KENNEDY NOTE ON CRISCI, 1978

1. Insurance contracts: Insurance is a well known "exceptional" area within contract law, since there has been a great deal of overt and covert judicial and legislative intervention in this field since the beginning of the 19th century. It is therefore very dangerous to generalize from what judges will do to protect an insured against an insurer to what they will do for other weak parties against strong ones. But it is equally dangerous to disregard insurance cases altogether, since they have often been harbingers of what was to come in other fields. The materials that follow will permit the student to judge for himself just how important the insurance cases are.

a. The Tort of Refusal to Settle: We will use this tort to develop a general model of the consequences of the judicial creation of tort duties in contractual situations. We will then repeat the same analysis in a series of different factual contexts, elaborating the model as we go along. It is therefore vital to get the model straight from the beginning. It is based on the analogy between the imposition of a tort duty, going beyond the duties the parties have created by express contractual language, and the imposition of a tax on the commodity or service involved in the contract. There are three steps to understanding the model: understanding the analysis of the "incidence" of a tax, understanding the analogy between a tax and a tort duty, and understanding the limits of the analogy. We will then be in a position to give some definite meaning to the vague terms "unequal bargaining power" and "paternalism" that are commonly used by those who support or oppose judicial interventions in this area. As a preliminary matter, we must be clear on just what the court in Crisci did.

i. Fitting Crisci into our classificatory scheme:

x. Is this a case of adding a new tort remedy where there is already a contract remedy? Of creating a new obligation where the parties have not specified to the contrary? Or of creating a non-disclaimable duty?

xx. Has the court imposed strict liability? Liability for negligence? Liability for intentional injury?

xxx. How could the court have achieved the same result within the contract cause of action?

ii. The incidence of a tax: The 15 pages of material assigned on this subject are nonmathematical and designed to be comprehensible to college freshmen in the first week of an elementary economics course. Nonetheless, you may be confused. If so, don't panic. Come and talk to me.

x. The basic message is that, if both buyers and sellers of a commodity, are so numerous that none can affect its price, and the supply curve for the industry is upward sloping, a tax on the commodity will

-- increase the price of the commodity

-- reduce the amount sold

<u>but that</u>

-- the increase in price will be less than the amount of the tax, and

-- the burden will be borne:

-- partly by the producers through the reduction in their return for each item sold and the shrinkage of sales, and

-- partly by consumers, either forced out of the market or compelled to pay more for what they buy.

xx. If we relax the assumptions that there are many buyers and sellers and/or that the supply and demand curves are sloped, the outcome of the imposition of the tax becomes highly indeterminate. For example:

--If the demand curve is vertical (buyers buy the same quantity no matter what the price), then the whole tax will be added to the price, sellers will be unaffected, and buyers will have less money to spend on other goods.

-- A seller who is a monopolist will maximize his profits after the imposition of the tax by absorbing some of the increased cost himself, thereby keeping customers--to whom he still charges a somewhat inflated price--and losing <u>less</u> monopoly profit than he would if he tried to pass on the whole tax. In this case, some consumers bear some of the cost of the tax by being priced out of the market. Others bear that part which is passed along in price. And the monopolist bears the rest through a reduction of his profit.

-- If there is one buyer and many sellers, the above analysis applies in reverse.

-- If there are many buyers and sellers and the supply curve is horizontal, the full amount of the tax will be added to the price of the commodity; less will be sold and if there are marginal sellers they will go out of business.

-- If there is a single buyer and a single seller, the outcome will depend on their respective abilities to influence the negotiations about who will have to sacrifice how much. The result can lie anywhere between the buyer forcing the seller to provide the same quantity at the old price (seller "eats the tax") and the seller forcing the buyer to buy the same number of items at a price increased by the amount of the tax (buyer "eats the tax").

xxx. Economists tend to argue that a typical industry supply curves will be sharply upward sloping in the short run, but, close to horizontal in the long run. But this analysis applies only if we keep the output of all other industries constant. If we allow all industries to vary simultaneously, the shape of supply curves becomes indeterminate except on the basis of empirical investigation.

iii. <u>The analogy between a tax and a tort liability</u>:

x. The first problem with the analogy is that a tax collected by the government is of no (immediate) value either to buyers or sellers, whereas the whole purpose of imposing a tort liability is to aid one of the parties, generally the buyer. The analogy holds nonetheless: the buyers could have, but did not choose to pay the sellers enough of a permium on the price to induce them to assume the obligation the courts have decided to impose through tort law. It follows that the obligation in question is worth less to the buyers than it costs the sellers. In the <u>Crisci</u> case, the good faith obligation to settle is worth less to buyers, at the time they take out their policies, than it would cost the companies to provide it. It follows further that the courts are forcing the sellers to include in their product something buyers don't want. From the point of view of supply and demand, this is no different from increasing the sellers' costs by requiring them to pay a tax on each item sold.

xx. The analogy to a tax is not perfect, however, since the tort liability imposed on sellers is of some present value to buyers. Though they wouldn't voluntarily pay what it costs for it, they would pay something. It follows that the court-ordered addition of this obligation will shift the demand curve for the product to the right, as well as shifting the supply curve to the left. Both sellers and buyers lose less than they do in the case of a tax. Nonetheless, in analyzing the impact on the parties, we can disregard this aspect of the situation. We are concerned only with a general statement of possible impacts, and the range of possibilities is unchanged by the shift in demand.

xxx. Pursuing the analogy to a tax, the impact of the imposition of liability should be as follows:

-- Where there is a rising supply curve and many buyers and sellers, prices will rise, but not by as much as the new obligation costs the seller. Those buyers who remain in the market will receive the benefits of the imposition of liability while paying less than it costs; other buyers will be forced out of the market; sellers will lose sales; what they do sell will cost them less, but that reduction in product cost will be more than made up again by the cost of meeting the new obligation; they lose all their profits on the quantity they can no longer sell and some of their profit on what they can still market.

-- In the case of monopoly, the results will be just as varied as in the tax situation, according to whether there is a single monopolist or two, and according to the shapes of the demand and marginal cost curves. At one extreme, the buyers manage to make the sellers supply the old quantity plus the new obligation at the old price. At the other extreme, it is the buyers who have to "eat the cost."

-- In most cases, there will be a reduction in sales following the price rise, and this will mean less employment in the product industry, but there is no reason to believe that overall employment will change. In the case of a tax, government spending compensates for the reduction in consumer demand. In the case of a tort liability, spending by those injured and then compensated by the sellers should have the same general effect.

-- We have been talking thus far in terms of general tendencies. It is well to keep in mind the extreme case in which there is not just a reduction in demand at the new higher price, but a total extermination of demand. There may be no consumers who will buy any of the commodity at the lowest price at which it can be offered with the new seller's obligation attached. In this case, the industry goes out of business and consumers spend their money on other things.

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iv. A Major Flaw in the Analogy as Drawn:

A crucial step in the above analysis was the assertion that, because "the buyers could have but did not choose to pay the sellers enough of a premium on the price to induce them to assume the obligation," it follows that the obligation was worth less to the buyers than it would cost the sellers. This inference is incorrect because it disregards the impact of transaction costs. Given transaction costs, it is quite conceivable that buyers would gladly pay a price for the sellers' assumption of the obligation that would make it profitable for the seller to provide it, yet the transaction will not take place. If this is the case, the judicial imposition of the obligation should make both buyers and sellers better off (with the distribution of the benefits dependent on the same factors that determined the distribution of the burden of a tax).

x. In Section II of the course, we were generally concerned with transaction costs in the polluter-pollutee type of situation, where the main obstacles to a large group of victims bribing a victimizer to desist are the costs of organization and overcoming the freeloader problem.

In a case like Crisci, however, there are a small number of sellers who can modify contractual terms and price at very little cost. If by doing so they can make a profit, they have a strong incentive. It might therefore appear that there are no transaction costs involved in the contractual situation, so that the conclusion--that terms not provided are not worth their cost--is valid. This is incorrect. There are at least three situations in which there may nonetheless be terms the parties desire that are not provided.

xx. In each situation, assume that a few sellers face a large number of middle class, well educated consumers. Sellers are specialists in providing this commodity and engage in many many transactions. Consumers engage in very few transactions of this kind. The transaction is enormously complicated; it pays sellers handsomely to invest a little to master the complexity, but a rational consumer might conclude that it is just not worth the effort. The obligations we are concerned with annexing to the transaction refer to sellers' liability to consumers if a particular event happens. It will not happen to all consumers; consumers have a limited amount of knowledge of the probabilities that apply to them at the time of making the contract. There are a very large number of other unexpected disasters that might also afflict them, and they may rationally decide that spending even a little time on legal protection from each would be a waste of effort. Assume that buyers also suspect that sellers in general tend to lie about the contract terms they offer, and that even when they have legally assumed an obligation they tend to resist honoring it when it falls due, so that the consumer will probably have to pay more in legal fees than the value of the injury, if he wants to enforce his contract. Given all of this,

<u>well-educated</u>, <u>middle class</u> buyers <u>behaving perfectly rationally</u> have decided that the risk of being cheated, injured or abused by sellers is one of the inevitable risks of life in our economy, and that it is not worth it to invest time and energy in the obviously futile enterprise of trying to stop it by fighting over contract language. It is more rational to simply ignore the terms and hope that you have happened on an honest seller.

xxx. The three scenarios are as follows:

-- <u>Simple information cost case</u>: All sellers are honest; they know that, if buyers fully understood the cost to them of a refusal to settle like that in <u>Crisci</u>, they would willingly pay a price premium that would make it worth while for sellers to assume a good faith obligation. It is also clear that if all sellers band together to carry on an educational drive, they can convince buyers to pay the premiums. But it is also clear that this campaign will be very expensive, given the consumer attitudes just described, with consumer distrust likely to be intensified by outrage that the sellers have all along been engaging in bad faith refusals to settle. The payoff in terms of profits on the assumption of the new obligation would be more than its cost, but not nearly great enough to give a reasonable return on the capital outlay involved in the initial creation of buyer receptivity.

-- <u>Simple freeloader case</u>: The situation is as in the information cost case, except that the cost of the educational campaign is small enough so that it would be well worth undertaking, <u>if</u> the firm that did it could get all the new business it would generate. But the seller who does the educating finds that other sellers, who have invested nothing, are able to jump on the bandwagon, offer the new contract term, and retain their old customers. Although undertaking the campaign makes sense from the point of view of the industry, it makes sense from the point of of each seller to sit tight and let someone else do it, and then move in to reap unearned benefits. As a result, no one undertakes the campaign.

-- <u>Case of competitive pathology</u>. Thus far we have looked at situations in which sellers do not assume added obligations in spite of the fact that consumers would buy them if they understood them and believed they were for real. Now suppose that all sellers are offering an insurance contract that includes a particular liability.

Buyers are paying for it, but as described above, they make no attempt to understand it. One seller discovers that he can disclaim this liability or simply stop assuming it, without losing any customers. This seller begins to refuse to settle in cases like <u>Crisci</u>, thereby increasing his revenues. He can then choose some mix of reduced prices, higher salaries, or larger dividends (with concommitant higher prices for the company's stock). Whichever he chooses, he will put pressure on competitors: they have market shares, employees and stockholders to protect, and he is threatening all three. These competitors may believe that the disclaimer policy is utterly immoral, but, as we have seen already, they may be unable to persuade their customers that there is any difference, between their "good faith obligation to settle" policy and that of their rival, that justified their higher prices. To preserve their market shares, personnel and stock prices, they are forced to disclaim as well. There is a competitive flurry of price cutting until all the gains from disclaimer have been passed on to consumers. The seller who began the cycle tries to preserve his ill-gotten gains by further devaluing of the insurance contract; the competitors try briefly to expose him through an advertising campaign; but no one believes them; and soon all sellers are forced to offer the worst contract permissible under the law. Consumers congratulate themselves on across the board cuts in the price of insurance; the insurance companies as a group are slightly worse off than before, since they are selling less product; the seller who began the devaluation process may be considerably better off, if he has managed to hold onto his initial gains; his success is a lesson to knowing businessmen in other industries. <u>Note</u>: For the last 100 years, American businessmen have used the argument just summarized to justify government regulations (especially licensing statutes for everything from lawyers to undertakers to electricians to garage mechanics) that restrict "unfair," unethical" or "cutthroat" competition, and thereby keep out new talent and new ideas, and drive up prices. The argument is neither left nor right, and it is very easy to abuse.

KENNEDY NOTE ON EMPLOYMENT CONTRACTS
1978

:. Employment Contracts: In this section we will be concerned with the tort of bad faith dismissal of an employee on an at will contract. This is a new tort (like the insurance torts) but there have always been torts peculiar to the employment situation. For many years the most common of these were industrial accidents, and in this area the courts made the character of the contractual relationship the key to the law, through the doctrine of assumption of risk and the fellow servant rule. These have been abolished by statute, so far as they relate to employment, and workmens compensation is now the body of law governing industrial accidents. We will take it up in Section IV, in our discussion of the socialization of risk. Here we will use employer torts to elaborate our model of the imposition of tort duties by opening up the issues of bargaining power that were implicit in the discussion of insurance torts.

a. Fitting bad faith discharge into our classificatory scheme:

i. Does the tort action supplement already existing contract remedies for the injury in question, or create a new obligation wherever the parties have not specified to the contrary, or does it create a non-disclaimable duty?

ii. Are we dealing with an intentional tort, negligence or strict liability?

iii. How could the courts have achieved the same result within the contract cause of action?

b. Effect of imposition of the obligation on wages and employment: In the case of imposed terms in sales of goods, the effects of intervention were assessed by looking at the shift in the supply curve, which produced a price rise (generally less than the cost of the obligation) and a reduction in volume of sales. In the employer-employee case, there are two added complexities.

i. The demand for labor is a "derived" demand, i.e. it is a function of demand for the end product into which the employer incorporates the labor. This means that the impact of the new cost of employing labor will depend on the interaction of three aspects of the situation: the ease with which the employer can replace labor with other factors which are now relatively cheaper; the loss in the volume of final sales he will suffer if he attempts to pass along the costs to his customers; and the amount of the reduction in the supply of labor that will occur if he tries to force his employees to pay for the benefit through lower wages. The end result is as variable as in the simple sales cases, but here there are three rather than two groups who have to distribute the burden: workers, employers and consumers. In the most likely case, there will be (a) an increase in the price of the finished product; (b) a reduction in sales; (c) a reduction in the employer's profit; (d) a fall in the wage rate; and (e) a reduction in employment. The workers who are still employed when it is all over will receive the benefit for less than it costs, because some of the cost will be paid by consumers, employers, and other workers who lose their jobs.

ii. The second complexity arises from the difficulty of understanding a "good faith discharge" obligation in at-will contracts. In the case of the good faith obligation to settle an insurance claim, it is not altogether implausible to imagine the company going through a dollars and cents calculation of how much the new liability will cost them through the foregoing of litigation in cases where they have some chance of winning and nothing to lose. In the case of refusal to settle a valid claim, the making of the calculation is less plausible but not absurd--the company may figure that "so many times a year we will have to pay damages for emotional injury and pain and suffering, given the inevitable lapses in any bureaucratic procedure." But what is the calculation in Monge or Agis? Will the employer really try to deduct from wages a sum meant to cover liability for foreman who try to extort sexual favors from workers, or for managers who invent sadistic methods for finding out petty thieves? It seems more likely that they will make it clear to supervisors that it is a very serious breach of their employment contracts to behave in such a fashion, and that they will be fired if they are caught. Perhaps there will then be a general fall in labor productivity when workers realize that the employer can no longer effectively keep them in line through tactics of this kind? If this is implausible, then it may be that the main cost of the added liability is that of having to settle "strike suits" or "nuisance suits" brought by disgruntled former employees who know that it is cheaper for the employer to pay a little than to go to trial. Are there other costs to the employer from the imposition of the liability? If not, it may be that the claim that there will be significant "burdens" to distribute is basically false, or at least greatly exaggerated, especially given the availability of liability insurance.

b. Bargaining Power: The first thing most people say when asked for a justification of decisions like Crisci, Eckenrode, Monge or Agis is that there is a great disparity of bargaining power between the parties, and that the judges are quite right to intervene to "right the balance."

i. The Problems

x. Does the judicial imposition of an obligation really benefit one party at the expense of the other?

xx. In what sense is there an inequality between the consumer or employer and the business he or she is dealing with? It makes obvious sense to speak of inequality if we are dealing with a situation in which many unorganized buyers face a monopolist, or in which the commodity is a "necessity" which consumers simply cannot do without, or if the consumers in question are a special, disadvantaged class because of race, language, income or education. But in most of these cases, none of these conditions obtains. Are you willing to accept the consequence that there are few if any baragains that will be exempt from judicial intervention of the kind we are discussing?

xxx. If you are not willing to accept this consequence, are you willing to eliminate all the existing compulsory or semi-compulsory terms judges interpolate into bargains as a matter of course?

ii. In trying to assess the extent to which judicial intervention does shift the balance of power, we have to distinguish among the various situations we have already analyzed. For purposes of illustration, I will stick with the buyer-seller case. The employer-employee situation is more complicated, but the conclusions are the same.

x. Where sellers are numerous and the supply curve is horizontal, the full cost of the imposed obligation will fall on the consumer. In this case, in which sellers are making only the minimal profit necessary to keep them in business, it is hard to see the intervention as having anything at all to do with rectifying an inequality of bargaining power. This does not mean that the intervention cannot be justified, as we will see in the discussion of paternalism.

xx. Where there is an upward sloping supply curve, the cost of the new obligation will be borne in part by the sellers in the form of lower profits and lost volume, and through the bankruptcy of marginal sellers. Thus judicial intervention has caused buyers (employees) to receive a benefit for less than it costs. Of course, not all consumers enjoy the benefit, because some of them refuse to buy at the higher price. Their welfare is reduced, if we accept their own valuation, because they use their income to enter a transaction that is less desirable than the one they could have entered if the courts hadn't driven the price up.

xxx. Where there are only a few sellers, (or a monopoly), they will again be forced to bear some of the cost of the new obligation. They will pass on some of the cost, but this will reduce sales, and lost sales mean lost monopoly profits. In all cases, the best solution for them will be to stop short of passing the full cost along, because they would lose more profit than they would be eating some of the cost and keeping volume up. As in xx above, some consumers will be priced out of the market and will lose the difference in benefit between the old transaction and the next best one they can find.

xxxx. Where the obligation was not available because transaction costs rather than consumer preferences rendered it unprofitable, the effect of judicial imposition will vary according to how consumers value the new term after it has been imposed. They may come to see it as worth paying for, in which case it will generate profits like any other commodity, with benefits distributed between buyers and sellers according to the shape of demand and supply curves and the competitive structure of the industry. Or they may continue to refuse to pay the price of the benefit, in which case the analysis of effects is as in cases xx and xxx above.

xxxxx. Given this array of effects, the argument that imposed terms are good because they redress an inequality of bargaining power must be taken with a grain of salt. There are <u>some</u> cases where imposition has no effect <u>at all</u> on the division of benefits between the parties, and it is only in a few highly exceptional situations that one can imagine the seller being forced to eat the whole cost of the obligation. In almost all cases, the consumer has to bear a part of the cost, and in almost all cases there will be some consumers who are priced out of the market as a result. The cases suggest neither that the issue is "necessities" rather than "luxuries", nor that lack of education or poverty is a necessary qualification for the beneficiaries of intervention. It is just as wrong, however, to claim that "the increased cost is inevitably passed along in higher prices, so that there is no benefit at all to the consumer." Such a statement, if not backed up by evidence of a horizontal supply curve, is simply right-wing propaganda. It is possible to soak sellers for the benefit of buyers to some extent in many or most situations, if one is willing to accept that consumers pay something too.

iii. If one grants that a measure of redistribution is possible through judicial action of this kind, it remains to justify it. There are a number of people who seem entitled to object. The problem is to weigh those objections in some moral calculus.

x. There are the consumers who don't want the commodity at the higher price made necessary by the assumption of the new obligation, and who have to move to the next best transaction. (Also, employees who won't take the job at the low wages required by assumption of the good faith discharge obligation.)

xx. There are consumers who are being required to buy an obligation they don't want as a condition of buying a commodity they do want.

xxx. There are, in the case of many sellers, the marginal sellers forced out of business by higher costs not all of which could be passed on to consumers. (In the Monge/Agis situation, there are employees who can't get work because employers won't hire them if they have to give them a right to good faith discharge.)

xxxx. In the case of the rising supply curve, there are the sellers who stay in business but lose profits and/or volume, in spite of the fact that they have no monopoly power at all and are selling their last unit for no more than it costs them, making profits only on the earlier units that cost less than the equilibrium price.

xxxxx. There are the monopolists or oligopolists who have accepted a loss in total profits because to pass along the whole cost of the obligation would have led to even more serious loss of profits by loss of volume.

iv. The most common arguments against the imposition of liabilities (aside from the mistaken one that the full cost will inevitably be passed on to the consumer) are that it is stupid and/or immoral to make people buy things they don't want, and that it is stupid and/or immoral to "confiscate the sellers' property." We will consider the first argument in some detail under the next two headings (Landlord's Duty to Repair and Products Liability). The second argument is either:

x. A version of the reliance/surprise argument, entitled to some weight in the short run--sellers may have invested capital or entered contracts with a legitimate expectation that the law stood one way, and be mad when it is changed after they have committed themselves--supposing that sellers' lawyers are too dumb to see the trend; or it may be:

xx. The circular argument that the seller has a legal right to sell without assuming the obligation because he has no legal duty to provide the obligation. The issue here is *whether* the seller has that legal right. Or it may be:

xxx. The argument that one has a "natural right" to enter into any contract one wants to, and to have the state enforce it as is, without modification. This argument has been formally rejected by the U.S. Supreme Court in the case of *West Coast Hotel v. Parrish*, 300 U.S._____(1937), and it is not valid constitutional law as against legislative regulation in any state in the Union. Or it may be:

xxxx. The argument that while the *legislature* can validly interfere with freedom of contract, judges should not do so, either because to do so would be an unconstitutional usurpation of legislative power, or because courts are not "well equipped to make the factual and value judgments involved." The most obvious objection to this is that they make decisions of this kind every day in hundreds of different private law contexts, and have done so throughout the history of the common law. In fact, the fundamental legal institutions of property, tort and contract represent extreme judge-made limitations on the "natural" outcome of the interaction of economic forces. For a detailed discussion of the pros and cons, leading ineluctably to the conclusion that the "institutional" arguments against intervention just won't wash, read part VIII of my article in the Harvard Law Review.

v. A much more cogent argument against intervention is that it is neither practically nor politically feasible for one or even many judges to undertake the ad hoc regulation of all consumer and labor transactions. The "bargaining power" notion applies, as we have seen, even to situations in which there is competition (many sellers), so long as there is a rising supply curve and therefore profits that can be tapped (here they are technically called "producers' surplus" or "economic rent"). Many of the most appealing cases involve neither uneducated lower class buyers, nor "necessities," nor "emergency situations." "Won't chaos ensue if every judge sets himself up as a very small scale Federal Trade Commission and National Labor Relations Board rolled into one? Won't legislatures that are controlled by business interests intervene to put a stop to the slide toward socialism?" (Sample answer on an old exam.) But even if one accepts this argument as persuasive against the imposition of terms as a self-sufficient general program, it may still be appropriate for an individual judge who thinks he or she can figure out the likely consequences of intervention, including the practical and political consequences, to go ahead and act. Judicial intervention is itself a factor in the political process, and may influence the legislature in a desirable direction even when it is not practically successful. There is a good argument, for example, that judicial activism has been a major source of strength for consumerism, both by legitimizing consumerist demands and by creating practical difficulties that forced legislative responses. In this perspective, however, the main criterion is success, and as we will see in the case of malpractice, there is always a danger of intervention backfiring and provoking the opposite response from that desired.

E. Responses to Objections to Interference

[This could go on forever; it may seem that it already has. Rather than spinning out the next round of arguments, I'll just suggest that you refer to the version in Syllabus [redacted] p. 99-101.]

Torts IV-Kennedy
12/6/79

Two Outlines on Compulsory Terms

These are two outlines of issues, designed to help you to sort out, rapidly, the pros and cons of legal rules specifying compulsory or semi-compulsory terms in contractual relationships. The first outline deals with issues that arise for all compulsory terms. The second deals with the differences between negligence and strict liability as the duty of care for the performance of a compulsory term. Both outlines are rather summary and abbreviated. Much of the detail is filled out in the readings; I will deal with the rest in class, to the extent time permits. Please try to use the outlines as checklists to make sure you have fully considered the cases.

FIRST OUTLINE: COMPULSORY TERMS IN GENERAL

A. Analyzing the legal situation

1. What is the legal form of the compulsory term?

   a. a rule defining certain conduct within a relationship of a particular kind as tortious

      i. when engaged in intentionally
      ii. when engaged in negligently
      iii. whenever engaged in (strict liability)

   b. a rule defining some set of contractual expectations as a legally protected interest, whose invasion is a tort

   c. a general tort rule (applying both outside and inside contractual relations) particularized to govern a constellation of facts that only arises within a particular contractual relationship (intentional infliction of emotional harm; outrageous conduct; deceit)

   d. an implied contractual term treated as though it were an inference of the actual intent of the parties

2. Possible differences between a contract and a tort action

   a. disclaimability of the duty may be greater in contract action.

b. damages for mental suffering or outrage generally not available in contract

c. the rule in Hadley v. Baxendale vs. proximate cause

d. statute of limitations often runs longer in tort

e. willingness to create new duties may be greater in tort

f. standard of care in performance of duties is generally strict liability in contract, varies in tort.

g. other

3. Is the obligation created by the rule disclaimable?

a. are there legal obstacles to disclaimer

i. the term is illegal and will never be honored
ii. there is a rule of construction that makes it difficult to draft an effective disclaimer (contra proferentem)

b. are there practical obstacles to disclaimer

i. it would be more expensive than it would be worth to try to draft a way out, either because it would be technically difficult or because the obligation is so insignificant that it can be ignored.

ii. the disclaiming party would be embarrassed to disclaim

B. The Gains and Losses from Enforcement of Compulsory Terms

1. Who bears the cost?

a. buyers in general

i. higher price
ii. some forced out of the market and spend money on next most favored good

b. sellers in general

i. lower returns per unit
ii. fewer units sold

c. third parties

i. the industry factors of production
ii. dependents of buyers & sellers

2. Who gains?

a. injured buyers who would not have self-insured

b. buyers in general, who would have had to pay more to self-insure

c. the people who would have had to pay more social insurance if society (the state) had chosen to compensate the victims

d. other industries, which gain by the purchases of buyers forced out of the market by the compulsory term

C. Why Would Anyone Ever Favor Interference with Freedom of Contracts (Transaction Costs, Paternalism, Regulation)

1. In order to force the parties to the agreement that they would have reached if they hadn't been prevented by <u>transaction costs</u>, and thereby make everyone (almost) better off than they would have been under freedom of contract.

2. <u>Paternalism</u>: In order to force the beneficiaries of the duties imposed into the "correct" choice, rather than letting them make the "incorrect" choice.

a. the notion here is that one party does not know his "real best interests," and should not be allowed to injure himself by entering into the contractual relationship without the protection afforded by the compulsory term. If a person will not enter into the relationship if she has to pay the price of protection, then it is "better for her" not to enter it at all.

b. This argument is often supplemented by reference to the interests of third parties, for example family members who may be injured, or the people who will have to pay to compensate victims who do not insure themselves.

3. Bargaining Power, Regulation, Redistribution

(Note: compulsory terms designed to eliminate the effects of transaction costs--1 above--and those motivated by paternalism--2 above--have redistributive effects, making some people better off and others worse off. But those are "side effects" rather than motivating purposes for imposing the compulsory term. Here we are dealing with a positive argument that actually justifies the compulsory term by reference to redistribution)

a. "Unequal bargaining power"

i. The basic problem with the idea of inequality of bp is that it is meaningless unless you can point to a situation in which bp is not unequal. There are three ways in which people try to do this: (1) there is equality of bargaining power when the market is competitive because of the presence of many buyers and many sellers; (2) there is equality of bargaining power when the good being bargained over is not a necessity, but there is inequality where the good is a necessity; (3) there is equality of bp when the outcome of the bargaining process corresponds to a just (or natural) price and fair terms for the commodity--deviation from just price and/or fair terms is conclusive evidence of inequality. I want to argue here that the use of the concept of inequality of bargaining power is almost always confused or obfuscatory.

ii. If there is inequality of bargaining power in any market which is less than perfectly competitive, then there are precious few markets anywhere in the U.S. that ought not to undergo intensive judicial scrutiny to determine the substantive fairness of contract terms. I am no partisan of free market economics and I would be more than willing to contemplate a large increase in social control of prices and terms. But the people who propose this criterion for intervention never seem to be willing to take the idea to its logical conclusion. They don't want to propose a criterion of fairness that would put the whole economic system in jeopardy. Furthermore, if one is willing to contemplate a large scale attack on the exercise of monopoly or oligopoly power in the economy, it is not usually because one thinks that the prices and terms that result from perfect competition are somehow a priori the "right" ones. If the economic system is unjust (and I think it is), it is not because it operates through imperfect markets, but because the distribution of welfare, power and access to enlightenment is skewed by the class system, race and sex. If compulsory terms are desirable, it is because of their impact on these substantive inequalities, not because they "rectify unequal bp."

iii. The notion that a good is a "necessity" and that buyers of it therefore have less bargaining power than sellers has no more than a grain of truth to it, even assuming that we can come up with a meaningful definition of what goods are necessities. If the market for the necessity is competitive, then the price and terms are determined by the mutual pressure of supply and demand, on the basis of the preexisting distribution of income. If there are only a few sellers, then they may be able to charge higher prices than they could if there were many sellers. Food, shelter and clothing are no different in this respect than other commodities like yachts or ostrich feathers. When people say that bargaining power is unequal "because the commodity is a necessity," they usually mean something like "the poor should have more money so they could buy more of this kind of commodity, since they really need it badly." Or they might mean, "sellers ought to sell necessities to buyers at lower prices than prevail in the existing market, and on good terms, because sellers as a class are better off than buyers and should share some of their wealth with them." Once again, the real objection is to the underlying distribution of income, and the "necessities" rubric is just a way to make a fundamental attack into a limited and superficial one.

iv. The final notion is that of just price and fair terms. It is very hard to figure out what people mean by just or "natural" prices and terms. The notion is often invoked in response to a "shortage" producing an "artificially inflated" or "extortionary" price. In this context, it is sometimes meaningful to argue against a price on the ground that sellers have a moral obligation not to take advantage of "temporary" variations in supply and demand. Rather, according to this notion, they should devise some non-price method for rationing the short good, keeping prices steady until "normal" conditions return. I tend to favor this idea, but on income distribution grounds: the sellers have no particular claim to get rich when everyone else is getting poorer, and poor buyers should not suffer more than rich ones from market fluctuations. But this is an income distribution argument about equity between social classes during periods of retrenchment, and should be acknowledged as such. Another aspect of the just price notion is that certain groups have a claim to maintenance of their old welfare positions when changes in technology or tastes threaten to reduce their wealth permanently. They have a right to a particular level of income, and that demand gets put in terms of a "just price for farm products," or a "fair return for labor," or "shelter at prices all can afford," or "food prices are outrageous." It seems to me simply a mistake to think the real issue is the price or terms in question: the real issue is income distribution, and particularly the distribution of income losses between relatively richer and poorer groups in the population.

v. The concept of bargaining power is perfectly intelligible when it is used to make comparisons between buyers or between sellers. One can say that a starving person dealing with a monopolost has less bargaining power, if the issue is food, than a middle class buyer in a perfectly competitive grain market. Or that a non-English speaking immigrant who does not understand the market is more likely than the "average citizen" to be ripped off the first time they rent an apartment. Or that a motorist in a broken down car on a Sunday night on an interstate has less bargaining power vis-a-vis a towing service than the same motorist on a weekday in a built up suburb. But none of this has to do with equality between buyer and seller, which seems to me a meaningless notion.

vi. The argument from inequality of bargaining power is nonetheless enormously popular, since it makes it sound as though there is a "neutral" standard for deciding when we can intervene with compulsory terms to help one party at the expense of the other. Liberal judges want to be able to impose compulsory terms in favor of some buyers at the expense of some sellers without having to attack the whole economic system, and without being accused of being radicals. The inequality formula sounds as though it will apply in some cases and not in others, and it sounds as though it identifies cases where any right-thinking person would want to help out the weaker party. But, in fact, if you take it seriously, it just means that the judge is free to try to redistribute income from some people to other people, on the ground that the existing distribution is unfair.

b. <u>The redistribution of income and wealth from one group in the population to another.</u> This is a perfectly <u>intelligible</u> goal (unlike "equalization of bargaining power"), and it is possible to accomplish it, in some situations and to some extent, by the insertion of compulsory terms into bargains. But if one wants to justify a compulsory term on the ground that it redistributes income in a desirable way, it is necessary to first establish the following:

   i. that the actual effect of imposing a compulsory term will be to redistribute income (the problems of "pass along", forcing people out of the market, and forcing people to buy goods that they don't want to spend their already limited income on).

   ii. That redistribution between the groups involved in the transaction is in fact "desirable."

   iii. That there is no better way to accomplish the redistributional goal.

D. Objections to Interference with Freedom of Contract

1. <u>The Transaction Costs Argument:</u> The objection to interfering with freedom of contract in order to force the parties to make the agreement they would have made absent transaction costs is "wrong on the facts."

   a. This objection sometimes takes the strong form of asserting that it is simply <u>impossible</u> to determine what the parties "would have" agreed to: the only valid evidence of people's preferences is what they do with their money in the market, and all other methods smack of paternalism.

   b. A weak form is that it is impossibly difficult to make such calculations in practice, so judges should stay out of it for reasons of formal realizability.

   c. A third, tricky form, is to offer a substantive justification of the choices actually made--arguing either that transaction costs did not in fact impede bargaining, or that bargaining ould have produced exactly the same result as actually occurred.

2. <u>Paternalism:</u> It is important to distinguish four different objections to judicial paternalism.

   a. The "philosophical objection:" It is "meaningless" to speak of a person being better off as a result of being forced to choose something they didn't want. The only meaningful criterion of better offness is what people choose freely. Compulsory terms reflect the desires of those who impose them, and have nothing to do with the welfare of those they supposedly "benefit."

b. The "rights objection": People have a right to choose anything they want to, as long as the choice doesn't injure others. It makes sense to invalidate the transactions of infants, the insane, and people under duress because they lack free will. But if a person suffers from no such incapacity, it is a fundamental principle of a free society that a person should be allowed to make wrong choices without state interference (this is what I have been calling the "self-determination" argument.)

c. The formal realizability objection: Although it may be true that poeple sometimes make the wrong choices, it is dangerous and impractical to give judges power to correct them. It is better to take the chance that people will often choose wrong than to take the chance that judges will abuse their power and arbitrarily impose their values on others, as well as embroiling the legal system in a hopelessly uncertain morass of vague arguments about what is "really in the consumers' best interest."

d. The institutional competence objection: It may be be valid to correct peoples' choices by imposing compulsory terms, but judges are the wrong people to do it. They are appointed not elected, their role is to apply law, not to make it, and they lack the information and the enforcement resources that would be necessary to make this kind of decision in a rational way.

3. The Redistribution of Income: There are two different sets of objections to judicial imposition of compulsory terms, depending on whether the opponent is a conservative or a liberal.

a. Conservative objections:

i. "Long term social welfare objection": This is an objection to redistribution from rich to poor "on the merits." The claim is that over the long run the poor will be worse off if they despoil the rich, because the only way to make everyone better off is to accelerate economic development, and economic development is dependent on (1) a high rate of saving and investment, which the rich accomplish and the poor do not, and (2) stimulation of innovation and effort by giving high rewards to those who make the greatest contributions to economic welfare--riches in our society are the reward for high contribution, and if you want the high contributions, which benefit everyone, then you have to put up with the inequalities and the short term low standard of living of those at the bottom.

ii. The rights objection: People come by property in some lawful way (gift, inheritance, creating it through their own labor, paying someone else to create it, or buying it from someone). It is then legally theirs.[9] Someone approaches them and wants to buy it from them. The owner is not legally obliged to sell. No matter how badly the potential purchaser needs or wants it, the legal system puts no obligation on the owner to help the other person for free (no duty to act). The buyer makes an offer, without the owner exercising any compulsion. The buyer is neither an infant nor a lunatic. The owner would rather have the money offered than the property, and the buyer would rather have the object than the money. Can't we say that the owner has a right to accept the offer, take the money and part with the property? And if the owner has a right to sell for whatever price the buyer offers, how can anyone object to the owner selling on whatever contract terms he and the buyer agree on? It may be that the seller is richer than the buyer, but all that means is that through lawful means the seller has accumulated more property. Trying to equalize them by controlling their contracts violates both their rights: the sellers lose their right to sell on any terms they want to, and the buyers lose their right to buy on any terms they want to. The result for the buyers is that some of them will be forcibly prevented from making the purchase they wanted to, and will have to buy something they wanted less. In the name of redistribution, each has been deprived of his rights.

iii. The formal realizability objection: Both the standard of inequality of bargaining power, and the general goal of redistributing income in a desirable direction, are hopelessly vague. If judges try to apply them, there will be opportunity for every kind of arbitrariness and judicial tyranny masquerading as "law." Moreover, the uncertainty generated by knowing that your transactions may be interfered with arbitrarily will discourage all kinds of individual effort and enterprise, and will reduce the pace of economic activity, making everyone worse off than they would have been had we been willing to tolerate a certain amount of social injustice in exchange for a climate favorable to productive effort.

iv. The institutional competence objection: It may be perfectly legitimate for the legislature, democratically elected, to pass law designed to redistribute income and wealth. That is at least part of the goal of the tax system, the labor laws, the antitrust laws, the welfare system, and a host of programs supposed to "equalize" the regions of the country. But it is a completely different matter for judges to do this. Nothing could be more clearly a "political" as opposed to a "legal" question than the distribution of income. And no task is less suited to being accomplished through individual lawsuits based on facts of particular cases. It's not just that it violates the separation of powers and the elementary principles of democracy. It's also that the judges will make a hopeless botch of it.

b. Depressed liberal objections:

i. Courtroom victories have little impact on the real world. Consumers are generally unaware of their rights and/or too poor and disorganized to exercise them effectively. Enforcement costs are so great that the rights are merely theoretical.

ii. Insomuch as income is redistributed, it is from the poor to the middle class, who are the only ones for whom the new obligations have any meaning, (pass along, forced out of the market, etc.).

iii. Corporations do not equal "the rich," and corporate power is not in any way dependent on control of contract terms. It is ridiculous to think that the overall distribution of income in this country or the total power of corporations have been even slightly modified by the rise of judicial consumer protection.

iv. The minute judicial activity poses a real threat to corporate interests, those interests simply roll back the court decisions in the state legislatures. The judicial reform movement will be tolerated only so long as it remains practically insignificant.

v. While it remains insignificant, there is every reason for the rich and the corporate powers to tolerate it, since it diverts activist energies into a dead end and gives people a powerful illusion that "the public interest" is winning victories over the "vested interests" when in fact nothing is happening.

vi. The main impact of consumerism has been to create legal complexities and a regulatory morass which large corporations can handle relatively easily, but which make it increasingly difficult for small or new businesses to survive in the market. The overall effect is to shut down opportunities for the lower middle class, reduce the overall level of competition in the economy, increase the power of large economic units, and put consumers even more completely at the mercy of the giants than they were to begin with.

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III. The Impact of Pre-Existing Relationship on Tort Liability

At the beginning of these materials, I described tort law as a collection of rules that judges follow in deciding whether or not to grant compensation for injuries not arising from a breach of contract. While such a definition is useful, it is also misleading. In this section, we will examine in much greater detail the relationship between contract law and tort law, and in the process explore the impact on the rules of tort law of the necessity of taking into account a prior relationship between the parties to the lawsuit.

When the parties have entered a contractual relationship, and one party breaches, it is common for the victim to bring an "action on the contract for breach," or an "action in quasi-contract for recission and restitution." These two actions are subject to a host of special rules with a host of special exceptions, and these rules are (a) different according to whether the action is for breach of contract or in quasi-contract, and (b) different from the rules that govern a "cause of action in tort." There are three particularly important differences between the rules governing actions in contract and actions in tort. (a) The torts statute of limitations is likely to allow more time for the bringing of actions than the one governing contracts. (b) In a tort, but not in a contract action, it is normally possible to collect damages for pain and suffering or emotional harm caused by the violation of duty, and, if the tort is intentional the rule of <u>Hadley v. Baxendale</u> does not apply (cf. <u>Vosburg</u>). (c) In order to succeed in an action on the contract, but not in a tort action, it is usually (but by no means always) necessary to show that the parties <u>intended to create</u> the obligation which the plaintiff claimed the defendant breached.

The existence of different rules for these two causes of action would not pose a serious technical problem <u>if</u> there were also a set of rules that allowed us to say of a given fact situation: "Here, because the following elements are present in the fact situation, the plaintiff must bring an action on the contract and may not bring an action in tort. If the plaintiff fails in her contract action, she is without a remedy and her loss is damnum absque injuria (damage without infliction of a legal wrong)." In most jurisdictions in the United States, there are no longer any general rules of this kind. It is still true that a plaintiff who claims simply that she lost money because she had to cover when a defendant seller did not deliver the goods will not be allowed to sue in tort. But there are now no valid generalizations that can be made about when courts will react in this way to injuries within relationships.

This is a fact of enormous importance to lawyers who deal with such injuries. It means that as time passes it has become more and more frequently possible to bring tort actions, under tort statutes of limitations, seeking tort damages, for injuries that arise within or on the borders of contractual relationships. To win such actions, it is not necessary to show that the defendant breached an obligation that the parties had previously created, expressly or by implication, in the contractual process. On the contrary, it is often possible to win such actions in spite of the fact that there is a good argument that the parties expressly or impliedly agreed that the defendant would not be liable for injuries of the kind he has inflicted on the plaintiff. From the point of view of contract law, the tort invasion means (a) new remedies for injuries that have all along been remediable in contract actions; (b) remedies for injuries within the contractual relationship that previously would have gone unrecompensed; (c) new limitations on the ability of the parties to control their relationship, according to their respective bargaining power, by limiting their duties to one another.

There are no logical limits to the expansion of tort duties within contractual relationships. Suppose we define a tort as an unprivileged invasion of a legally protected interest. As we saw in our discussion of intentional torts, the judges must then decide what interests are protected. The judges could define all contractual rights as legally protected interests to be vindicated through tort actions, and dispense with contract altogether. There would still be special rules governing injuries inflicted by refusing to abide by agreements, just as there are special rules for automobile accidents, competitive torts and defamation. But all the special rules would be part of a one general legal category of "civil wrongs," rather than divided into the mutually exclusive categories of contract and tort. Something quite close to this actually occurred in Renaissance England when the action of trespass on the case expanded to include most contract breaches. In the process, case both displaced the actions of debt and covenant and created liability for many injuries that had previously been without remedy.

Conversely, judges could just as well accomplish the expansion of liability that is now occurring through tort law through the incremental modification of contract law. "Implied" obligations within a contractual relationship are sometimes imposed because it is quite clear that the parties actually intended them. But they are also imposed "as a matter of law," quite independently of intent, and the courts sometimes refuse to allow the parties to effectively disclaim these obligations. The process of "implying" obligations in contract is not significantly different from that of creating "legally protected interests" in tort. Indeed, there is now a considerable body of scholarly opinion that holds that the recent expansion of semi-voluntary or involuntary obligation within the contract cause of action has already almost abolished the distinction between contract law and tort law. (Gilmore, The Death of Contract, ch. 4, 1974).

The absence of logical limits to the expansion of liability (whether from within contract or through the tort invasion) does not mean that the expansion ought to occur. The point is merely that what limits there are derive from our ideas of policy, exactly as was the case in our discussion of compensation for intentional economic harm in Section I of the course. As we have seen throughout the course, there are a rather small number of policy arguments that recur on each side of the debate about the expansion of liability. There are special versions of these arguments that are customarily employed when the issue of liability arises within a relationship whose legal content the parties can easily vary by contract. There is also a special version of the economists' claim to be able to "resolve" the policy conflict by reference to the concept of "efficiency." I have divided these materials as follows:

A. Relationships Short of Formal Contract

B. Contractual Relationships

1. Insurance contracts
2. Landlord's duty to repair
3. At-will employment contracts
4. Fraud and products liability
5. Malpractice

A. Obligations Arising From Relationships Short of Formal Contract

In the late 19th century, is was a common view that tort law consisted or ought to consist only of obligations that were sufficiently minimal and sufficiently abstract so that they would apply between strangers. Such, for example are the obligations to avoid intentional or negligent invasion of another's interest in bodily security. The existence of a relationship with another person did not create any new tort duties, indeed it was more likely to extinguish them (as in the case of privity). Of course, relationships constantly lead to other kinds of legal obligations that had not existed when the parties were strangers, but these must be derived either from agreement (contract) or from the specifically fiduciary character of the relationship (e.g. guardian and ward).

This view was implicitly individualist. It meant that there was a gap in the legal system: the courts treated people whose actual relationship might be highly developed, with consequent feelings of moral obligation going far beyond what would exist between strangers, as though they were in fact strangers, on the ground there was no legal category lying between strangerhood and formal contract. Over the last 75 years, this gap, which was never total anyway, has gradually filled. The judges have operated from both sides, so to speak. On the contract side, a variety of doctrinal shifts have made it easier both to establish the existence of formal contractual obligation (relaxation of rules of offer, acceptance and consideration) and to establish the borderline causes of action in quasi-contract and promissory estoppel. From the tort side, the important developments have been (a) the abolition or limitation of defenses based on non-contractual relationship (assumption of risk; duty of landowners to licensees and social invitees; intrafamily immunity) and (b) the expansion of liability in situations where there has been no "act," but the existence of relationship makes the failure to act as morally reprehensible as an act would be between strangers. This section traces both of these developments.

~~.~~ Contractual Relationships

We will take up five kinds of contractual relationship within which the issue of tort liability has begun to arise frequently. These are insurance contracts, employment contracts, leases, contracts for the sale of consumer goods, and contracts for the provision of medical services. Each of these fields has its own specialized body of legal doctrine, and the developments we will examine have occurred under different rubrics and at different rates from field to field. As a result, it has traditionally been possible for those who deny that change is occurring or ought to occur to argue that each is "exceptional," or that some four of the five are exceptional, while the fifth "used to be governed by sound principles" but is unfortunately now moving in directions "foreign to the common law" (i.e. it is becoming "exceptional" as well). The problem with this attitude is that, taken together, insurance, employment, leases, sales of consumer goods and malpractice cover a very large proportion of the total legal experience of the average person. If they are all to be treated as exceptional, it is hard to see where we will find the "normal" law of contracts affecting normal people.

The cases demonstrate not that there is a uniform and harmonious process of change going on across all doctrinal boundaries, but that the same conflict, resolved sometimes one way and sometimes another, recurs from area to area. There may be good reasons why the tort invasion should expand liability more or less in one field by contrast to another. Or it may be that differences in treatment reflect not a meta-principle of "appropriate tortification," but merely differences in the judges' understanding of the issues, or differences in the strength of the two sides of the argument at different times and in different jurisdictions. It will come as no surprise that the evidence suggests to me that what is involved is the gradual and uneven emergence of a consciousness of contradiction that cuts across doctrinal boundaries.

For all five issues, it is important to try to assess the lengths to which the court is willing to go to impose its conception of how the parties ought to behave. It is a commonplace that there are many degrees of interventionism: (a) the court may use tort law to impose more extensive damages to recompense the plaintiff for actions by the defendant that are clearly in breach of contract under existing contract law; (b) or it may use tort law to add to the already substantial list of contractual duties that the law impose on contractual parties in the absence of a specific disclaimer; (c) or it can add to the list of duties that the parties are not free to disclaim or otherwise modify by contract.

These different kinds of intervention shade into one another by imperceptible degrees, as the cases will show. A particularly frequent kind of ambiguity arises because the decision to impose liability for a particular kind of conduct in the absence of explicit contractual provision to the contrary may be tantamount to imposing a non-disclaimable duty. This will be the case where the behavior in question is of a type that it would be very costly or perhaps embarrassing for the parties to deal with in advance through contractual language. An equally frequent situation is that in which the contractual language might be construed as a disclaimer of liability of a particular kind, but is susceptible of a forced but not altogether crazy interpretation in the opposite direction. When the court chooses the strained construction, or imposes a duty while simply ignoring the arguable language of disclaimer, it is doing more than merely interpolate a new term, though less than imposing a clearly non-disclaimable duty.

It is crucial to distinguish between two arguments against the interpolation of a new obligation into a contract. One argument is good only for the particular case before the court, and does not apply to the new rule in general: it is that the parties entered the relationship with the then-existing law in mind. To change the law ex post facto, after the defendant had relied on the pre-existing rule that absolved him of liability for the damage he has caused, is at least unfair, and may fall only a little short of a taking of property without compensation. I will call this the "reliance/surprise argument." It applies only to the retroactive effects of the decision, and should be sharply distinguished from the argument that the imposition of a new duty will, in the general run of future cases, put an unfair burden on the party obligated. In this second, future-oriented argument, it is of course crucial to know whether defendants as a class will simply pass the costs of the new burden on to someone else, and, if so, to whom.

In each case of intervention, the court will have a choice between imposing a duty merely to refrain from intentional harm of the kind in question, a duty to refrain from both intentional and negligent harm, and the imposition of strict liability. There will also be a choice between casting the new duty as one in tort or one in contract. Although we will deal here only (or almost only) with cases in tort, it is important to keep the contractual alternative constantly in mind, since in some jurisdictions it may offer a better or the only argument on a given issue.

SECOND OUTLINE: THE CHOICE BETWEEN NEGLIGENCE AND STRICT LIABILITY IN COMPULSORY TERMS

There are two issues:

the level of investment in safety

what happens to accident losses that occur in spite of investment in safety

The background question is: what would happen if we imposed no duties at all on sellers to buyers for injuries caused by products or services? That is, what would happen under caveat emptor?

The first step is to imagine a totally unrealistic situation in which buyers and sellers have total knowledge of all risks and all consequences, and in which there are no impediments to bargaining to an individualized transaction in every case.

In such a situation, buyers would offer some increase in the base price of the commodity in exchange for particular investments in safety, and they would also be willing to pay something for insurance through the price against injuries that occur in spite of investment in safety.

Sellers might or might not be willing to provide the services of investment in safety and insurance against accidents at a price consumers were willing to pay. If no bargains about safety and insurance were struck, we could conclude that the services were not worth to consumers that it would have cost sellers to provide them.

The bargains that were struck or not struck about accidents would reflect the buyers' risk preferences. In other words, if buyers were aware of a risk, say a 10% risk of a $100 accident, which could be prevented by a precaution that would cost only $5, they might or might not be willing to pay the $5 to get the seller to take the precaution. They might prefer $5 in hand to a 10% chance of avoiding a $100 loss. If that were the case, then they would be "risk preferers." On the other hand, buyers might be willing to pay $12 in advance to avoid a 10% chance of a $100 injury, in which case they would be "risk averse."

The same analysis applies to bargains about compensation for accidents occurring in spite of the taking of precautions. Some buyers would not want insurance even if the premiums paid in advance were sure to be less than the compensation received for injury to them. Others would buy the insurance even if the premiums were very likely to be more than the cost of the injury.

There is another reason than risk preference why buyers might be unwilling to bribe sellers to take precautions or provide insurance: buyers might feel that they could achieve the same benefits on their own at less cost. For example, they might calculate that a product was dangerous to most people because most people are ignorant and careless,.but not dangerous to them because they were knowledgeable and careful and knew how to use it safely. Or they might prefer not to buy insurance from the seller because they could get their own personal injury and lost wages insurance for less than it would cost to buy it from the seller. Or they might be confident that if injured they would be compensated from other sources, such as family members or social insurance or charity.

In short, if there were no duties at all on the seller--caveat emptor--<u>and</u> there were a world of perfect information and costless bargaining, the bargains struck would reflect the particular tastes and particular alternatives of buyers. No buyer would have to buy a level of protection higher than he wanted.

There are two reasons why one might favor interference with this free contractual outcome, even maintaining the assumption of perfect information and costless bargaining, these being the general reasons discussed in the first outline: paternalism, and the desire to redistribute income from sellers to buyers, or among buyers.

Paternalism justifies nondisclaimable negligence liability for the seller on the ground that the buyer's risk preference is "not in his best interest." If we think buyers will not voluntarily contract with sellers to have the sellers exercise due care, or that buyers will only pay sellers for obvious or very cheap precautions, then we may feel that buyers would be better off if we forced them to pay for the level of precautions that judges and juries think amount to due care.

Redistribution justifies a nondisclaimable negligence duty on sellers if we think the shape of supply and demand curves is such that sellers will end up taking the precautions and passing on less than their full cost in price increases. But we have to take account of buyers forced out of the market, and of the impact on marginal sellers.

But it is important that a negligence duty will <u>not</u> have any impact on consumer choices about insurance to cover the losses from those accidents that occur even after sellers have been forced to exercise due care. The negligence term leaves consumers free to pay sellers a premium for insurance against these losses, or to choose to buy insurance elsewhere, or not to insure at all and take the chance that they won't be injured, or that their injuries will be compensated from other sources.