Numerus Clausus: An Economic Perspective

Wei Zhang, University of California - Berkeley
Numerus Clausus: An Economic Perspective

Zhang Wei*

I. Introduction

Numerus clausus refers to the principle that both the form and the substance of a property right shall be prescribed by the law, which essentially restricts the freedom to “customize” the legally enforceable property interests. It has long been regarded as a basic principle in Civil Law countries, while the recent studies of U.S. scholars suggest that its essence exists in the Anglo-American law as well.

In the ongoing legislative process of the Chinese Property Law and the Civil Code, however, the numerus clausus principle is increasingly called into question by Chinese writers from both sides of the Taiwan Straits. Yet those who advocate an entire or partial abolition of this principle fail to spell out the exact meaning of the “freedom of property rights” which they are arguing for. Absent numerus clausus, it is still possible to set certain restrictions on the customization of property rights just as contract law does to the contractual arrangements between private parties. Due to the vagueness of the “freedom of property rights” concept, we assume that the parties are totally free to devise their property rights under a regime without the numerus clausus principle in Part II of this paper, and try to set up some limitations on this freedom in Part III.

In this paper, we will explore the costs and benefits of the numerus clausus principle as well as a property regime without it, using an “information cost externality versus frustration costs” framework. The paper is centered on positive analysis elaborating the possible consequences under each of the two property regimes. We do not attempt to make a direct choice for the policy-makers though certain normative implications will be mentioned in Part III.

II. Information Cost Externality versus Frustration Costs
1. Information cost externality

(1) Merrill and Smith’s theory

Merrill and Smith suggest that “(p)arties who create new property rights will not take into account the full magnitude of the measurement costs they impose on strangers to the title.” They point out three classes of individuals who may potentially be affected by the creation of idiosyncratic property rights: 1) the originating parties, the participants to the transaction creating such new rights; 2) the potential successors in interest, those who will succeed the property interests from the originating parties; 3) the other market participants. And the third class can be further divided into two subclasses. In the first are the individuals dealing with the same type of assets as the one in which the originating parties create new property rights. The second subclass includes all other people that do not transact with the above type of assets yet must avoid violating property rights in all these assets. Merrill and Smith offer the following example to illustrate their idea.

A is the sole owner of a watch. He wants to create a “time-share” in it, a fancy under the current property law, and transfer this right to B, which allows B to use the watch only on Mondays. In this example, A and B are the originating parties. Those who might purchase A’s reserved rights in the watch as well as who succeed to the interest acquired by B are the potential successors in interest, named respectively as Cs and Ds. Anyone selling and purchasing rights in other watches, Es and Fs, are in the first subclass of the other market participants, while the remaining market participants, identified as Is and Js, make up the second.

Merrill and Smith argue that no externality exists with respect to the originating parties and the potential successors in interest because any change in the value of the interests resulting from the creation of new property rights will be reflected in the dealing prices among these parties. The information cost externality, however, does affect the other market participants. First, since a legally permitted Monday-only property right is created in A’s watch, for fear of potential claims from third parties, F may have to investigate whether the same right exists in E’s watch which he is going to buy, while E might also need to disclose to F whether such right is in existence. These costs of investigation and disclosure externalized to E and F come from the customization of the nonstandard property right between A and B. Second, concerned about violating the new property right in A’s watch, Is and Js will be obliged to collect information about it as well. Again, these information costs are not to be borne by A or B. In this paper, the externality arising among the first subclass of other market participants, such as E and F, is referred to as “the first level information cost externality,” and the externality affecting the second subclass, i.e. Is and Js, as “the second level information cost externality.” According to Merrill and Smith, the numerus clausus principle, by compulsory standardization of property rights, is one way to control the externalized information costs to third parties.

Let’s turn to the second level information cost externality first. Do Js and Js necessarily need to know about the new right in A’s watch at additional costs in order to avoid violating such a right? The answer should be negative. Although property right is in
rem, general market participants are charged with no more than a duty of abstention. To observe this duty, they do not need to know who has a property right or what the right is. Knowing that I do not have a right is sufficient. Therefore, the second level externality appears to be imaginary even under a property regime without numerus clausus, provided that the ownership cannot be devised freely and that nobody is allowed to customize a property right beyond his power as an owner. This point is convincingly illustrated by the fact that we hardly, if ever, consult the registration to avoid violating other people’s rights in real estates in spite of the existence of well organized land registration systems in both Common and Civil Law countries. Only the current and potential holders of property rights (like A, B, and C, D) will have the incentive to investigate the substances of these rights.

As to the first level information cost externality, it can be a real problem if there is no legal protection for bona fide purchasers. As we see under modern property regimes, however, bona fide purchasers will rarely be obligated to honor the idiosyncratic rights. So next we are trying to analyze the first level information cost externality with the bona fide purchaser protection rules in place.

(2) Taking the Bona Fide Purchaser Protection Rules into Account

The term “bona fide purchaser” can be possibly interpreted in two ways. First, it may refer to purchasers who do not have actual notice of the encumbrances in assets. They are not required to honor any unknown fancy in the assets to be acquired, even if their ignorance results from negligence. If this meaning is applied, then potential buyers do not have to investigate the property rights in the subject matter of purchase, while sellers merely need to disclose nonstandard rights when they do exist. In other words, in this case, information costs incident to the creation of new property rights are completely internalized by the originating parties. Using Merrill and Smith’s illustration, we can find that, in essence, there are only A, B, C, D in the market but no E or F exists if all purchasers without actual notice are protected as bona fide purchasers.

Second, “bona fide purchaser” may also be limited to the acquirers not only without actual notice but also with no constructive notice, i.e., those who do not know and should not have known the fancies. Under this interpretation, the occurrence of information cost externality will turn on the different systems for information disclosure.

The information cost externality does not arise in a decentralized disclosure system where the originating parties disclose the customized property rights on a one-on-one basis. In such a system, the potential buyers have but one way to obtain constructive notice, namely, the direct disclosure by the creator of the novel rights. Essentially, the distribution of information costs among the transacting parties remains identical in the decentralized system, no matter how “bona fide purchaser” is defined. In Merrill and Smith’s example, this means that F will be protected as a bona fide purchaser insofar as E does not disclose the “time-share” in his watch, and that E need not make any disclosure unless his watch does bear such an interest, yet the existence of a “time-share” in A’s watch is totally irrelevant.
Things will change, however, in a centralized disclosure system. Real estate registration may be the most familiar paradigm of a system where information is gathered and disclosed collectively. Externality will become a real issue if the information about a non-standard property right is so released. Again, we take Merrill and Smith’s “time-share” in a watch as an example. Consider that the “time-share” created by A is the first non-standard property right in a watch and that it must be disclosed by filing. This invention brings about two kinds of information costs that are not to be borne by A or B, the originating parties. One is the cost of establishing a filing system for watches, including the expenses for devising and maintaining this system. The other is the information costs incurred by potential buyers of all watches in verifying the legal dimensions of the property. When F wants to buy E’s watch, he will have to check whether the novel right exists in that watch by consulting its filing, because F will assume any filed fancy in E’s watch even without actual notice. The first kind of externalized costs falls on the whole society, and according to Hansmann and Kraakman, this can be regarded as “system costs”; the second kind, which is borne by those who do not use the nonstandard property right, parallels the “nonuser costs” in their framework. Some writers argue that with the development of computer and internet technologies, costs involved in the operation of filing systems tend to decrease consistently, and therefore, the legal dimensions of more assets can be disclosed collectively through filing systems. Indeed, this prospect seems highly credible, yet lawyers may find difficulties in estimating the magnitude of such decrease and may be concerned about, among other things, the reliability of network or the necessity of backup in hard copies. It is the technical experts that are more appropriate to make these estimations. Above all, even though the monetary costs for establishing and maintaining filing systems reduce to zero, opportunity costs are still unavoidable for those who make or check filings and who keep the system running. In this sense, technological development is not bound to eliminate these two kinds of externalities.

These externalized costs are distinct in one aspect: after a new property right is created in a particular type of assets thus giving rise to the externalities, the marginal costs will increase only insignificantly when a second nonstandard right turns up, regardless of whether the second right is in the same category as the first one. Once a filing system for watches is built up because of the “time-share” coined in A’s watch, then the “system costs” as well as the “nonuser costs” have already sunk. These costs will largely remain unchanged when another “time-share” or a “place-share” is created in E’s watch. As a result, the legal restrictions set on the forms of property rights have a bipolar character for a given type of assets. The law tends to either permit no exceptions to the prescribed forms or provide for an open-ended set of forms that can be customized freely.

Is it practical to internalize the above two costs by charging fees? This may not be an easy task. As stated above, even a single nonstandard property right in a certain type of assets will suffice to initiate almost the entire “system costs” and “nonuser costs”
if this right is to be disclosed in a centralized system. Consequently, the externality cannot be ruled out unless the fees charged to the originator of such a right are equivalent to the sum of these two kinds of costs. As a practical matter, nevertheless, it appears unfeasible to charge that high amount for one filing. In addition, difficulties may also arise concerning the appropriate compensation to “nonusers” given that they are not entitled to collect fees directly from those who make filings. Free access to the filings alone will not be sufficient as the nonusers’ transportation costs or even opportunity costs deserve compensation. Yet overcompensation will probably lead to too many consultations on filings. In fact, filing fees are usually charged on a per-item basis or according to the value of the subject matter to be filed, which is indifferent to actual costs involved in filing itself. These practices may arguably be explained as a response to the many difficulties in internalizing costs.

2. Frustration costs

Frustration costs are usually considered to be the disutility originated from the fact that mandatory rules sometimes prevent the parties from achieving a legitimate goal cost-effectively. For our purposes, frustration costs are costs attributable to the *numerus clausus* principle, and any goal unattainable even under a regime without this principle should not be counted as a source of frustration costs. In this sense, frustration costs may well be understood as the difference in transaction costs of a given deal under a *numerus clausus* regime and one without it.

(1) “Generative property right” theory

Merrill and Smith apply Noam Chomsky’s *Generative Grammar* theory to property law and believe that the generative power of the system of property rights will help lower the frustration costs. They compare the inventory of property rights prescribed by law to the lexicon of a language, and the rules for combining property rights to a language’s grammar. The parties can tailor potentially infinite forms of property rights in line with their transaction goals by combining the standard property rights under certain available rules. They further argue that “a complex property rights built from a small number of standard building blocks is likely to be easier for third parties to process than functionally equivalent complex property rights for which third parties must figure out the nature of the building blocks.”

The soundness of this “generative property right” theory is nevertheless subject to doubt in American law. Even if some new property rights, such as a “tenancy for the duration of the war,” can be generated, it by no means warrants free customization of any form of property rights. The feasibility of generating depends ultimately on the nature of the building blocks. For instance, it seems hardly possible, using currently available estates, to imitate the right of entry and create a future interest shifting the ownership of land to a third party only upon his choice of accepting the land.

The generative theory can be more problematic in Civil Law countries. This is due to the different ways of standardizing property rights in American and Civil Law. The former emphasizes restricting the forms, and leaves space for customizing the substance of property rights. The latter, on the other hand, limits both the forms and the substance.
Japanese Civil Code, for example, there are three types of usufruct rights in land: the superficies, the emphyteusis and the easement. The substance of the first two types is strictly defined, and the parties are allowed to tailor the duration of rights only. The easement is the only type that is relatively open to customization, which is more or less similar to equitable servitude in American law. Its non-possessory character and dependency on titles of the dominant land nevertheless confine the scope of its application. Using Merrill and Smith’s analogy to language, we can say that the easement is like an uncommon word with a poor potential for combination. In this sense, we may draw an analogy between the standardization of property rights in American law and an algebraic expression with plenty of variables while the standardization in Civil Law is closer to an arithmetic expression composed basically of constants. Against such a legal background, it is more impractical to generate new types of property rights out of the standard building blocks provided by Civil Law.

(2) The analysis of frustration costs: comparing the transaction costs under the two regimes

We formulate the following example to facilitate the analysis. A, the owner of a watch, hopes to create a property right in the watch and grant it to B. This will entitle B to use the watch on Mondays during his lifetime. Also, B may freely transfer this right while he is alive. But the right reverts to A or his successors upon B’s death. Under a property regime without the numerus clausus principle, A can set up the new property right directly and convey it to B, while under a numerus clausus regime, the parties will resort to the contractual mechanism to achieve this transaction. A comparison is made below between the transaction costs of creating the property right directly and those resorting to contractual arrangements.

First, we need to classify the transaction costs to be compared. Usually, transaction costs are divided into three categories: search and information costs, bargaining and decision costs, and police and enforcement costs. The first category, the search and information costs, is not closely relevant for our purposes, because it is always necessary for the parties to discover each other, to investigate the creditability of their partners, to disclose or search the physical and legal characters of the watch, etc. The legal devices they are utilizing do not affect their costs of taking these actions. The amount of the costs depends instead on such non-legal factors as whether the relevant information is readily available in the particular market, and how well the parties know each other. Therefore, we will dispense with the search and information costs and focus on the bargaining and decision costs, and the police and enforcement costs.

Two aspects need to be considered when we talk about the bargaining and decision costs. One is the costs involved in the negotiations determining the material rights and duties of the parties. The other is the cost spent documenting these rights and duties in certain forms. The former does not vary with the legal devices used to do the transaction. The parties aim to realize the same business objective regardless of the legal mechanism they are utilizing, so the costs invested in bargaining and decision rest on the parties’
experiences in negotiations, their bargaining power, the reliability of their partners and other business factors. However, the *numerus clausus* principle does make a difference with respect to the second part. Under a property regime without this principle, *A* and *B* can simply define the new right in the watch in their contract, and label it as a property right. Under a *numerus clausus* regime, though the parties still need to enumerate the merits of the right in their contract, they cannot directly characterize it as a property right, but have to design additional clauses to imitate the legal effects of a property right. In other words, the parties cannot use the term of “property right” to identify the nature of the new right: rather, they must elaborate on the substance of this term in their contract.

To grant *B* a right in *A*’s watch bearing the legal effects of a property right, the contract between *A* and *B* should stipulate that 1) *A* is prohibited from granting a third party any right incompatible with *B*’s right; 2) *B* and the successors of his right can transfer the right freely and the successors can claim the right directly against *A* or his successors; 3) neither *A* nor any of his successors is allowed to transfer *A*’s rights in the watch to a third party without delegating *A*’s duties under this contract; and 4) *B*, as well as the successors of his right, is entitled to require specific performance of duties provided in 1), 2) and 3). These clauses are referred to as “clauses imitating the property effects” in this paper.

Of course, adding the “clauses imitating the property effects” entails costs as well. Nevertheless, bargaining and decision costs have already sunk significantly beforehand to fix the parties’ material rights and duties. Thus, the marginal cost of inserting these clauses is relatively small. In addition, since the effects of a property right do not shift with the subject matter or merits of the right, it is entirely conceivable that one can design certain boilerplate clauses meeting the needs of all contractual arrangements mimicking the effect of a property right. In that case, the marginal cost becomes even smaller. Consequently, only minimal transaction costs will accrue in most cases when the parties have to add the “clauses imitating the property effects” under a *numerus clausus* regime.

Between *A* and *B*, the contract itself is sufficient to illustrate the rights and duties. However, disclosure is necessary if a third party needs to know the new right *A* confers upon *B*. Under a non-*numerus clausus* regime where the new right is designated as a property right, the disclosure is made through entering notation or taking possession, otherwise the bona fide purchasers will not be required to honor the new property right. Similarly, under a *numerus clausus* regime, the contract creating the new right has to be disclosed to the assignees and delegates of the contractual rights and duties. In short, regardless of the nature of the right created between *A* and *B*, its substance should always be disclosed to successors of such right and the corresponding duties insofar as the right and the duties are transferable. Thus, the costs involved in demonstrating the new right to third parties will arise under both regimes.

In a decentralized disclosure system, such costs will be the same whether or not the property regime embodies the *numerus clausus* principle: *A*, *B* may use the same method — e.g. binding the contract to the
watch, or attaching a label to the watch indicating “B is entitled to use the watch and please refer to B for details” — to disclose the new right in either regime. However, in a centralized disclosure system, the costs for disclosure can be different under these two property regimes because the centralized system is applicable only to property rights, but not to contractual rights imitating property effects. With respect to originating parties like A and B, a centralized disclosure system might save their costs for disclosure. A decentralized systems is probably less reliable and more expensive to maintain. The label attached to the watch, for instance, may fall off or be falsified, so the parties need to check it frequently. By shifting to a centralized system, they can spend less time and money on these checks. Nevertheless, this states but one possibility. The scale of the costs for disclosure tends to vary with the substances of the rights to be disclosed. To illustrate, imagine that there is a real covenant prohibiting pets in a condominium. Perhaps it is much cheaper to disclose this covenant by posting it in the lobby than filing it with the real estate registry if the homeowners have already employed doormen, as they can take care of the post at almost no additional cost. Generally speaking, therefore, with a decentralized disclosure system, the costs for disclosure are substantially identical under a numerus clausus regime and one without it, while with a centralized system, these costs can be greater under a numerus clausus regime for some rights, yet for others, a regime without numerus clausus costs more.

Finally, we turn to the police and enforcement costs and focus on the costs incurred by B (and his successors), the holder of the right, in seeking legal remedies. Presumably, there are two major types of violators to B’s right — the owner A (and his successors) and third parties in general. With respect to each type, the remedial costs further differ depending on whether the violator is in bankruptcy. So the police and enforcement costs should be discussed in four separate situations.

In the first situation where the owner A violates and is not in bankruptcy, B can allege the claims out of property right and request A to restore his right under a regime without the numerus clausus principle. To make these claims, B only has to prove that A does violate his right. Under a numerus clausus regime, however, B must allege a breach of contract and seek contractual remedies. As the parties have agreed on specific performance, normally the results are the same no matter whether the contractual or the property remedy is sought. Also, in the jurisdictions where res ipsa loquitur (e.g. Japan) or strict liability (e.g. China) is applied to the breach of contract, B’s burden of proof will not be any heavier. In general, B’s costs for seeking legal remedies do not change to any meaningful extent under either property regime, as long as he brings suits before the statute of limitations runs out.

In the second situation where A, the violator, is in bankruptcy, because of the priority of property rights, B’s claims out of property right remain intact in a non-numerus clausus regime. On the contrary, B’s contractual right enjoys no priority in the bankruptcy proceeding. His right of using the watch on Mondays may thus be totally sub-
verted and he may recover no more than the damages equivalent to a fraction of the value of this right. Such a result cannot be possibly avoided through ex ante contractual arrangements. Therefore, in the second situation, the *numerus clausus* regime may lead to serious frustration costs.

The third situation involves the violation by a third party who is not in bankruptcy. Without the *numerus clausus* principle, $B$ is entitled to a property right and may seek legal remedies based on claims out of property right. Under a *numerus clausus* regime, on the other hand, $B$ is granted a contractual right that cannot be claimed against a third party. Consequently, he must turn to the rules of unjust enrichment or interference of contracts for recovery. Yet in either the unjust enrichment suit or the interference suit, $B$ will have to prove more elements, compared with asserting the claims out of property right, to make a prima facie case. In terms of the remedies, injunctions may be awarded in unjust enrichment suits, but $B$ might merely recover damages in tort cases. Hence, the third situation will give rise to high frustration costs as well.

Finally, when $B$’s right is violated by a third party in bankruptcy, he will become an unsecured creditor and wait for distribution if he did not acquire a property right in the first place due to existence of the *numerus clausus* principle. By contrast, he is able to make the claims out of property right under a non-*numerus clausus* regime. Similar to the second situation discussed above, *numerus clausus* will also lead to great frustration costs in this scenario.

It is evident from the above analysis that the *numerus clausus* regime brings about higher policing and enforcement costs. In particular, when the violator is in bankruptcy, the parties’ business goals can fail completely with the restriction laid by the *numerus clausus* principle. The policing and enforcement costs are the major components of frustration costs resulting from the *numerus clausus* principle. This is attributable to the extreme difficulty in establishing, through contractual arrangements, the priority coming with a standard property right.

### III. Normative Implications

1. **Two revelations and one puzzle**

   (1) Two approaches to alleviate the frustration costs

   The most powerful argument against the *numerus clausus* principle relies on its accompanying frustration costs. The theoretical analysis done above reveals, nonetheless, that the frustration costs in a *numerus clausus* regime comes mainly from the different enforcement rules available to property rights and contractual rights. Given this diagnosis, we can easily find two prescriptions: either to keep the current dichotomy in enforcement rules and abolish the *numerus clausus* principle, or to keep this principle but eliminate the disparities in enforcement rules. In terms of lowering the frustration costs, these two approaches are supposed to play comparable roles. So to make a choice between the two may require studies on their differences in other aspects, such as the potential costs associated with the reform of rules, which is beyond the scope of this paper. No matter which approach is to be taken, however, we can predict for sure that the holder of the nonstandard right will always
prevail over the unsecured creditors of the grantor or violators of this right. In other words, for these creditors, these two approaches lead to the same end.

(2) Rights that need to be earmarked as property rights

The analysis in Part II indicates that the priority of property rights cannot be easily established by contractual arrangements, and the policing and enforcement costs are especially high when the grantor or violator of the novel right is in bankruptcy. Therefore, among the rights in property, those particularly sensitive to bankruptcy are most in need of being earmarked as property rights to ensure their priority. A typical example is the security interest, the essential function of which is to create priority over other creditors in a bankruptcy proceeding. There has been a fair amount of literature advocating more freedom to customize security interests. The enormous transaction costs involved in imitating the priority effect of security interests through contracts is the key rationale behind our support of these arguments.

Whether to earmark a right as property right is one thing; whether to disclose the information of such a right through a centralized system is quite another. When making decision on the second issue, we need to compare the “users’ savings” from disclosing through a centralized system with the sum of the “system costs” and the “nonuser costs.” Only if the former outweighs the latter should a centralized disclosure system be applied.35

In terms of the assets that already have a centralized system for disclosure, such as real estates, the information cost externality will not be aggravated significantly even if new items are added to the list of property rights. Hence, if a centralized system helps reduce the costs for disclosing the individually tailored rights in these assets, such rights may as well be designated as property rights, though they are probably not so sensitive to bankruptcy as is the security interest.

(3) Why strictly restrict property rights in real estate

If a centralized disclosure system already exists for a certain type of assets, no further information cost externality will accrue by adding new forms of property rights. This lends support to free customization of property rights in that type of assets. Yet the property rights in real estates are strictly restricted in both Common Law and Civil Law countries, although the registration systems for real properties have been functioning, at least in some of these countries, for centuries. Certain historical backgrounds may account for this conservatism,36 but do these restrictions still serve the needs of modern society? They are at least unwarranted under our analytical framework. It is worth mentioning, however, that the development of equitable servitude in the Anglo-American legal system does signal some compromise of *numerus clausus* with respect to real property.37 This being said, it might still be too early to decide whether such compromise is but an isolated coincidence or represents an ongoing retreat of the *numerus clausus* principle.

2. *N*umerus clausus and the current Civil Law property right system

(1) Ownership

The concept of ownership refers to the most complete property right in an asset that can be enjoyed by a private person in a Civil Law property system. It also serves as the
basis for creation of the other two categories of property rights—the usufruct rights and the security interests. We have assumed so far that the substance of the ownership is not subject to personalized designs. Now let us explore the reasons for prohibiting such designs. To customize an ownership is, in essence, to either narrow or expand the legally prescribed scope of the power of the owner. On one hand, to narrow the scope is effectively equivalent to giving up certain legal entitlements, which is usually no big issue insofar as the abandonment is made at the owner’s free will. On the other hand, however, the expansion of powers deserves close observation.

First, we shall explore the problem of efficiency. If the legally defined scope of private ownership can be altered unilaterally, then owners will have the potential power to encroach upon each other’s domain of ownership. To illustrate, suppose A declares that the ownership of his land embodies a right of overlooking within 3 miles. Similarly, B, the owner of the adjacent land, announces that his ownership includes a right of dropping farm chemicals from airplanes over his land. The law must then decide which of these two individualized ownerships should prevail when B’s airplane interrupts A’s view. “First in time, first in right” might be a clear-cut criterion for solving such a conflict. In other words, whoever declares and discloses his right first will win the game. However, this solution is by nature a variation of the first possession rule which is believed to be inefficient as it inspires uneconomic investments. In addition, as suggested by Merrill and Smith, the second level information cost externality will occur as a byproduct of such free customization of ownership. Now that A is allowed to declare a 3-mile overlooking right, who knows that he has not declared a 30-mile or even 300-mile right? Consequently, any party planning to build up a mansion or fly an aircraft within a reasonable radius from A’s s land will have to make out the exact merits of A’s right to avoid violation.

Secondly, allowing the free customization of ownership will directly compromise the distribution standard set by law. For example, the current rules governing the adjacency relation require the landowner, A, not to block the natural flow of ground water coming from a neighboring piece of land, which means that the law allocates the right of passage of water to the neighboring landowner, B. If A is free to change this allocation of rights and forbid the water flow from B’s land, B will have to either refrain from draining water through A’s land or pay A for removal of such prohibition. This way, the distributional standard established by the law will be overthrown. In short, if we believe that the legal rules prescribing the scope of ownership represent the legislature’s sense of equality, any alteration of this scope at odds with such a sense should be disallowed.

(2) Usufruct rights

If we allow free customization of usufruct rights but do not establish a centralized disclosure system for these rights, we will be able to eliminate the frustration costs while getting around the information cost externality problem. Conversely, if we strictly implement the *numerus clausus* principle, for those usufruct rights that are not expensive to enforce or sensitive to bankruptcy, there
will not be enormous frustration costs either. If we choose to abolish the *numerus clausus* principle with respect to the usufruct rights, however, we need to strike a balance among the “user benefits,” the “nonuser costs” and the “system costs,” when further deciding whether to set up centralized systems for disclosure of individually tailored rights.

Let’s take the heavily discussed “right of occupancy” as an example. The functions of the “right of occupancy” are achievable through many other legal mechanisms such as trusts or third party beneficiary contracts. So our goal is to identify the most cost-effective one among them. The cost of enforcing the “right of occupancy” does not change whether it is characterized as a property right or not, because it is a possessory right in real property and the right-holder is always able to assert the claims out of possession for legal remedies. Thus, judging from the police and enforcement costs, it is unnecessary to label the “right of occupancy” as a property right. With this being said, it nevertheless deserves a spot in the list of property rights, if we wish to strengthen protection to the occupant when the homeowner is bankrupt. Furthermore, since the registration system already exists for disclosing property rights in real estates, not only will no information cost externality arise with the introduction of this new property right, but the right-holder will save disclosure costs by registering his right as well. Therefore, it is desirable to recognize the “right of occupancy” as a new property right as far as efficiency is concerned.

(3) Security interests

As mentioned above, security interests in particular need to be established as property rights because of their dependency on priority in bankruptcy proceedings. But this by no means requires abolishing the *numerus clausus* principle for security interests. The gist lies in diversity of collaterals rather than free customization of the substance of security interests. This task can be well accomplished even under a *numerus clausus* regime by gradually lengthening the list of statutory security interests. Among those who argue for freedom of property rights or security interests, very few, if any, have clarified the essence of the “freedom” they are advocating.

Notwithstanding our vote for diversifying collaterals, we also believe that the substances and effects of security interest ought to be strictly regulated by law. The fact that the priority status of security interests greatly influences the interests of third parties warrants the adoption of mandatory legal provisions to control the externalities this is likely to cause. There are other open questions not covered by this paper, including whether to allow the parties to choose the method of foreclosure — judicial sale, gaining title or appointment of receiver — when the debtor is in default, and whether to allow the parties to tailor the status of junior creditors when the collateral is auctioned off. These questions must be revisited if one wishes to argue for a non-*numerus clausus* regime for security interests.

**IV. Conclusion**

Merrill and Smith suggest that the function of the *numerus clausus* principle is to lower the externalized information costs resulting from free customization of new
forms of property rights. These costs are thought to be imposed basically on two categories of nonusers of the idiosyncratic property rights: those who intend to acquire the same type of asset as the one in which new forms of property rights are created, and those who have no intention of dealing with this type of asset yet have to refrain from violating such fancies. Such a theory does not seem to have taken into account protections the law would afford to bona fide purchasers. In this paper, we argue instead that the issue of information cost externality regarding the first type of nonusers turns on whether the disclosure system for property rights is centralized or decentralized. In a decentralized disclosure system, information costs associated with idiosyncratic property rights are essentially internalized by their users. By contrast, information cost externality does occur in a centralized disclosure system. In addition, such costs as are involved in managing a centralized disclosure system are yet another component of externality attributable to customization of property rights. As for the second category of nonusers, we concur with Hansmann and Kraakman that it is unnecessary to incur any cost to investigate the merits of idiosyncratic property rights.

On the frustration cost side, Merrill and Smith stopped with the compromise that it was a negative effect of *numerus clausus* that might be reduced by a so-called “generative” approach. We reasoned, however, that when forms of property rights are strictly defined by the law, parties desiring new rights will be forced to achieve the same through contractual arrangements, in which case the police and enforcement costs will significantly increase should there be a breach or other violation of such rights by third parties. It is this increased cost that frustrates the parties’ intention to transact and the problem is especially severe if the breaching or violating party is in bankruptcy.

Our study on information cost externality leads to a puzzle: why are property rights in real estate strictly restricted even when the registration system is fully established in both Civil and Common Law countries. As for frustration costs, we come up with two normative implications. The first is that there are at least two ways to overcome frustration costs, either by abolishing the *numerus clausus* principle or by unifying enforcement rules for contractual and property rights. The second is that among the rights in property, those particularly expected to enjoy a preferred status in enforcement, with security interests as a typical example, are most in need of being earmarked as property rights to ensure their priority.

* Zhang wei, LL.D. Student, Graduate School of Law, Waseda University.

---

**Notes**

1. The author would like to thank Prof. Su Yongqin, Prof. Duan Kuang and Dr. Cai Xiang for their help with the authoring of this paper. All errors are the author’s.


4. My study is vastly influenced by the pioneering works of Merrill & Smith (see note 3) and Hansmann & Kraakman (Henry Hansmann & Reinier Kraakman, “Property, Contract, and Verification: The Numerus Clausus Problem and the Divisibility of Rights,” Journal of Legal Studies, 2002, vol. 31, p. 373). Based on this path-breaking literature, this paper proposes to shed new light on the numeros clausus problem mainly by analyzing the information cost externality when legal protections to bona fide purchasers are taken into account, and by ascertaining the origins of frustration costs under a numeros clausus regime.

5. Merrill & Smith, supra note 3, pp. 26-27. Merrill and Smith admit that for the purposes of their article, the term “measurement costs” can be used interchangeably with “information costs” (Merrill & Smith, supra note 3, p. 26, footnote 107). Therefore, we use “information costs” instead in this paper.


7. Ibid., pp. 29-32.


10. Dr. Zhang Peng has mentioned notation as a mechanism to overcome the information cost externality. See Peng Zhang, “The Numerus Clausus Principle in American Law,” Faxue, 2003, no. 10, pp. 108 and 111-112. This is supposed to be an approach similar to bona fide purchaser protection in its second meaning.

11. Hansmann & Kraakman, supra note 4, p. 396.


13. This does not mean, however, that there will be no increase in these costs at all with the appearance of more novel property rights, but merely suggests that the increase is insignificant marginally. See Hansmann & Kraakman, supra note 4, p. 401.

14. Ibid., pp. 399-400 (expressed in a different way to this paper, yet conveying substantially the same meaning).

15. Prof. Su states that the costs for investigating filings can be internalized by charging fees, see Su Yongqin, “Social Costs of the Statutory Property Rights: A Comparison Between and Some Suggestions on the Legislative Policies of the Two Sides across the Taiwan Strait,” Zhongguo Shehui kexue, 2006, no. 6, pp. 79 and 90.

16. Merrill & Smith, supra note 3, p. 35.

17. Ibid., pp. 35-36.

18. Ibid., p. 37.

19. See Hansmann & Kraakman, supra note 4, p. 382, footnote 23.

20. Merrill & Smith, supra note 3, p. 35.

21. This is distinguished from the standard executory interest in that the ownership does not shift automatically on the occurrence of contingencies.

22. Merrill & Smith, supra note 3, pp. 16-17.

23. We slightly change Merrill & Smith’s example to make the new right more fancy even in Civil Law countries.

24. Contract is by no means the only legal mechanism available to the parties. They can turn to, among others, the trust as well. In this paper, we discuss the contractual mechanism alone simply because it is universally available in almost every modern legal system.


26. Here, 1) is aimed at imitating the exclusive effect of a property right, 2) and 3) imitate the *in-rem* effect, and 4) is the remedial mechanism safeguarding these effects. The priority effect of a property right is hardly imitable through contractual arrangements. See the analysis below about the police and enforcement costs.

27. Contractual rights imitating the property effects are *in personam* by nature, which means third parties should not be required to obtain information from a centralized source even if there is such a disclosure system. In essence, no constructive notice can be expected on the part of assignees and delegates.

28. A similar conclusion is reached in Hansmann & Kraakman's study with respect to rights in intangibles. See Hansmann & Kraakman, supra note 4, p. 391.

29. These conclusions are drawn on the disclosure side. How about the costs on the searching side? Some scholars argue that a centralized system can immensely lower the searching costs (Su Yongqin, “The Property Right System Under a Mitigated Numerus Clausus Regime: Re-probing the Feasibility of the Civil Code in Mainland China,” Cross Straits Law Review, 2005, no. 8, pp. 110-142). However, we do not think this is always true. Regarding the processing of information, costs will not change insofar as the information to be processed is substantially the same, regardless of the place of disclosure. Regarding the discovery of information, costs may vary with the different ways of disclosure. Information about a right can be disclosed in either of the two methods: disclosing the particular terms of the right (direct method), or disclosing the mere presence of the right and leaving the details with the holder (index method). The index method incurs two costs—for discovering the presence of the right and the terms of the right—and therefore is more expensive than the direct method. Both the centralized and the decentralized systems can use either of these methods. See Hansmann & Kraakman, supra note 4, pp. 394-395.

30. But if B’s right is possessory and A physically intrudes on his possession, B can assert the claims out of possession, which is essentially the same as the claims out of property right.

31. Indeed, B will become an unsecured creditor once A falls in bankruptcy, even if B’s right is not actually violated by A. This also gives rise to an increase in B’s enforcement costs. For convenience, we do not discuss this situation separately.

32. Similarly, if B’s right is possessory and the third party physically intrudes on his possession physically, B can assert the claims out of possession, which is essentially the same as the claims out of property right.

33. These four situations are based on the dichotomy of enforcement rules for rights *in rem* and *in personam* in the German Civil Law system. With the fluctuation of the extent of disparities between property and contractual remedies, the magnitude of frustration costs arising under a *numerus clausus* regime will vary accordingly.

34. Hansmann & Kraakman showed us the difficulties in establishing by contract the priority of business creditors over shareholders’ personal creditors, which is largely applicable to our situation. In short, there exist two major obstacles: the enormous transaction costs entailed in reaching subordination agreements with all other creditors, past or future, of the creator of nonstandard property rights; and the problem of moral hazard facing the grantee of such nonstandard rights in that the creator has strong incentive not to obtain the necessary subordination agreements. See Hansmann & Kraakman, “The Essential Role of Organizational Law,” Yale Law Journal, 2000, vol. 110, pp. 407-409 and 410-411.

35. Hansmann & Kraakman, supra note 4, p. 397.

36. For some of this historical background, see Duan, supra note 2, p. 266.


40. e.g., Statute 214 of Japanese Civil Code.


42. e.g., Liang Shangshang, “Numerus Clausus: Between Freedom and Compulsion,” in *Faxue yanjiu*, 2003, no. 3, pp. 43 and 54.


—Translated by the author from *Zhongguo shehui kexue*, 2006, no. 4

Revised by Sally Borthwick