

## THE COASE LECTURE SERIES

The Coase Lecture Series, established in honor of Ronald H. Coase, Clifton R. Musser Professor Emeritus of Economics at the University of Chicago Law School, is intended to provide law students and others with an introduction to important techniques and results in law and economics. The lectures presuppose no background in the subject.



## FREEDOM OF CONTRACT

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Talking about freedom of contract is tricky, because the topic carries a heavy ideological charge. Depending on one's point of view, freedom of contract can be seen as a choice between individual liberty and heavy-handed government control, or between communitarian consensus and the worst excesses of *laissez-faire* capitalism. In other words, freedom of contract is a sort of lightning rod, which always attracts strongly-held political beliefs.

In fact, freedom of contract is such a charged topic that I have to start with a disclaimer, and point out that most of what we know as contract law has very little to do with freedom of contract as such. Most of contract law consists of default rules, or rules that apply when parties fail to address a topic one way or the other in their contracts. For example, most of the rules governing offer and acceptance, or implied warranties, or implied excuses such as impracticability or mistake, apply only if the parties have not agreed otherwise. And as long as the parties are free to agree otherwise, it is hard to see how freedom of contract is at all affected by these default rules. There are lots of other arguments that might bear on the desirability of any particular default rule, but arguments about 'freedom of contract' are largely irrelevant.<sup>1</sup>

There are some parts of contract law, though, that do raise freedom of contract issues. The rules against excessive liquidated damage clauses, for example, or the rules blocking enforcement of promises

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<sup>1</sup> For discussions of possible bases for choosing default rules, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *Yale L.J.* 87 (1989); Richard Craswell, *Contract Law, Default Rules, and the Philosophy of Promising*, 88 *Mich. L. Rev.* 489 (1989); *Symposium on Default Rules and Contractual Consent*, 3 *S. Cal. Interdisc. L.J.* 1 (1993).

unsupported by consideration, both limit the freedom of contracting parties to some extent. The same is true, in at least some cases, when enforcement of harsh contract terms is deemed unconscionable by courts. And outside of contract law itself, limits on freedom of contract can also be found in insurance law, labor law, landlord-tenant law, products liability law, and in many other doctrinal fields.

Since this is supposed to be a *short* lecture, I'm going to set aside some of the relatively uncontroversial doctrines like fraud and duress. It's not that these doctrines are uninteresting, from either an economic or a philosophic point of view. Indeed, as many writers have discovered, it's not at all easy to explain just why a contract induced by fraud or duress should not be enforced.<sup>2</sup> Still, most people would agree that no one should be held to a contract that was signed at the point of a gun, or a contract signed as a result of fraud. Most people would also agree that there may be a case for limiting contract terms that create externalities, or effects on people who aren't parties to the contract.<sup>3</sup> Since I don't want to talk about things that everybody agrees on, I'm going to focus instead on some of the more controversial limits on the enforceability of contract terms.

To give us some examples, think about a clause that gives a creditor the right to repossess all of the debtor's furniture if the debtor misses a payment,<sup>4</sup> or a clause that releases a manufacturer from all liability—including liability for physical injury—if its product turns out to be defective.<sup>5</sup> These are the kind of clauses that are often challenged under the contract-law doctrine of unconscionability. My topic is, what can economics tell us about when clauses like these ought to be restricted?

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<sup>2</sup> For a survey of some possible arguments, see Anthony T. Kronman, *Paternalism and the Law of Contracts*, 92 *Yale L.J.* 763 (1983); Michael J. Trebilcock, *The Limits of Freedom of Contract* chs. 4-5 (Cambridge: Harvard University Press, 1993).

<sup>3</sup> For discussions of this issue see, e.g., Richard A. Epstein, *Why Restrain Alienation?* 85 *Colum. L. Rev.* 970 (1985); Susan Rose-Ackerman, *Inalienability and the Theory of Property Rights*, 85 *Colum. L. Rev.* 931 (1985).

<sup>4</sup> E.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965).

<sup>5</sup> E.g., *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J.359, 161 A.2d 69 (1960).

At this point, though, I have to make another disclaimer. The question that economics tries to answer is whether clauses like these are efficient or not. In other words, economics has nothing directly to say about whether these clauses are fair, or just, or whether buyer's freedoms have been infringed. There are of course political and moral theories which speak to those questions, and I think economics does have something to contribute to these theories. In this lecture, though, I'm going to be speaking primarily about questions of efficiency. In other words, we can rephrase the question I'm addressing here as, 'When can legal restrictions on contract clauses be efficient?'

#### I. AN EXAMPLE OF A PERFECT MARKET

To answer this question, let me start with a story in which restrictions on contract clauses would never be efficient. (If this were a technical economic paper, what I'm about to say would be called a *model*—but since this is a nonmathematical lecture, you can think of it as a story.) The moral of this story is that if the market is working perfectly, there should never be any inefficient contract terms, so efficiency can never be improved by forbidding certain terms. I'm not going to end my analysis with this story—but it does make for a convenient starting point, if only by way of illustration.

Suppose, then that we have a market that's highly competitive, in the sense that there are lots of sellers competing for buyers' business. Even more important, suppose buyers in this market are perfectly informed about what they are buying. By this, I mean not only that buyers know what kind of product they're buying, but also that they know everything there is to know about the risks they have to bear, given the contracts that sellers use. For example, if one seller's contract limits the seller's liability for damages caused by a defective product, buyers not only know that they have to bear that risk, they also know just how likely a defective product is, and just how much damage a defective product is likely to do. This is an extreme assumption, in some ways—but, as I said, it's useful to start with an extreme case to use as a benchmark.

*A. The Efficiency of Perfect Markets*

In this market, economists would claim, any contract clause which survives very long must be an efficient one. Efficiency, in this context, is defined in cost-benefit terms: A clause is inefficient if the harms it inflicts on buyers are greater than the savings it creates for sellers. There are of course difficulties in how we measure these harms, and how we compare the harm to buyers against the benefits to sellers—but it will be easier to talk about these difficulties later, after I've finished this story. Let me focus first on the claim this story attempts to illustrate: the claim that, in a market such as this, the only clauses that survive will be the ones whose net benefits are positive. If this claim is right, it follows that prohibiting those clauses could only reduce efficiency, by getting rid of clauses whose net benefits were positive.

Why would only efficient clauses survive in this market? If buyers in this market know exactly what risks a clause imposes on them, any seller can make her product more attractive by getting rid of terms that impose risks on buyers.<sup>6</sup> Of course, the seller will lose something by getting rid of those terms: she'll lose whatever benefits the terms gave her. If a seller gets rid of the limitations on her warranty, for example, her product will then be more attractive to buyers, but the seller's own costs will go up because she'll have to pay more warranty claims. Still, the seller can make up for her own higher costs by raising the product's price to cover her costs. And here's the key: if buyers know exactly what risks the seller's contract does or does not impose, the higher price won't necessarily scare buyers away. Instead, buyers will be more attracted to the product (on balance) whenever the higher price is outweighed by the better contract terms they're now getting. Conversely, buyers will be less attracted to the product whenever the better contract terms are not enough to outweigh the higher price. And that's exactly what we want to happen, from an efficiency point of view.<sup>7</sup>

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<sup>6</sup> For convenience in the use of pronouns, all of my examples involve female sellers and male buyers.

<sup>7</sup> The fact that the sellers' costs can be passed on to buyers in the form of a higher price also eliminates some of the difficulties involved in comparing gains to buyers and costs to sellers. For a more complete discussion of this

Another way to put this point is to think of the risks that a product imposes as just one more element of the product's total price. By 'total price,' I mean not just the monetary price the buyer has to pay, but also the expected costs of all the risks the buyer has to assume. If getting rid of a particular clause will make the total price go down, from the buyer's point of view, that will make the product more attractive to the buyer, and sellers in a competitive market will have an incentive to get rid of that clause in order to make their products more attractive. But if getting rid of that clause will make the total price go down, this means that the benefits to the buyer must exceed the costs to the seller (i.e., the costs reflected in the higher monetary price), so getting rid of that clause must also be efficient. This is why, in markets where buyers are perfectly informed, the only clauses which survive should be those that are efficient.

## II. MARKET FAILURES

In a perfect market like this, then, there would never be an efficiency case for any restrictions on freedom of contract. Indeed, if all markets were this perfect, economists would have very little to say about freedom of contract: I could end the lecture right now, and we could all go home. However, much of economics consists of studying markets that are not this perfect, and then trying to figure out which institutions could arise to deal with the imperfections. Let me talk now about this branch of economics: the branch that analyzes what are sometimes called *market failures*. As I'll use the term here, a 'market failure' is simply anything that prevents a market from operating as perfectly as it did in the scenario I just described.

### *A. Monopoly*

I'm going to spend most of my time talking about market failures that result from imperfect information. First, though, I should say something about markets where the problem is a monopoly. Economists have known for a long time that monopolized markets may not behave as well as markets where there's lots of competition. As a result, monopoly is the kind of market failure that's become

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point, see Richard Craswell, *Passing On the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 *Stan. L. Rev.* 361 (1991).

most familiar to laypeople. Indeed, for a long time many courts and legal scholars assumed that, if inefficient contract terms seemed to be persisting in certain markets, it must be due to monopoly power.<sup>8</sup>

Today, though, most economists would not list monopoly power as a likely source of inefficient contract terms. Moreover, even in those cases where a monopolist did have an incentive to choose inefficient contract terms, most economists would not say that prohibiting the inefficient terms would necessarily improve things for consumers. While I don't want to spend too much time talking about monopolized markets, let me give you a brief sketch of the economic argument.

First, monopolists usually will not have an incentive to choose inefficient contract terms. The monopolist may have an incentive to charge a high price, of course, but this does not mean that she'll also have an incentive to distort any of the other contract clauses. If consumers know what the monopolist is doing—an important qualification that I'll come back to in a minute—then any attempt by the monopolist to insert an inefficient term will be seen by consumers as an increase in the 'total price' of the product. In other words, the effect will be much the same as if the monopolist had not introduced the inefficient clause, but had simply raised the monetary price of the product by an equivalent amount. But if the monopolist wants to exploit buyers, she can usually do better by raising the monetary price of the product, rather than by raising the 'total price' by using an inefficient contract term. The problem with raising the total price indirectly, by using an inefficient contract term, is that—by definition—an inefficient contract term hurts buyers by more than it benefits the monopolist. By contrast, a higher monetary price helps the monopolist by exactly the same amount that it hurts buyers: the amount of the higher price. This is why the monopolist will usually be better off exploiting buyers by

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<sup>8</sup> For example, the link between unfair contract terms and market power was asserted in an influential article by Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 *Colum. L. Rev.* 629 (1943). In Henningsen, *supra* note 5, the market power of automobile manufacturers was put forward as one explanation for the persistence of the (allegedly) inefficient limitations on the manufacturers' warranties.

charging a higher monetary price, rather than by inserting an inefficient contract term.<sup>9</sup>

Now, I have to add that there are some situations where a monopolist might indeed profit by using certain kinds of inefficient contract terms. Monopolists can sometimes increase their profits by dividing their customers into different groups, so that they can charge each group a different price, and sometimes the introduction of an inefficient contract term can help sort out the buyers who would be willing to pay the highest price. Even in these situations, though, it does not follow that buyers would necessarily be made better off if the law were to prohibit the inefficient term *without doing anything about the monopoly power*. If the law prohibits the monopolist from using the inefficient term, the monopolist can simply go back to charging all consumers the same price, and it is very difficult to define the circumstances under which buyers will be benefited rather than being hurt by this response.<sup>10</sup> Indeed, in some cases the only way to benefit buyers as a class would be to make the monopolist adopt a term that was *less* favorable to buyers than the term the monopolist would prefer—which might suggest that the legal system should try to strike down terms that were unduly

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<sup>9</sup> This issue is analogous to the question, often addressed in the economic literature, of whether a monopolist will have an incentive to produce a level of product quality or durability that differs from that produced by a competitive firm. For a survey of the economic literature on this point, see Richard Schmalensee, *Market Structure, Durability, and Quality: A Selective Survey*, 17 *Econ. Inquiry* 177 (1979); see also the articles cited *infra* in note 10. Discussions in the legal literature include M.J. Trebilcock, *The Doctrine of Inequality of Bargaining Power: Post-Benthamite Economics in the House of Lords*, 26 *U. Tor. L.J.* 359 (1976); Alan Schwartz, *A Re-examination of Nonsubstantive Unconscionability*, 63 *Va. L. Rev.* 1053, 1071-76 (1977); Duncan Kennedy, *Distributive and Paternalistic Motives in Contract and Tort Law, With Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 *Md. L. Rev.* 563, 617-18 (1982).

<sup>10</sup> For formal economic models of this problem, see A. Michael Spence, *Monopoly, Quality, and Regulation*, 6 *Bell J. Econ.* 417 (1975); David Besanko, Shabtai Donnenfeld & Lawrence J. White, *Monopoly and Quality Distortion: Effects and Remedies*, 102 *Q.J. Econ.* 743 (1987); Avery Katz, *Your Terms or Mine? The Duty to Read the Fine Print in Contracts*, 21 *Rand J. Econ.* 518, 531-33 (1990).

*generous* to buyers.<sup>11</sup> Fortunately, these cases are very difficult to identify in practice, so no court that I know of has ever felt compelled to try to carry out this theory.

To be sure, there are other arguments that might be made about a monopolist's incentives to choose efficient nonprice terms. If the monopolist is securely protected from competition, she might not face as much pressure to maximize her own profits, and thus might not take as much trouble to use efficient terms, even if using efficient terms would be more profitable. On the other hand, a monopolist is not subject to some of the free-rider problems that affect competitive firms, and this might make it easier for the monopolist to offer more efficient terms. In short, the theoretical case for being particularly suspicious of contract terms in monopolized markets is, at best, weak. Significantly, an empirical study of warranties in monopolized and non-monopolized markets found no appreciable difference between the two.<sup>12</sup> This is not to say that the monopolists' terms were always efficient, of course—just that they were no more and no less likely to be inefficient than the terms used in competitive markets.

For now let me return to something I mentioned earlier. I said that if the monopolist tried to introduce an inefficient contract term, consumers would perceive that as an increase in the 'total price' of the product, *if* consumers were aware of the inefficient term. If consumers didn't realize the monopolist had inserted an inefficient term—for example, if the inefficient term were hidden in thirty pages of fine print—then the monopolist might well be able to exploit consumers by using an inefficient contract term. In other words, it might seem that, when we have a combination of a

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<sup>11</sup> For example, if a liquidated damage clause exposing the monopolist to large damage payments would assist the monopolist in sorting its customers, overall consumer welfare could conceivably be improved if the law required the monopolist to set a lower limit on her potential damage liability. For formal models with this characteristic, see Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 *Yale L.J.* 615, 661-64 (1990); Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 *Yale L.J.* 729, 744 (1992).

<sup>12</sup> George L. Priest, *A Theory of the Consumer Product Warranty*, 90 *Yale L.J.* 1297 (1981).

monopoly seller and uninformed buyers, we would then have reason to worry about inefficient contract terms.

Once we introduce imperfect information into the story, however, the presence of a monopoly becomes largely irrelevant. As I'll explain in a minute, if buyers don't realize what clauses are hidden away in the fine print, then even markets with lots of competitors may still generate inefficient contract terms. This is what I'm going to talk about for most of the rest of the lecture: the market failures that can arise from imperfect information, regardless of whether the market is monopolized or has many competing sellers.

In short, I think the focus on monopoly power is really a red herring where contract terms are concerned. If courts and laypeople tend to associate inefficient terms with monopolies, it's probably because monopoly is the only form of market failure that courts and laypeople are familiar with. The economic analysis of imperfect information came along much more recently in economic history—most of it in the last twenty years or so—so information economics hasn't yet had time to sink into the collective legal consciousness. But this is where these Coase Lectures come in: One of the goals here is to introduce lawyers and law students to more recent developments in economic analysis. With that in mind, let me now turn to some of the market failures that might arise from imperfect information. I'll then talk about the implications that these market failures might have for the regulation of contract terms.

### *B. Imperfect Information*

In particular, I want to talk about three distinct kinds of information problems, so I'll be introducing three more models (or stories). The first two both have to do with imperfect information on the part of buyers. The third story is more paradoxical: it shows how terms that are unduly harsh to buyers might also arise if *sellers* are the ones who are not perfectly informed.

#### *1. Buyer misperception of risks*

Let me start, though, with the simplest of these stories. This is the story that I've already alluded to: Suppose buyers simply don't know all the risks associated with the products and contracts they buy. For example, suppose they don't know that the seller's contract

makes buyers bear all the losses if the product turns out to be defective—or suppose that they know they'll bear all the losses, but they don't know how likely it is that any losses will occur (i.e., they don't know the defect rate). In other words, in this story buyers are aware of the *monetary* price the seller is charging, but they do not correctly estimate the *total* price of the product (the monetary price plus the expected cost of the risks they have to assume).

Obviously, in markets like this there is no guarantee that sellers' contract terms will be efficient ones. If buyers don't know enough to evaluate the total price they're paying, an inefficient term could survive simply because buyers didn't realize how costly the term was likely to be. In fact, in addition to inefficient contract terms being provided, buyers might also end up purchasing too much of the product in question, if they didn't fully appreciate the risks associated with the product. To be sure, this problem doesn't mean that laws attempting to prohibit inefficient terms will necessarily improve matters: I'll return to that issue a little later. Still, in the market I've just described, there's at least a *potential* for improvements in efficiency from legal rules banning certain contract terms.

Indeed, this market problem could be analogized to a kind of fraud, or (at least) to a kind of misrepresentation. That is, the effect on buyers is the same as if they had been defrauded: buyers end up with inaccurate beliefs about the purchases they make. To be sure, common-law fraud required that the seller play an active and knowing role in creating the buyer's inaccurate beliefs, and that may not be the case with the problem I have just described.<sup>13</sup> The

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<sup>13</sup> Of course, the line between affirmatively creating a false belief, on the one hand, and merely failing to correct an existing false belief, on the other, is not easy to define. For a discussion of this issue, see Howard Beales, Richard Craswell & Steven Salop, *The Efficient Regulation of Consumer Information*, 24 *J. Law & Econ.* 491, 499-501 (1981). Indeed, many states now treat the mere failure to disclose information as actionable (in certain cases), while others reach similar results by being quite willing to treat silence as an *implied* representation. Compare, e.g. *Swinton v. Whitinsville Savings Bank*, 311 Mass. 677, 42 N.E. 2d 808 (1942) (mere failure to disclose that house was infested by termites held not actionable), with *Kannavos v. Annino*, 356 Mass. 42, 247 N.E. 708 (1969) (failure to disclose that apartment building was in violation of local codes was held actionable, because the appearance of the building implicitly represented that it was suitable for use as an apartment house). See gener-

problem described here could arise simply because buyers are inattentive, or because the cost of reading detailed contracts makes such close attention inefficient for buyers. Nonetheless, the economic *effect* of this problem is very similar to the economic effect of fraud—and since I said I wasn't going to say very much about fraud, I won't say very much about this problem, either.

2. *Buyer misperception of changes in risks*

My second story involves a more complicated sort of market failure. In this story, buyers can be perfectly informed about all the risks associated with the products they actually buy, but they might not be perfectly informed if any seller were to change the risks associated with her product. In technical terms, buyers might not be perfectly informed about possible actions off the equilibrium path. If buyers would not accurately evaluate any change in the level of risks, sellers might then have no incentive to change their products, and the market could get stuck in an inefficient equilibrium. Even though buyers would be accurately informed about all the risks actually created in that equilibrium, no seller will have an incentive to offer a more favorable level of risks, because buyers would not accurately perceive the significance of the seller's change.<sup>14</sup>

Let me make this more concrete. Suppose that buyers are accurately informed about the scope of the average warranty in some market. Suppose, though, that buyers get this information not from reading each warranty carefully before they buy, but from their own personal experiences (or from the experiences of friends) in cases where they were or were not allowed to collect on the warranty. Suppose, finally, that this general perception about the scope of the average warranty is perfectly accurate. That is, suppose that all sellers do limit their warranties to exactly the extent that buyers expect them to, meaning that no buyer is misinformed about the extent of any existing warranty.

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ally W. Page Keeton, Dan B. Dobbs, Robert E. Keeton & David G. Owen, *Prosser and Keeton on the Law of Torts* § 106 (5th ed. 1984).

<sup>14</sup> For a formal economic model, see Michael Spence, *Consumer Misperceptions, Product Failure and Producer Liability*, 44 *Rev. Econ. Stud.* 561 (1977). Nontechnical discussions in the legal literature include Victor P. Goldberg, *Institutional Change and the Quasi-Invisible Hand*, 17 *J. Law & Econ.* 461 (1974); Kennedy, *supra* note 9, 41 *Md. L. Rev.* at 597-603.

Now consider a seller who is thinking of improving her warranty, to make it a little more generous to buyers. If buyers only have a general idea about the average warranty offered by all sellers, buyers might fail to notice if this particular seller improved her warranty. Moreover, if this seller improves her warranty, her costs will probably also go up, so she'll have to raise the price of her product to compensate. And if buyers don't realize that her warranty is now more generous, they'll only see the higher price, and will shy away from buying her product. In such a market, the seller will have no incentive to make this improvement in her warranty. Instead, she'll continue to offer the less generous warranty that buyers already expect—thus turning buyers' beliefs about the average warranty into a self-fulfilling prophecy.

Indeed, we could get even worse results than this. Some other seller might decide to offer a slightly *less* generous warranty—and if consumers know only the average level of warranty in the industry, they might not realize that this particular seller's warranty has gotten worse. Moreover, since this seller will be able to reduce her costs by offering a stingier warranty, she'll now be able to reduce her price. If buyers see only the lower price, and do not see the less generous warranty, this seller's sales should increase. In the extreme case, other sellers will be forced by competition to follow her example and we'll have a 'race to the bottom,' at the end of which all sellers will be offering stingy warranties. This is what George Akerlof has called the 'market for lemons': in the end, only lemons are left on the market.<sup>15</sup> Once again, consumers' information may be perfectly accurate after this end-state is reached—that is, consumers may soon become perfectly aware that every seller offers a stingy warranty, so they may continue to have accurate beliefs about all existing warranties. The problem is that, under these assumptions, consumers would *not* be perfectly aware if any seller were to change her warranty, so the market will never get out of this equilibrium.

Now, having sketched out the theory behind this story I should mention that there are several factors which in practice may prevent the result from being so bad. For one thing, consumers don't always buy from whichever seller charges the lowest price. In some markets

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<sup>15</sup> George A. Akerlof, 'The market for "Lemons": Quality Uncertainty and the Market Mechanism,' 84 Q.J. Econ. 488 (1970).

a low price may be a signal that the seller is probably cutting corners somewhere, maybe by offering a stingy warranty. Another check comes from the fact that a seller who offers a better warranty may be able to advertise that fact, thus bringing the better warranty to buyers' attention.<sup>16</sup> (The occasional outbreaks of warranty advertising in the automobile industry show that this is not impossible.) A third possible check comes from the fact that a seller who offers less generous terms will have more disappointed customers than a seller who offers more generous terms. If these disappointed customers repeat their stories often enough to other potential buyers—and if enough buyers remember the particular seller associated with this story—sellers who reduce their warranty coverage may suffer the reputational loss they deserve.

Still, I also have to mention that these countervailing factors may not work perfectly in every market. Sellers' advertising claims may not always be believed by buyers, or it may simply be too expensive for sellers to convey the level of detail needed to inform buyers correctly. Reputations may not work perfectly, either: in some industries, the repeat business of buyers may not be important, or it may be too hard for buyers to remember which sellers were associated with good experiences and which were associated with bad ones. In short, the possibility that inefficient terms might persist because of imperfections in buyers' information cannot be ruled out purely as a matter of theory. And if this last theory I've been discussing is sound, imperfections in buyers' information can't be ruled out even if, in equilibrium, buyers are perfectly informed about all the warranties actually offered by sellers.

### 3. *Imperfect seller information*

Finally, let me also mention that it's possible to get inefficient contract terms if *buyers* are perfectly informed and *sellers* are the ones who lack information. This is most likely to be a problem when different buyers bring different degrees of risk to the transaction, and sellers don't know how risky any particular buyer is. In technical terms, buyers may have an incentive to agree to certain contract

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<sup>16</sup> See Ronald H. Coase, *The Choice of the Institutional Framework: A Comment*, 17 *J. Law & Econ.* 493 (1974).

clauses to *signal* their level of risk, even if the clause is inefficient in the sense that its total benefits are less than its total costs.<sup>17</sup>

For example, suppose that some credit buyers (the good credit risks) have a very low probability of defaulting on their loans, while other buyers (the bad risks) are six times as likely to default. Suppose, though, that sellers can't tell which buyers are good risks and which ones are bad risks. Sellers can, of course, get a lot of information by looking at buyers' credit records and employment histories. However, within any group of buyers with similar credit records and employment histories, there will always be some unobservable factors that make some of these buyers relatively good risks and others relatively bad risks. These differences in risk that remain, after sellers have done whatever screening they can, are the differences I want to focus on here.

To make the example more concrete, suppose that if sellers could find out who the good-risk buyers are, they would be willing to loan to those buyers at a 10% interest rate, while they would only be willing to loan to the bad-risk buyers at an interest rate of 20%. That is, a 10% interest rate would cover the sellers' expected losses to the good-risk group of buyers, but a 20% interest rate would be necessary to cover the higher expected losses to the bad-risk buyers. But if sellers don't know which buyers are which, they won't be able to charge one group of buyers 10% and the other group 20%. Instead, they'll have to charge a rate that's somewhere in between, to cover their expected losses from both groups of buyers. For example, if there are an equal number of good-risk and bad-risk buyers, sellers might have to charge an interest rate of 15% to cover their expected losses from both groups.

Now let's introduce a potentially inefficient contract term. Specifically, consider a clause in which buyers agree to let the seller

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<sup>17</sup> For technical economic models, see Janusz Ordover & Andrew Weiss, Information and the Law: Evaluating Legal Restrictions on Competitive Contracts, 71 Am. Econ. Rev. Papers & Proceedings 399, 403-04 (1981); Samuel A. Rea, Jr., Arm-Breaking, Consumer Credit, and Personal Bankruptcy, 22 Econ. Inquiry 188 (1984); Philippe Aghion & Benjamin Hermalin, Legal Restrictions on Private Contracts Can Enhance Efficiency, 6 J. Law, Econ., & Org. 381 (1990). A more accessible explanation can be found in Douglas G. Baird, Robert H. Gernter & Randal C. Picker, Game Theory and the Law 142-47 (1994).

repossess all their furniture if they default on their loan. Since I want to set the example up so that the clause *is* inefficient, let's assume that the threat of losing their furniture has no effect on the likelihood that buyers of either type will repay their loan. (Maybe the probability of being able to repay depends on events that are entirely beyond the buyer's control.) In fact, let's assume that the threat of repossession has no effect on anyone's behavior: all it does is transfer assets from the buyers to the seller. Finally, let's assume that this transfer creates a net loss, thus making the repossession clause inefficient overall. (The net loss might be because the used furniture is worth more to the buyers than it is to the seller, or it might just be because of the transaction costs associated with repossession.) These assumptions may be unrealistic—but I already told you that I was cooking the example to make sure repossession is inefficient.

I now have to make the example both more concrete and also a little more complicated. Let's quantify the inefficiencies associated with repossession by saying that the right to repossess reduces the interest rate sellers can charge by one percentage point, because it reduces the seller's losses if the buyer doesn't repay. That is, if sellers have a repossession clause in their contracts, they can afford to loan to all buyers at an interest rate of 14%, rather than the 15% rate they'd have to charge without the repossession clause. (If sellers could tell the two groups of buyers apart, they could loan at rates of 9% and 19%, rather than the 10% and 20% they have to charge without the right to repossess.<sup>18</sup>)

Suppose, though, that a repossession clause inflicts expected costs on the buyers which are equivalent to *more* than one percentage point in the interest rate. (This is what makes the repossession clause inefficient.) Specifically, suppose that the expected cost of the repossession clause to low-risk buyers is equivalent to two percentage points of interest, while the expected cost of the repossession clause to high-risk buyers is the equivalent of twelve percentage points of

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<sup>18</sup> In a more realistic example, the repossession clause might reduce the interest rate sellers charged the high-risk buyers by more than it would reduce the interest rate they could charge the low-risk buyers, as the repossession clause would be more likely to come into play against the high-risk buyers (who, by definition, are more likely to default). Introducing this refinement, though, would merely make the example more complex without changing the basic point.

interest. The expected cost is greater to high-risk buyers because they're the ones that are most likely to default, and thus most likely to have their furniture repossessed. But as I've set up the numbers, the repossession clause is actually inefficient for both groups of buyers. In each case, the expected cost to the buyers exceeds the expected savings the clause yields for sellers.

Now we come to the potential for market failure. Even if the repossession clause is inefficient for both groups of buyers, the low-risk buyers may nonetheless find that it pays to agree to this clause, in spite of the clause's inefficiency. Here's why. No high-risk buyer would ever agree to this clause, because the expected cost to a high-risk buyer (the equivalent of twelve percentage points of interest) is far too high. But this means that any buyer who does agree to the repossession clause must be a low-risk buyer. If sellers are smart enough to figure this out, that means they can lend to anybody who's willing to agree to a repossession clause at the low-risk buyer rate (9%). And if low-risk buyers can get credit at 9% by agreeing to a repossession clause, that's a better deal than refusing to agree to the repossession clause and having to pay 15%. (If the low-risk buyers don't agree to the repossession clause, the seller won't have any way of telling them from the high-risk buyers, and she'll have to charge them all 15%).

Meanwhile, once the low-risk buyers all agree to the repossession clause, sellers will then be able to figure out that anybody who refuses to agree to that clause is a high-risk borrower. Consequently, sellers will charge anybody who doesn't agree to the repossession clause the interest rate appropriate to high-risk buyers: 20%. High-risk buyers cannot do better by agreeing to the repossession clause and paying a nominal rate of 9%, since (as noted above) the clause inflicts expected costs on high-risk buyers equal to an additional twelve percentage points, which more than wipes out the reduction in the nominal interest rate. In the end, therefore, all high-risk buyers will pay a 20% rate and will not be subject to a repossession clause; while all low-risk buyers will pay a 9% nominal rate but will agree to a repossession clause, thus paying an effective rate equal to 11%. (The two contracts offered and accepted in equilibrium are shown in bold in Table I.)

TABLE I  
EFFECTIVE INTEREST RATES TO BUYERS

	Low-risk Buyers	High-risk Buyers	All Buyers (pooled)
Without repossession clause	10%	20%	15%
With repossession clause	11% (9%+2%)	31% (19%+12%)	—

NOTE: The repossession clause yields a 1% benefit to sellers, but has an expected cost equal to 2% for low-risk buyers and 12% for high-risk buyers.

In this example, then, the low-risk buyers agree to the repossession clause as a way of distinguishing themselves from the high-risk buyers. By distinguishing themselves from the high-risk buyers, the low-risk buyers get an interest rate six points lower than the 15% rate they would have to pay if all buyers refused to agree to the clause. This six-point savings is more than enough to offset the expected costs these low-risk buyers suffer as a result of the clause. But this savings to the low-risk buyers is mostly a transfer from the high-risk buyers, who are now going to have to pay an interest rate of 20% (rather than the 15% rate that they, too, would pay if all buyers refused to agree to the clause). The 'market failure' involved here is thus a form of externality, in which low-risk buyers are able to shift some costs to the high-risk buyers by agreeing to a clause which signals their low level of risk. The overall effect, though, is a loss in efficiency. The gains to the low-risk buyers and the losses to the high-risk buyers cancel out, and the only thing left is the cost imposed by the repossession clause itself.<sup>19</sup>

<sup>19</sup> In mathematical terms, the equilibrium involves the high-risk buyers paying an interest rate of 20% (with no repossession clause) and the low-risk buyers paying an effective rate of 11% (with a repossession clause). The average rate paid by all buyers is thus  $(11\% + 20\%) \div 2$ , or 15.5%. This is 0.5% higher than the 15% rate that all buyers would pay (with a repossession clause) if the repossession clause were banned, and sellers could no longer distinguish between high-risk and low-risk buyers. The 0.5% average loss comes from the fact that the clause inflicts a 1% deadweight loss on all loans to low-risk buyers,

At this point, let me repeat that I've cooked the numbers to make the example come out this way. It's just as easy to come up with variations on these numbers in which a repossession clause would be efficient. For example, in some cases it might not be efficient for sellers to loan to high-risk buyers, and a repossession clause might then be an effective way of preventing this inefficient result. In other cases, low-risk buyers might not be willing to borrow if they have to pay a 15% interest rate, in which case the only way those loans would ever take place is if low-risk buyers can distinguish themselves by agreeing to a repossession clause. In still other cases, the repossession clause might be efficient for all buyers—for example, if the threat of repossession creates more efficient incentives for buyers to take precautions against accidents that might leave them unable to repay.

In short, all I've shown so far is that it's *possible* for imperfect information to cause inefficient contract terms to persist in competitive markets. For this to justify the legal regulations of contract terms, we have to look at how effective the regulation will be at preventing these inefficiencies without creating new ones. In other words—and I promise this will be the last topic—we now have to turn to the question of legal remedies.

### III. REMEDIES

One remedy that I'm not going to address attempts to solve the information problem directly, by mandating the disclosure of information. This kind of remedy will not always be workable, for disclosure itself has costs, and sometimes there may be no information that could usefully (or practicably) be disclosed. In the high-risk/low-risk buyer example, for instance, it is hard to think of any specific piece of information that buyers could possibly disclose. Still, in any case in which disclosure *can* be used to restore the market to something close to the perfect information that I described earlier, a disclosure remedy is certainly worth considering. If disclosure rules could recreate the perfect market described earlier, it would then be

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who make up exactly half of the population in this example. (The 1% dead-weight loss on loans to low-risk buyers is because the repossession clause inflicts costs on those buyers equal to 2%, but benefits sellers by only 1%.)

unnecessary for courts to try to decide which contract terms were inefficient.<sup>20</sup>

My focus here, though, is on direct restrictions on freedom of contract, in the form of bans on the enforcement of certain contractual terms. I showed earlier that there could be cases where the market could generate inefficient terms. The problem I want to point to now is that, even if we're certain that the market is working inefficiently, we still may not know which terms we ought to ban.

This is easiest to see in the high-risk/low-risk example I just described. In my example, the repossession clause was in fact inefficient—but I also pointed out that, if the example were changed slightly, the repossession clause might well be efficient. The problem that a court or legislature is going to face is that it won't know for sure which theoretical model best describes any particular real-world contract. This problem introduces another risk: the risk that the legal system, in attempting to increase the efficiency of markets, may make a mistake and end up reducing efficiency.

The same problem comes up in my first two examples, stories, where buyers were the ones who were imperfectly informed about sellers' contract terms. Even when buyers know nothing at all about the contracts they sign, it hardly follows that *every* term ought to be prohibited, for if every term were prohibited then no enforceable contract could ever be signed. Instead, even in such an extreme case of imperfect information, courts still have to be able to tell whether any given clause produces net efficiency benefits or net efficiency losses. You can think of this as the economic analog of the legal distinction between procedural unconscionability and substantive unconscionability.<sup>21</sup> Even if we're sure there's something wrong with the market processes that generated the contract terms—the economic equivalent of procedural unconscionability—we also have to

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<sup>20</sup> For more extended discussions of the costs and benefits of information disclosure, see Beales, Craswell & Salop, *supra* note 13; Alan Schwartz & Louis L. Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. Pa. L. Rev. 630 (1979).

<sup>21</sup> The legal distinction is due to Arthur Alan Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. Pa. L. Rev. 485, 487 (1967). For more on an economic interpretation of this distinction, see Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. Chi. L. Rev. 1, 17-20 (1993).

be sure the clause is substantively undesirable before it makes sense to ban the clause.<sup>22</sup>

In other words, even when we are quite sure that the market is not working perfectly, the market can be improved upon only if a court or legislature can ban the inefficient terms without also banning the efficient ones. This requires the court to be able to determine whether any given clause is inefficient or not. But a direct analysis of the efficiency of any given clause will often be very difficult, and courts (or other legal institutions) may not be very good at this task.

Think about it this way: most challenged contract terms produce both good and bad effects. For example, a term limiting a manufacturer's liability under a product warranty might, on the one hand, reduce the manufacturer's incentive to produce a reliable product. This effect, taken by itself, would probably be a bad one (in efficiency terms), since it could lead to an inefficiently low level of product reliability. On the other hand, the same term might increase the customer's incentive to use the product more carefully. This effect, taken by itself, would probably be a good one in efficiency terms. On the third hand—for those of you who have three hands—the same term would also reduce the extent of customers' insurance, by limiting the compensation they would receive if the product was defective. This effect could be either good or bad, depending on the degree of consumers' risk-aversion.<sup>23</sup>

Now, there's a lot more that could be said about each of these three effects, as well as other effects that I haven't even mentioned. However, this is enough to give you a general idea of the kind of things that a court would have to consider in any direct evaluation of the efficiency or inefficiency of a challenged term. Moreover, the court would also need some way to estimate the approximate size of

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<sup>22</sup> A ban on the enforcement of even efficient terms could be justified as a kind of penalty against sellers who fail to comply with a mandatory disclosure program of the sort described at the beginning of this section (see text *supra* at note 20). However, this makes sense only when disclosure is both feasible and desirable. For a further discussion of this possibility, see Craswell, *supra* note 21, at 7-12.

<sup>23</sup> Risk-aversion, in this context, is just economic jargon for, 'depending on whether consumers want insurance strongly enough to be willing to pay for it.'

the good and bad effects, to figure out whether the net effect was good or bad. But measuring the actual size of any of these effects will usually be extremely difficult, at least at the present state of our knowledge. While there's been a great deal of theoretical work identifying the effects that *might* be present in any given case, there's been much less empirical work aimed at measuring the exact size of those effects. Moreover, the size of the effects will probably vary from market to market or from industry to industry, so empirical studies of the size of the effects in one kind of contract may not tell us much about the size of the effects in other contracts. This could make it difficult for even a trained analyst to decide whether any particular contract term is inefficient or not. And if we're imagining a legal test in which courts (and not trained analysts) would have to figure out whether a contract term is inefficient, the problems become even greater.

In short, the appropriate comparison here (as in so many other areas) is not between an imperfect market and a perfectly functioning legal system. Instead, the relevant comparison is between an admittedly imperfect market, on the one hand; and an admittedly imperfect legal system, on the other. Moreover, the imperfections of each institution are likely to vary significantly from case to case, or from industry to industry. In some industries, buyers may be quite well-informed and the market may work very well; in others the industries, market imperfections may be much more serious. Presumably, the same is true of the imperfections of the legal system—though these imperfections are, at present, much less understood.

What this means is that we have a good deal more to learn about the potential inefficiencies of markets, on the one hand, and the potential inefficiencies of governmental efforts to improve those markets, on the other. I realize that it may be a bit self-serving for an academic professor to conclude 'further research is needed,' but I think that's the only conclusion possible here. We've certainly come a long way in our understanding of the economic effects of limits on contract terms—but we've also got a long way to go.

## IV. CONCLUSION

To some of you, it might seem odd that I've devoted most of a Coase Lecture to talking about market failures. There's a popular impression that economists in general, and maybe University of Chicago economists in particular, spend most of their time proving that markets do *not* fail. I want to close, though, by suggesting that the comparative analysis I've just highlighted is actually in the best Chicago tradition, if that tradition is properly understood. Indeed, this sort of comparative analysis is similar in many ways to the comparison called for in Ronald Coase's pathbreaking 1937 article, 'The Nature of the Firm.'<sup>24</sup>

Coase's article did not begin by assuming that prices and markets always worked perfectly. Instead, he pointed out that many economic activities—specifically, the production and allocation decisions that take place within a firm—have deliberately been removed from the workings of ordinary markets and subjected instead to a sort of hierarchical or command-control ordering system. For example, factory managers don't normally put each day's jobs out to bid to the different members of the factory's work force, or require their workers to buy each day's supplies from the inventory room at a market-clearing price. Instead, the question of how many workers to hire and how many supplies to stock is generally decided centrally by the factory's management. The allocation of those workers and supplies on a day-to-day basis also is usually left to centralized planning within the factory.

For Coase, the question was what explained the existence of these 'islands' of centralized planning within an otherwise market economy. His insight was to realize that this question could not be answered from a theoretical framework which assumed that markets always worked perfectly. Instead, the way to answer a question like this was (a) to recognize that markets generally entail frictions or costs; (b) to recognize that the alternatives to markets (in this case, hierarchical allocation systems) also have costs; and (c) to begin the inquiry into the exact nature and extent of those costs, in order to figure out where and when each regime would minimize the total costs. (Of course, Coase's insistence on the importance of transac-

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<sup>24</sup> Ronald H. Coase, *The Nature of the Firm*, 4 *Economica* 386 (1937).

tion costs was also to lead to his 'Coase Theorem' article,<sup>25</sup> and eventually to a Nobel prize in economics.)

In short, one of Coase's insights was that both markets and their alternatives have imperfections, and that the most interesting questions concern the nature and degree of the imperfections of each. I believe that this same insight must drive any inquiries into the efficiency of restrictions on freedom of contract. If one starts with the premise that markets are always efficient, the inquiry will be over as soon as it is begun, and any analysis of the comparative efficiency or inefficiency of judicial and regulatory regimes will never get off the ground. If we instead recognize that markets may not always work perfectly, and we also recognize that this conclusion is not itself sufficient to justify the legal regulation of contract terms, we can then proceed to the questions that are really worth studying.

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<sup>25</sup> Ronald H. Coase, 'The Problem of Social Cost,' 3 *J. Law & Econ.* 1 (1960). (The phrase, 'Coase Theorem' —never mentioned in the article itself—was coined by later scholars.)

Coase's insights into the nature of the firm have since become the basis for an entire branch of industrial organization economics. For citations to this literature see, e.g., Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 90 *Colum. L. Rev.* 1757 (1989); Conference Issue, *Contracts and the Activities of Firms*, 34 *J. Law & Econ.* 451 (1991); Oliver E. Williamson, *Markets and Hierarchies: Analysis and Antitrust Implications* (1975).



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