arizona v. City of Phoenix Bd. of Adjustment*, 268 P.3d 370 (Ariz. App. 2011); *Green v. Douglas County*, 263 P.3d 355 (Or. App. 2011).

[125]E.g., *Hadacheck v. Sebastian*, 239 U.S. 394, 36 S.Ct. 143 (1915) with respect to brickmaking.

[126]The Washington state high court held that zoning rules could not prevent a homeless encampment supported by a church as that would violate freedom of religion, *City of Woodinville v. Northshore United Church of Christ*, 211 P.3d 406 (Wash. Sup. Ct. 2009); a lower court later followed this decision and recognized the externality argument, but upheld the challenge to a homeless encampment as void on procedural grounds. *Mercer Island Citizens for Fair Process v. Tent City 4*, 232 P.3d 1163 (Wash.App. 2010).

[127]*City of Los Angeles v. Alameda Books, Inc.*, 535 U.S. 425, 122 S.Ct. 1728 (2002).

residential neighborhoods."[128] Alameda Books and the discussion about externalities have been cited in a number of challenges to zoning rules. The rules were upheld in every case that includes any discussion of the problem of externalities.[129] In all zoning cases, externalities is used in the standard economic sense of something that spills costs on to others; the term appears to matter little in the substance of the law as it is not used as the rational for expanding the traditional acceptance of the ability of governments to impose zoning regulations.

5.16 Random Cases

Externality pops up in scattered other areas. In some cases the term externality means outside forces, events or information that the court will or will not take into account.[130] In most cases the usage is in the economic sense of something bad or good that spills over to affect others.[131] It was used in passing, not seeming to play

[128] *Id.* at 446, 1740.

[129] *Ben's Bar, Inc. v. Village of Somerset*, 316 F.3d 702 (7th Cir. 2003); *George Washington Univ. v. Dist. of Columbia*, 318 F.3d 203 (D.C. Cir. 2003); *Greenville County v. Kenwood Enterprises, Inc.*, 577 S.E.2d 428 (Sup.Ct. S.C. 2003); *R.V.S., LLC v. City of Rockford*, 361 F.3d 402 (7th Cir. 2004); *Andy's Restaurant & Lounge, Inc. v. City of Gary*, 466 F.3d 550 (7th Cir. 2006); *Ballen v. City of Redmond*, 466 F.3d 736 (9th Cir. 2006); *City of Chicago v. Pooh Bah Enterprises, Inc.*, 865 N.E.2d 133 (Sup. Ct. Ill. 2006); *State v. Stummer*, 171 P.3d 1229 (Ct. App. Ariz. 2007); *Martin Marietta Materials, Inc. v. Board of Zoning Adjustment of Cass County*, 246 S.W.3d 9 (Ct. App. Mo. 2007); *City of Joliet, Ill. V. New West, L.P.*, 562 F.3d 830 (7th Cir. 2009).

[130] *State of Texas v. Sec. of Interior*, 580 F.Supp. 1197 (D.C. Tex. 1984), referring to outside information; *Peters Township School Dist. v. Hartford Accident and Indemnity Co.*, 643 F.Supp. 518 (W.D. Pa. 1986), regarding events beyond insurance coverage; *In re 523 East Fifth Street Housing Preservation Development Fund Corp.*, 79 B.R. 568 (S.D. N.Y. 1987), concerning outside events; *Wint v. Yeutter*, 902 F.2d 76 (D.C. Cir. 1990), referring to things that damage crops; *Northern California Drywall Contractors Assn. v. Dist. Council of Painters No. 8*, 879 F.Supp. 96 (N.D. Cal. 1995); concerning language outside an arbitration agreement; *Demers v. Snyder*, 659 A.2d 495 (Super. Ct. N.J. 1995), referring to outside information that could taint jury deliberations; *Federal Trade Comm. v. QT. Inc.*, 448 F.Supp.2d 908 (N.D. Ill. 2006), referring to external factors that affect pain relief studies.

[131] *Smith v. City of Riverside*, 34 Cal.App.3d 529 (Ct. App. Cal. 1973), referring to events that spill over from one city to another; *In the Matter of the Valuation Proceedings under Sections 303(c) and 306 of the Regional Rail Reorganization Act of 1973*, 445 F.Supp. 994 (Sp. Ct. R.R.R.A. 1977), noting the need to consider externalities and social values in rail reorganization; *South East Lake View Neighbors v. Dept. Housing and Urban Develop*, 685 F.2d 1027 (7th Cir. 1082), referring to bad effects of investment decisions that are non-actionable by third parties; *Kastenbaum v. Michigan State Univ.*, 327 N.W.2d 783 (Sup. Ct. Mich. 1982), regarding positive benefits from the spread of information; *International Union, UPGWA v. Dept. of State Police*, 373 N.W.2d 713 (Sup. Ct. Mich. 1985), concerning positive benefits from the spread of valuable information; *Martin v. Sullivan*, 912 F.2d 1186 (9th Cir. 1990), referring to the bad consequences of a reduction in SSI benefits; *Vieux Carre Property Owners, Residents and Associates, Inc. v. Brown*, 948 F.2d 1436 (5th Cir. 1991), noting damage to historic properties from bad construction; *Yang v. Reno*, 852 F.Supp. 316 (M.D. Pa. 1994), referring to added costs of further review of deportation orders; *F.D.I.C. v. Perry Bros., Inc.*, 854 F.Supp. 1248 (E.D. Tex. 1994), referring to financial setbacks suffered by debtors from

an analytical role in the decisions. In sum, in the scattered areas where externality pops up, its use is not influential.

5.17 Summary of Externality Usage in Case Law

Approximately two-thirds of the cases that mention externality do so in the context of some sort of cost. In some areas, such as antitrust, the use has mostly been technical, with reference to network externalities. In the zoning area, the term is commonly used to refer to certain negative things regulators intend to control, or, in a few cases, positive things being encouraged. The use of the term is non-analytical; it is essentially a generic term meaning bad things that impose costs. That is the sense in which is it used in other scattered areas too. In some instances, the word is not used properly in a technical economic sense, but the readers of the case will understand that the judge is referring to something generally considered to be a bad. As such, it is a vague descriptive term coming into more common usage.

However, in a minority of the cases, perhaps a dozen, externality appears to be a justification for an expansion of costs that will be considered by the court. In some public utility rate cases there was explicit talk of monetizing the externalities from assorted forms of pollution. The argument did not carry the day, but the economic argument is recognized. Similarly, in a couple air pollution cases there was discussion that went beyond the normal vague use of externality to refer to pollution and instead to use it in a stronger sense of an analytical justification for imposition of liability. In one water pollution case, in dissent, Justice Stevens appeared to use externality as a supposedly scientific justification for his view.

The most aggressive use of externality is in tort cases. In some cases scattered over time we see a discussion of externality in an expansive economic sense, justifying a

(Footnote 131 continued)
setoffs; *Escalera v. New York Housing Authority*, 924 F.Supp. 1323 (S.D. N.Y. 1996), regarding drug dealing in housing projects; *Martens v. Smith Barney, Inc.*, 182 F.R.D. 243 (S.D. N.Y. 1998), noting the social benefits from Title VII; *Gardner v. Allstate Indemnity Co.*, 147 F.Supp.2d 1257 (M.D. Ala. 2001), referring to reducing bad effects from harmful acts; *Brooks v. Pre-Paid Legal Services, Inc.*, 153 F.Supp.2d 1299 (M.D. Ala 2001), regarding bad effects from forum shopping; *Fair Share Housing Center, Inc. v. Township of Cherry Hill*, 802 A.2d 512 (Sup. Ct. N.J. 2002), noting costs imposed on some property developers; *Territory of the United States Virgin Islands v. Goldman, Sachs & Co.*, 937 A.2d 760 (Ch. Del. 2007), concerning costs of financial abuses; *Assurance Co. of America v. Lucas Waterproofing Company, Inc.*, explaining that a party may act strategically in litigation to shift legal costs to another party; *Penn Mont Securities v. Frucher*, 534 F.Supp.2d 538 (E.D. Pa., 2008), making a similar point about improper fee shifting in litigation; 581 F.Supp.2d 1201 (S.D. Fla. 2008); *Department of Children and Family Services v. Chapman*, 9 So.3d 676 (Fla. App., 2nd Dist., 2009), noting that external costs of certain activities may be borne by the taxpayers; *Rock River Communications, Inc. v. Universal Music Group*, 276 F.R.D. 633 (C.D. Cal. 2011), explaining that fee shifting in litigation from one party to another is an externality suffered by the party who is forced to bear an unexpected cost.

non-traditional imposition of liability that would allow nearly anything to be counted as a cost for which a defendant may be held liable.[132]

Given the huge number of cases reported in the federal and state court systems over 40 years, and the pervasive use of externality in economics, the small number of cases in which the term has been employed to provide a justification for a peculiar decision seems remarkable. If judges wish to construct scientific-sounding arguments based on presumed economic analysis, externality provides a handy tool that few judges have stooped to use.[133]

5.18 Externality in Economics

Externality in economics is a concept is so loose as to be useless in an aid to legal analysis. Unlike other areas, such as antitrust, in which economic analysis has played a substantive role in helping courts comprehend market structures, externality may be a useful word that denotes costs or benefits that spill over, but it provides no substantive understanding of particular problems.

Consider some standard definitions of externality: "An externality exists when one (or more) economic actor(s) affect(s) another actor (or group) directly without the intervention of a market transaction." (Russell 2001, p. 45) "Maximum social welfare is only attained…if marginal private costs also equals marginal social cost, for it is only then that marginal social benefits and marginal social cost are equal." (Ferguson 1972, p. 497) "An externality exists when a person does not bear all the costs or receive all the benefits of his or her action. An externality exists when the market price or cost of production excludes its social impact, cost, or benefit. Externalities are everywhere." (Hanley et al. 2001, p. 17) Indeed they are. If you wear a shirt that offends the eyes of some beholders, you have inflicted costs on those persons; they have suffered externalities.

But, as noted before, only some externalities are regarded as worthy of concern in economics. Pecuniary externalities are ignored (Worcester 1969).[134] These are created, for example, when one law firm draws clients away from another law firm, thereby inflicting a financial loss on that firm. No doubt the members of the losing firm feel the pain; they have suffered a loss. But since the transactions are voluntary,

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[132]With respect to interesting applications of the notion of externality, one unreported case is worth noting, *Winter v. Office of the President of the United States*, 1997 WL 102513 (N.D. Cal. 1997), in which plaintiff issued a "writ of externality" on behalf of the American people for $50 trillion of laundered drug money, plus $10 million punitive damages. Externalities, used loosely, can cover just about anything imaginable.

[133]This does not imply that the judges who made use of externality to bolster their position were intentionally making clever use of economics they knew to be weak; economists talk so much about externality as if it is a scientific concept that one could easily assume it provides solid theoretical justification for a desired legal outcome.

[134]"[E]verything can be said to affect everything else, so we ignore many things and focus on technological externalities." (Hirshleifer 1980, p. 532).

we presume society as a whole is improved by better allocation of scarce resources. The transitory hits taken by parties in the process of competition are not the kinds of actions that affect others that are of concern. The law is consistent with economics on this point; so long as such transactions are voluntary and no fraud or tort is involved, there is no reason for economic or legal concern. A new contract has been formed by willing parties. Those who did not get cut into the deal cannot make a claim against those who are parties to the deal.

Technical externalities are the kinds of spillover effects of concern in economics. Network externalities, discussed previously, are one example. But the classic eternality is pollution. One makes wheelchairs for disabled persons and, in the process, throws wastes into the air, land and water that inflict harm (costs) on others. How to eliminate the problem?

Guido Calabresi has explained: "Thus if one assumes rationality, no transaction costs, and no legal impediment to bargaining all misallocations of resources would be fully cured in the market by bargains." (Calabresi 1968, p. 78). Those suffering from pollution emitted by the wheelchair maker will bargain with her to reduce emissions. This is often difficult to have happen, explained George Stigler: "The world of zero transaction costs turns out to be as strange as the physical world would be without friction." (Stigler 1972, p. 12). That is, trying to eliminate externalities is like investing in the perpetual motion machine. All "wrongs" cannot be righted and perfection in cost allocation can never occur. The gains to participants in potential exchanges may be very small or deals may be very difficult to make (high transaction costs).

5.19 Relevant Externalities

What externalities can be or should be addressed? One classic article on the subject suggested that Pareto-relevant externalities can be dealt with; Pareto-irrelevant externalities cannot (Buchanan and Stubblebine 1962). Pareto-relevant refers to gains from trade that parties recognize and, to their mutual benefit, bargain into existence. So long as the expected gains outweigh the bargaining costs, the parties can be expected to improve their (and, therefore, societys) welfare. Such externalities are self-correcting, as the parties recognize the potential gain, or they may become solvable if it becomes less costly for the parties to bargain, a point returned to below.

Pareto-irrelevant externalities are cases in which the expected cost of bargaining is greater than the expected rewards, so we let those events pass. The gains may be trivial what is it worth to you for a person not to wear a shirt that offends your sense of fashion? Life is an endless stream of little nicks and cuts that we ignore because the many tiny imperfections, as we see them,[135] are not worth messing with. Add them up across a huge number of people and the supposed losses can be

[135] The person wearing the ugly shirt probably thinks it is just dandy.

immense. Add up little potential gains from the many things that many people enjoy, but do not pay for, and that number can also be immense. The problem is that, in the absence of transactions, reliable measures of value do not exist. Dollar values cannot be placed on such externalities. "In economic terms, people have a difficult time assigning hypothetical dollar values to categories and commodities they virtually never confront in everyday experience." (Sunstein and Pildes 1997, p. 142)

The presumption that because such externalities are not priced, the bad ones will be oversupplied and the good ones will be undersupplied, analytically is not clear (Haddock 2007). Markets function within the law. The purpose of legal rules is to give guidance to market participants as to the boundaries and provide the possibility of restitution in case of improper action. The purpose is not for courts to set proper prices when consideration in contracts is not reflective of "fair market value" nor is it to invent costs, such as in cases of torts or environmental issues, that are not expected by parties to actions.

As the courts in several cases reviewed above noted, if it is desirable to pay for greenhouse gas offsets through the setting of electric rates by a public utility commission, it is for the legislature to give such instructions, not for courts to presume that such costs, traditionally not counted should be counted. Courts have no more business setting such rules than they would declaring there should be compensation for all externality sufferers from electricity. Because the lights are brighter, the offensive shirt is even more glaring, so the offended party should receive some compensation from all users of electricity. Externalities can be an endless regress. Summary Externalities are an empty set. Economists have employed the term for decades but know nothing more today than when the discussion started. Judges have, for the very large part, ignored externality other than as a reference to the fact that many events create bad or good effect. That is a perfectly sensible of the word. To go further and declare that knowledge of the fact of unmeasured costs allows them to be measured by expert economists opens the way to endless mischief of pursuing individual interests in the guise of high science. Decades of fruitless discussions among economists have made little progress in an operational meaning for externalities. Assuming such discussions can be put into practice would terrible consequences for the rule of law in a free society. Bad economics can contribute to the making of bad law. When it does, there is a major externality.

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