EFFICIENCY AND RATIONAL BARGAINING IN CONTRACTUAL SETTINGS

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I owe a rather large debt to Jules Coleman. In the early 1980s, when I was beginning to think seriously about law and economics, I had the good fortune to come across his exchange with Richard Posner concerning the relationship between efficiency and hypothetical consent in the normative justification of legal rules.[1] Judge Posner had argued that the rules that were most efficient could be justified both (a) on the basis of their efficiency *and* (b) on the basis of hypothetical consent, because it would be rational for all parties to consent to whatever rules were most efficient. Professor Coleman responded that justification (b) added nothing to the force of justification (a) if the consent involved in justification (b) was entirely hypothetical, and if the only reason for believing that the parties would have consented to the rule in question was the mere fact of that rule's efficiency.

Coleman's response persuaded me completely. As a result, in my own writings I have always tried to assess the efficiency of competing rules directly, without adding the superstructure of "this is what they would have agreed to" as a further justification for whatever rule turned out to be most efficient. Having been entirely persuaded by this aspect of Coleman's early writings, however, I now find that I am less persuaded by much of what *Risks and Wrongs* has to say on this issue.

This book, Coleman tells us, originated partly in an attempt to offer "a better defence [sic] of economic analysis than any Posner and the economists had to that point provided," by bas-

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1. Jules L. Coleman, *Efficiency, Exchange, and Auction: Philosophic Aspects of the Economic Approach to Law*, 68 CAL. L. REV. 221 (1980); Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980); Jules L. Coleman, *Efficiency, Utility, and Wealth Maximization*, 8 HOFSTRA L. REV. 509 (1980); Richard A. Posner, *A Reply to Some Recent Criticisms of the Efficiency Theory of the Common Law*, 9 HOFSTRA L. REV. 775 (1981). Coleman's essays were subsequently reprinted as Chapters 3 and 4 of JULES L. COLEMAN, MARKETS, MORALS, AND THE LAW (1988).

ing it on "a kind of rational choice contractarian political theory" rather than on any form of utilitarianism.[2] Ultimately, though, the enterprise of viewing law from the standpoint of rational choice theory led Coleman to develop his views further concerning the proper domain of, as well as the possible justifications for, economic analysis. In particular, Coleman concludes that the best interpretation of most of tort law (excluding products liability) is not provided by economics or by rational choice theory at all, but rather by a theory of corrective justice "which downplays somewhat the theory of rational risk management."[3] As a consequence, Coleman's attempt to provide a better normative defense of economic analysis ends up being limited to the domains of contract law and products liability.

In these comments, I will not address Coleman's theory of corrective justice, or his application of that analysis to tort law outside of products liability. Instead, my focus here is on Coleman's attempt to provide a better defense of economic analysis as applied to contract law and to products liability. While the portions of the book dealing with this topic contain much that is worthwhile, they do not do as much as they might to clarify the relationship between Coleman's analysis and more conventional economic analysis. Thus, my purposes here are: (1) to try to clarify the relationship between Coleman's rational bargaining theory and more conventional economic analysis, and (2) to argue that Coleman's theory adds little to conventional economic analysis, when conventional economic analysis is properly understood. As some of the confusion may be because of an inadequate recognition of the way that conventional economic analysis applies to contractual as opposed to non-contractual settings, I begin in Section I with a somewhat extended restatement of economic analysis as it applies to contractual settings. Section II then addresses the possible differences between conventional economic analysis and Coleman's rational bargaining theory.

I. Standard Efficiency Analysis

Standard neo-classical welfare economics begins by positing

2. Jules L. Coleman, Risks and Wrongs at iii (forthcoming 1992) (manuscript dated July 1991, on file with author; pages cited to manuscript).
3. *Id.* at v.

that individuals have preferences (or, in formal mathematical analysis, utility functions). To rank any two states of the world, the economist must first determine how much every individual will have, in each of the two possible states, of whatever that individual likes or dislikes. This determination permits a ranking of the two states from the standpoint of any given individual—that is, every individual will either prefer State A, prefer State B, or be indifferent between the two—but it does not by itself permit any overall ranking of the two states. To supply the overall ranking, the economist usually must posit the existence of a *social welfare function* to handle (among other things) comparisons between states of the world in which some individuals are better off while others are worse off.[4]

I describe welfare economics as "positing" the existence of a social welfare function because the shape of that function must depend on values and philosophies other than those supplied by economics. Just as economics does not purport to determine the content or shape of an individual's utility function, but instead must take those functions as given, economics also cannot determine how society ought to rank gains or losses to different individuals. Indeed, the exact shape of the social welfare function will often be controversial, although some aspects of it may command widespread agreement. For example, if State A differs from State B by giving some individuals more of whatever they prefer, without giving any other individuals less, State A should generally be ranked higher, at least in most cases (although perhaps not in all). In other words, most plausible social welfare functions should produce rankings that usually satisfy the criterion of Pareto superiority. But if individuals X and Y are better off in State A, while individual Z is better off in State B, the Pareto criterion does not help us, and the two states cannot be ranked without some further judgment about the relative claims to entitlement of individuals X, Y, and Z. The Kaldor-Hicks criterion—that is, whether individual Z gains enough in State B that he could afford to transfer enough money to individuals X and Y to make them no worse off than in State A—is one possible method of ranking the two states,

4. *See, e.g.*, PAUL SAMUELSON, FOUNDATIONS OF ECONOMIC ANALYSIS 219-30 (1947). As Coleman noted in 1980, most of the law-and-economics writing of Steven Shavell and Mitchell Polinsky (to cite two examples) can be placed in this tradition. *See* Coleman, *Efficiency, Utility, and Wealth Maximization*, *supra* note 1, at 548-49.

but it is not the only possibility. Even if the Kaldor-Hicks criterion were not satisfied, a social welfare function might still rank State B higher on the basis of some moral or political theory that gave individual Z a right to the benefits conferred by State B.

This thumbnail description of welfare economics leaves open a number of problems and questions, some of which will be addressed below. Fortunately, many of those problems are relatively unimportant when the analysis concerns parties who are already in a contractual relationship, as in the typical contract law or products liability case. Still more problems drop away if we assume that we are legislating for a single transaction between a single buyer and seller—or, equivalently, that we are legislating for a class of transactions involving homogeneous buyers and homogeneous sellers. While the assumption of single or homogeneous buyers and sellers is not always very realistic, it is a heuristic that is often employed in analyzing contractual relations, and it is one I will adopt throughout Section I.A. below. Some of the problems that arise when the law must legislate for transactions involving heterogeneous buyers or sellers will be discussed in Section I.B.

A. *Simple Contractual Relations*

For now, let us make the discussion more concrete by considering a particular question—whether breach of some particular contractual obligation ought to entitle the non-breaching party to an injunction compelling performance of the obligation—"specific performance"—or merely to monetary damages equal to the value of the obligation—"expectation damages."[5] One effect of a rule of specific performance will be to increase the expected costs of the non-performing party, because there may

5. The discussion that follows focuses on only a few of the possible efficiency arguments concerning specific performance. For more extensive treatments of this topic in the law-and-economics literature, see, for example, Anthony T. Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978); Alan Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979); Timothy J. Muris, *The Costs of Freely Granting Specific Performance*, 1982 DUKE L.J. 1053; Thomas S. Ulen, *The Efficiency of Specific Performance: Toward a Unified Theory of Contract Remedies*, 83 MICH. L. REV. 341 (1984); William Bishop, *The Choice of Remedy for Breach of Contract*, 14 J. LEGAL STUD. 299 (1985); and Richard Craswell, *Contract Remedies, Renegotiation, and the Theory of Efficient Breach*, 61 S. CAL. L. REV. 629 (1988). Needless to say, this example (and others that will follow) is not intended to advance the analysis of specific performance or any other remedy, but merely to provide examples to illuminate the nature of efficiency analysis and the implications of Coleman's rational bargaining theory.

be cases where it would cost that party more to perform the obligation than it would cost to pay the other party's expectation damages. For example, (a) the costs of performance might unexpectedly increase, as when a builder mistakenly uses the wrong brand of pipe in constructing a house and the pipe cannot be replaced without tearing down the house and rebuilding it again;[6] or (b) even if the cost of performance has not changed, expectation damages might be measured incorrectly and set at an unrealistically low level. Either of these scenarios would make specific performance more costly than expectation damages to the non-performing party. On the other hand, specific performance may also be more valuable to the injured party than expectation damages would be, if (a) specific performance would allow the injured party to threaten to force the non-performing party to perform unexpectedly costly repairs, and thereby extract a settlement in excess of what performance would have been worth; or if (b) expectation damages are incorrectly set too low, so that the injured party would prefer performance to expectation damages. At first glance, then, it appears that a rule of specific performance can only hurt the non-performing party and can only help the injured party.

1. *Kaldor-Hicks Efficiency*

One way to evaluate these mixed effects is to adopt the Kaldor-Hicks criterion and ask whether the injured party is likely to gain more or less than the non-performing party would lose from a rule of specific performance. This approach is equivalent to asking whether there are any gains or losses that are not mere transfers from one party to the other, or, in Coleman's terminology, whether either of these remedies has any "productive" dimension. The answer to this question is that while any monetary payment that changes hands after a breach may well be a pure transfer, the prospect of having to make such a payment could induce a number of additional productive (or destructive) effects.

For example, in the scenarios that were earlier labeled (a), in which the cost of performance increased unexpectedly, a rule of specific performance could cause some parties to perform even when performance would be inefficient in a Kaldor-Hicks

6. *See* Jacob & Youngs, Inc. v. Kent, 129 N.E. 889 (N.Y. 1921).

sense, by costing the performing party more than the other party would gain from performance. To be sure, the performing party should be able to buy his way out of performance in such cases by offering an additional side-payment, which would be a mere transfer as far as the Kaldor-Hicks criterion was concerned. However, the risk of having to make such a payment would increase the variability of the returns to the non-performing party, and this increased variability would constitute an additional loss to any non-performing party who is risk-averse. This loss would be partially offset by the chance of a windfall gain to the other party, but if both parties were risk-averse the offset would not be complete, and the increased variability would cause a net loss overall. Moreover, the risk of having to make such a payment could lead the non-performing party to take excessive precautions against the kind of accident that could lead to such an increase in costs—for example, precautions against using the wrong pipe. To the extent those precautions were excessive, they too would constitute a net loss.

On the other hand, in the scenarios earlier labeled (b), in which expectation damages were set too low, specific performance is more likely to result in net gains. If expectation damages are set too low, then a rule of expectation damages might provide insufficient inducement for the non-performing party to perform—even when performance would be Kaldor-Hicks efficient—if the cost of performing exceeded the legal measure of expectation damages but fell below the value performance would have to the other party. Once again, the injured party should be able to induce performance in such a case by offering an additional side-payment, which would be another mere transfer as far as the Kaldor-Hicks criterion was concerned. However, the chance of having to make such a payment would increase the riskiness of the venture to the injured party. Moreover, the ability to demand such a payment or to get away with paying an excessively low measure of expectation damages might cause the non-performing party to take insufficient precautions against accidents that would prevent performance. At least as a first approximation, then, a rule of specific performance seems likely to pass the Kaldor-Hicks test if scenarios of type (b), in which expectation damages are too low, are more frequent than scenarios of type (a), in which the cost of performance increases unexpectedly. It is likely to fail the Kaldor-

Hicks test if scenarios of type (a) are more frequent than scenarios of type (b).

2. *Pareto Superiority*

The preceding analysis asked only whether one party would gain more than the other would lose from specific performance, without asking whether the loser would be compensated for his losses. In the simple contractual setting analyzed here, no additional analysis of the compensation question is required, because any remedy that is Kaldor-Hicks efficient when compared to some other remedy will also be Pareto-superior to that remedy.

Suppose, for example, that scenarios of type (b) are more likely, so that specific performance is Kaldor-Hicks efficient compared to ordinary expectation damages. This means that a rule of specific performance increases the costs of one party to the transaction, while simultaneously increasing the other party's expected benefits from the transaction by an even larger amount. In a contractual setting, the increase in the first party's expected costs should cause that party to demand a more favorable price before she will enter into the contract. Simultaneously, the increase in the second party's expected benefits should make that party willing to pay a more favorable price to induce the first party to enter the contract. The exact extent of the price increase, and the resulting division of the gains from the more efficient rule, will depend on the parties' relative bargaining abilities; this issue will be discussed later in Section II.D. For now, the key point is that the "losing" party's ability to demand a more favorable price as a condition of entering into the contract should prevent that party from being any worse off as a result of the law's adoption of the more efficient remedy.[7] Consequently, any remedy that satisfies the demands

7. More precisely, neither party should be left any worse off in an *ex ante* sense: Each party's *expected* utility should either remain constant or increase whenever a Kaldor-Hicks efficient rule is adopted. If the contract involves some risk—for example, if the contract is for the sale of some commodity whose value fluctuates—then individual buyers or sellers may find themselves worse off *ex post*, if the risk turns out unfavorably to them. The Pareto and Kaldor-Hicks criteria are customarily applied only to parties' *ex ante* welfare, however. While this *ex ante* focus might seem odd at first glance, it simply means that *ex post* compensation is justified only when it improves (or leaves constant) the parties' *ex ante* welfare, and is not justified if the prospect of *ex post* compensation would reduce the parties' welfare *ex ante* (say, by making them pay a higher price for the right to receive compensation *ex post*). In effect, the choice of par-

of Kaldor-Hicks efficiency should also satisfy the test of Pareto superiority.

This conclusion highlights an important difference between legal rules governing the entitlements parties bring with them to the bargaining table—or, equivalently, legal rules governing the threat point each party can fall back on if no agreement is reached—as opposed to legal rules governing some or all of the terms that will become part of any agreement the parties do reach. Examples of legal rules that define the parties' pre-bargaining entitlements include those that prevent or permit factories to pollute the surrounding territories, or, in Coase's famous example, rules governing liability for the damage that ranchers' cattle may cause to surrounding crops. Indeed, most of tort law, with a few exceptions such as products liability, can be viewed as a set of rules defining the parties' pre-bargaining entitlements or threat points. Some contract rules—for example, the prohibitions against fraud or duress—also fall into this category, by defining the point on which each party is allowed to fall back if no voluntary agreement is reached.[8] These rules can all produce net gainers and net losers because there is no automatic mechanism, as there is for rules that will apply if and only if an agreement is reached, by which the disfavored party can demand a higher price as a condition of allowing the rule to take effect. Thus, when rules allocating pre-bargaining entitlements are at issue, the tests of Kaldor-Hicks efficiency and Pareto superiority will not always coincide.

Much of the law-and-economics literature, including almost all of Coleman's own writings, has concerned tort and property rules allocating pre-bargaining entitlements. It is therefore not surprising that so much attention has been given to the distinction between Kaldor-Hicks efficiency and Pareto superiority, and to the normative weaknesses of the former criterion as compared to the latter. However, this historical concern with the allocation of pre-bargaining entitlements should not cause us to overlook the differences between the two kinds of rules.

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ties' *ex ante* welfare as the basis for comparisons reflects a commitment to allowing the prospect of risky gains and losses to be balanced separately for each party, according to that individual's own attitudes toward risk.

8. For more extensive discussions of this point, see Anthony T. Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472 (1980); Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361, 386-87 (1991).

For example, Coleman's earlier assertion that "the economic analysis of law relies largely on the Kaldor-Hicks criterion of efficiency, less on Pareto optimality and almost not at all on Pareto superiority"[9] should probably be interpreted as a correct claim about the economic analysis *of rules governing pre-bargaining entitlements*. It is not a correct claim about the economic analysis of most contract rules.

3. *Hypothetical Consent*

Finally, it should by now be apparent that the choice between specific performance and expectation damages will come out the same way if, rather than asking which rule is Pareto superior or Kaldor-Hicks efficient, we instead ask what rule the parties would have agreed to if they had explicitly negotiated about remedies. The argument is trivial—in fact, it is essentially the same as the argument just presented.[10] If specific performance is Kaldor-Hicks efficient, in the sense of benefitting the second party more than it costs the first party, the second party should be willing to offer enough to make it in the first party's interest to consent to a rule of specific performance. In this setting, then, any rule that can be defended on the grounds of Kaldor-Hicks or Pareto superiority can also be defended on the grounds of hypothetical consent.

However, this use of hypothetical consent adds nothing to an efficiency argument based on Kaldor-Hicks efficiency or Pareto superiority. As Coleman puts it in his present work:

> [T]here appears to be nothing expressed by the concept of hypothetical consent that is not already captured in the idea of rational self-interest. . . . The claim that imposing obligations *ex post* is justified because the parties would have consented to them *ex ante* adds nothing to a defense of such a proposal that is not already expressed by the argument that imposing obligations *ex post* is justified whenever such obligations would have been *rational* for the parties *ex ante*. Thus, one might say that the reliance on *ex ante* rational bargaining provides a rationality or welfarist defense of the default rule, not a consensualist one.[11]

In particular, this use of hypothetical consent does not avoid

9. COLEMAN, MARKETS, MORALS, AND THE LAW, *supra* note 1, at *x*.

10. For a formal demonstration of this point, see, for example, Steven Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466, 475 (1980).

11. COLEMAN, *supra* note 2, at 272.

any of the problems to which the Kaldor-Hicks criterion is subject even in the simple contractual setting where Kaldor-Hicks efficiency and Pareto superiority coincide. For example, the test of Kaldor-Hicks efficiency (and therefore, in this context, the test of Pareto superiority as well) rests on comparisons of the amount that different individuals would be willing to pay for the right to demand specific performance or the right to demand expectation damages. It is therefore still subject to the criticisms that can be levelled against the concept of willingness to pay. Individuals' willingness to pay might be distorted by false consciousness, for instance, or by an unjust distribution of wealth that leaves all the purchasing power in the hands of a few individuals.[12] There might also be some remedies that are incommensurable with any other goods, so that the notion of willingness to pay could not even be coherently defined.[13] Whatever one thinks of these criticisms, their strength is not altered in any way by casting a Pareto or Kaldor-Hicks argument in terms of hypothetical consent, in the manner described above. As long as one's conclusions about what rule the parties would have hypothetically consented to rest entirely on one's conclusions about what rule would be Kaldor-Hicks efficient, any criticism of the Kaldor-Hicks analysis will apply with equal force to the conclusion about hypothetical consent.

To be sure, there is nothing necessarily wrong with describing the most efficient remedy as "the remedy to which rational parties would have consented." In the simple contractual setting analyzed here, the remedy that is Kaldor-Hicks efficient will also be the remedy that is Pareto-superior and will also be the remedy to which the parties would have consented, so any of these three descriptions can be used interchangeably. Referring to the rule to which rational parties would have consented may even be useful as a way of underscoring the fact that, in this setting, such a rule satisfies the rather strong criterion of Pareto superiority, not merely the weaker Kaldor-Hicks criterion.

12. For a survey of the literature on these arguments, see MARK KELMAN, A GUIDE TO CRITICAL LEGAL STUDIES 126-50 (1987).

13. *See* JOSEPH RAZ, THE MORALITY OF FREEDOM 123-32 (1985). Others have argued that even when it is possible to translate preferences into notions of willingness to pay, doing so may alter the character of those preferences, sometimes for the worse. *See, e.g.*, Margaret Jane Radin, *Market-Inalienability*, 100 HARV. L. REV. 1849, 1859-63, 1877-87 (1987).

In more complex settings, however, these various descriptions do not always converge, and references to the rule to which rational parties would have consented are likely to be more confusing than helpful. To document this claim, the following subsection describes some of those more complex settings.

B. *Some More Complex Contractual Relations*

1. *Heterogeneous Transactions*

As an initial example, suppose that a remedy of specific performance would be more efficient for eighty percent of all buyer-seller pairs, while the remaining twenty percent of contracting pairs would find a remedy of expectation damages more efficient. For example, suppose that eighty percent of the pairs are contracting in circumstances where it is likely that expectation damages will be measured too low, while only twenty percent are contracting in circumstances where it is more likely that the performing party's costs will increase. Suppose further that the law cannot reliably distinguish between these two situations, so it must adopt a single default rule to apply to all contracts (unless the parties specify otherwise) rather than a more complex default rule calling for specific performance in some circumstances and expectation damages in others. Finally, suppose that transaction costs are low enough that, whichever remedy the law selects as its default rule, those contracting pairs for whom the other remedy would have been more efficient will always take the trouble to negotiate and explicitly provide for that alternative remedy in their contract.

Under these assumptions, it is Kaldor-Hicks efficient for the law to adopt as a default rule the remedy that minimizes the total costs incurred by contracting pairs who must negotiate for and specify an alternative remedy. If, as seems likely, it is just as expensive to negotiate a provision calling for specific performance as it is to negotiate a provision calling for expectation damages, specific performance would be the most efficient default rule for the law to adopt because this would require only twenty percent of the contracting parties to specify otherwise. On the other hand, if negotiating for an expectation damages clause costs more than four times as much as negotiating for a specific performance clause, total transaction costs would be

lower if the law adopted expectation damages as its default remedy.[14]

In this context, however, the criteria of Kaldor-Hicks efficiency and Pareto superiority diverge. Moving from a default rule of expectation damages to a default rule of specific performance will increase Kaldor-Hicks efficiency, if such a move would lead to a net reduction in transaction costs. Such a move will not be Pareto superior, however, for its effect will be to force some contracting pairs—those for whom specific performance would have been more efficient—to incur additional negotiating costs that they would not have had to incur if the default rule were expectation damages. These contracting pairs will therefore be left worse off as a result of such a move, and the test for Pareto superiority will not be satisfied.[15]

Notice, by the way, that the reason Pareto superiority is not achieved here is not because one party to a transaction has gained *at the expense of the other party to that transaction.* The problem is not that buyers are being favored at the expense of sellers, or vice versa, but rather that certain buyer-seller pairs are being favored at the expense of other buyer-seller pairs. Viewing any single buyer-seller pair in isolation, the move should still qualify as either Pareto-superior (if that pair's transaction costs have gone down) or Pareto-inferior (if their transaction costs have gone up), because adjustments in the price should lead both members of the pair to share any increase or decrease in transaction costs. Unfortunately, there is no similar mechanism by which those pairs who must incur extra negotiating costs can demand a more favorable price from those pairs

14. For a more formal analysis of this choice, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 112-15 (1989).

It should perhaps be noted that the most efficient rule is not always the rule that minimizes transaction costs. The identity between "the rule that is Kaldor-Hicks efficient" and "the rule that minimizes transaction costs" occurs only under the assumptions stated in the text, which guarantee that the same set of transactions will take place regardless of which rule is adopted, so the only possible difference between the two rules will consist of the cost of effectuating that set of transactions. The following subsection presents an example where the most efficient rule cannot be defined as the rule that minimizes total transaction costs—unless, of course, "transaction costs" are defined so broadly as to make that concept meaningless.

15. A move in the opposite direction, from a default rule of specific performance to a default rule of expectation damages, also would fail the test for Pareto superiority, because such a move would force contracting pairs who preferred specific performance to incur additional, uncompensated transaction costs. Thus, either default rule would be Pareto-optimal, but neither would be Pareto-superior to the other.

who have their negotiating costs reduced. As the two groups of buyer-seller pairs are not in any contracting relationship with each other, some pairs will end up as net winners while others will end up as net losers.

Because some pairs will gain while others lose, some additional normative argument is needed to justify the law's adoption of the default rule that is Kaldor-Hicks efficient. The fact that the winners' gains exceed the losers' losses is not itself sufficient justification, without some further explanation for weighing the losers' losses no better than equally with the winners' gains. In many contractual settings, of course, a principle of equal weight may be relatively attractive, either because we have no systematic reason for favoring one group over another, or because we expect that in the long run most individuals will find themselves in the winning group just as often as in the losing group.[16] If the two groups differed in some systematic way, however—for example, if (for some reason) specific performance were generally more efficient in contracts involving consumer buyers, while expectation damages were more efficient in sales between merchants—we might then have a reason to weigh one group's losses more heavily than another's, or perhaps even to abandon the weighing metaphor and to completely disregard one group's losses. If so, the social welfare function implicit in such a judgment would reflect a method of evaluating different groups' gains and losses that differed from the Kaldor-Hicks criterion.

Finally, notice that no matter which rule we select—either the rule that is Kaldor-Hicks efficient or the rule that ranks highest according to some other social welfare function—we cannot simply describe the law as having selected "the rule to which the contracting parties would have agreed." If the law selects specific performance as its default rule, for example, this description will be true for eighty percent of the contracting parties but false for the other twenty percent.[17] In-

16. For examples of this latter argument, see A. Mitchell Polinsky, *Probabilistic Compensation Criteria*, 86 Q.J. Econ. 407 (1972); Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, *supra* note 1, at 491-95; *see also infra* note 23.

17. A similar point is made in Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 101 Yale L.J. 729, 733-34 (1992) and in David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 Mich. L. Rev. 1815, 1841-43 (1991). Coleman, too, recognizes this point, when he describes Alan Schwartz as attempting to develop a set of default rules that would apply to all consumers and producers. "Of course," Coleman adds, "it hardly seems accurate to

deed, the rule the law selects may not even be the rule to which *most* contracting parties would have agreed, if asymmetries in transaction costs lead some other rule to be Kaldor-Hicks efficient, or if a social welfare function other than Kaldor-Hicks efficiency is selected.

To summarize, then: When all contracting pairs are identical, or when only a single transaction is being regulated, the remedy that is Kaldor-Hicks efficient will also be Pareto-superior, and can also be described as the remedy to which rational parties would have agreed if they had negotiated. When all contracting pairs are not identical, however, the remedy that is Kaldor-Hicks efficient generally will not be Pareto-superior to any rival remedy, and can at most be described as the remedy to which *some* rational parties would have agreed.

2. *Heterogeneity and Imperfect Information*

The preceding example relaxed the assumption of homogeneous transactions but maintained the assumption that all parties were perfectly informed about the transaction into which they were entering. If the perfect information assumption is relaxed, the analysis becomes even more complex.[18]

As an example, suppose that different plots of land differ in their susceptibility to erosion, or to some other risk that would reduce their value as a building site without affecting their value for recreational uses. Suppose further that each potential seller knows the riskiness of his land, and the use to which each buyer intends to put the land, but that (a) buyers do not know which land is risky and which land is safe, (b) sellers cannot credibly communicate their knowledge to buyers, and (c) buyers cannot cost-effectively gather this information from any other sources. Finally, suppose that the question the law must answer is whether sellers should be liable for any damages buyers suffer because of erosion or whether buyers should be left

claim that such a procedure follows from the principle of consumer sovereignty which applies to *particular* contractual arrangements between *specific* contracting parties." COLEMAN, *supra* note 2, at 282 (emphasis added). Coleman's other uses of Schwartz's analysis of products liability law will be discussed in more detail below in Section II.C.

18. Still more complex examples are possible if heterogeneity and imperfect information are combined with monopoly power on one side of the transaction. For useful analyses of some of these cases, see Ayres & Gertner, *supra* note 17; Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990).

to bear that loss themselves.[19] For simplicity, assume in this case that transaction costs are relatively high, so that the default rule the law selects will be left in place by every contracting pair.

Under these assumptions, a rule holding sellers responsible for buyers' erosion losses might well be Kaldor-Hicks efficient. Such a rule would force sellers to reflect their potential liability payments in the price of the land, thus forcing sellers of the riskier plots of land to charge a higher price (*ceteris paribus*) than sellers of relatively safe plots of land. As a result, buyers who plan to build will tend to purchase the lots that are most suitable for building, and will tend not to purchase the lots that are most suitably left undeveloped (unless those lots have some other advantage that more than offsets the extra risk). Without such a rule, uninformed buyers would be just as likely to buy the risky plots for building and leave the safer plots vacant. The total benefits net of total damages will be greater if buyers make more appropriate purchase decisions, so a rule that induces more appropriate decisions by reflecting the risk of erosion in the land's price should qualify as Kaldor-Hicks efficient.

Once again, though, the adoption of such a rule would not represent a Pareto-superior improvement. Sellers who own relatively safe parcels of land, and buyers as a class, would probably gain from such a rule, but sellers who own relatively risky parcels of land would almost surely lose. Thus, some further normative argument would again be needed to explain why the (greater) gains to buyers and to owners of relatively safe parcels justify imposing the (smaller) losses on owners of relatively risky parcels.

For similar reasons, a rule of strict seller liability cannot necessarily be described as the rule to which all rational parties would agree in this situation. Admittedly, it is possible that all rational *buyers* might negotiate for such a rule, if they were sufficiently aware of their own ignorance and of the desirable incentive effects this rule would produce. Moreover, if buyers did adopt this negotiating strategy, sellers who owned relatively safe parcels of land would probably also agree to a rule of strict seller liability, because these sellers could assume such a risk at

19. For a real case raising such an issue, see Cook v. Salishan Properties, Inc., 569 P.2d 1033 (Or. 1977) (finding no implied warranty against erosion in the sale of unimproved sites for ocean-front vacation homes).

a price most buyers would be willing to pay. But sellers who owned relatively risky parcels of land would not agree to such a rule—and, indeed, would probably end up not selling their land at all. If owners of risky land agreed to offer a warranty, their expected liability costs would raise their price to a level no buyer would be willing to pay. If owners of risky land refused to offer a warranty, then wise buyers would realize what that implied about the riskiness of the land and would still refuse to buy from those sellers. Of course, the elimination from the market of these risky parcels of land is exactly what ought to happen if we accept the normative standpoint of Kaldor-Hicks efficiency. From the standpoint of hypothetical consent, however, this result cannot be described as the result to which all buyers and sellers would have agreed—unless we somehow limit the universe of hypothetical consenters to those parties who we decide ought to be transacting, where the class who ought to be transacting is itself defined according to Kaldor-Hicks principles.

In short, where some of the potential gains in Kaldor-Hicks efficiency can only be realized by *preventing* certain transactions from occurring, at least some of the parties who would have participated in the foreclosed transactions will probably end up as net losers. Consequently, the rule that is Kaldor-Hicks efficient probably will not pass the test of Pareto superiority. Nor can that rule necessarily be described as the rule to which all rational parties would have agreed, unless the class of parties whose consent is being considered is suitably narrowed. Just as utilitarians face boundary problems in determining whose preferences should count, hypothetical consent theorists face analogous boundary problems in determining whose hypothetical consent should be considered.

C. *Hypothetical Consent as a Shorthand Description*

The preceding subsections presented a view of Kaldor-Hicks efficiency to which, I think, most law-and-economics scholars, especially those who analyze contractual relations, would be willing to agree. On this view, when certain simplifying assumptions are satisfied, the rule that is Kaldor-Hicks efficient can also be accurately described as the rule to which rational contracting parties would have agreed. When those simplifying assumptions are not met, however, the rule that is Kaldor-

Hicks efficient cannot always be so described, and there may not even be any single rule to which all rational parties would have agreed. In those more complex situations, analyzing the problem in terms of hypothetical consent rather than directly in terms of Kaldor-Hicks efficiency seems to me to be more confusing than helpful.

Moreover, even when the simplifying assumptions are satisfied, so that hypothetical consent and Kaldor-Hicks efficiency coincide, analyzing the problem in terms of hypothetical consent does not add anything. In the view presented above, Kaldor-Hicks efficiency is logically prior to hypothetical consent, in the sense that conclusions about what rule rational contracting parties would have agreed to can be answered only by determining whether one party would gain from the rule more than enough to let that party compensate the other's losses. Thus, even when conclusions about Kaldor-Hicks efficiency *can* be translated into conclusions about what rule rational contracting parties would have chosen, there is little reason to do so. To be sure, some economists, such as James Buchanan, could be read as suggesting that this relationship might be reversed, and that the efficient rule can only be defined by reference to the consent of the relevant parties.[20] As Coleman notes, however, this definition of efficiency represents a departure from "orthodox" economic analysis.[21]

For most economists, then, statements about what rule rational parties would agree to in simple contractual settings are best understood as a kind of metaphor, or a shorthand way of referring to the rule that is most efficient in a traditional Kaldor-Hicks sense. The same is true of another shorthand phrase that is sometimes used to describe the most efficient rule: the rule that would be produced by a perfectly functioning competitive market. Indeed, both of these descriptions are on a par analytically with another metaphor or shorthand phrase that economists often use to describe the most efficient rule: the rule that would be adopted by an omniscient social planner. None of these metaphors calls for an independent method of analysis, in which one first tries to imagine some rational contracting parties (or an omniscient social planner) and then tries

20. *See* COLEMAN, MARKETS, MORALS, AND THE LAW, *supra* note 1, at 142-50 (analyzing Buchanan's theories of constitutional choice).

21. COLEMAN, *supra* note 2, at 97.

to determine *by some other means* what those imaginary parties would do. Instead, the metaphors are simply alternative ways of describing rules that have already been identified as passing the Kaldor-Hicks criterion by generating gains in excess of losses.

II. The Analysis of Risks and Wrongs

I now turn to the following question: What does Coleman's analysis add to the more-or-less standard view of economic analysis set forth above? The early portions of *Risks and Wrongs* are not organized in a way that highlights the answer to this question, so it may help to begin by summarizing some of Coleman's arguments.

A. *The Market Paradigm*

Part I of *Risks and Wrongs* begins with a discussion of three kinds of rationality: collective rationality, individual rationality, and division rationality. Collective rationality requires that no potential gains from interaction be left unexploited; it thus rules out all Pareto-inferior equilibria.[22] Individual rationality requires that no individual be left worse off than if he had refused to cooperate; it thus limits our attention to those collectively rational equilibria that lie to the "northeast" of the noncooperative threat point, in the sense of leaving every individual at least as well off as he would be at that threat point.[23] Finally, division rationality (also referred to as concession rationality) specifies how the gains from cooperation should be divided among the parties; it thus has the potential to let us choose from among the multiple equilibria that may satisfy the first two rationality criteria. The concept of division rationality represents a departure from standard economic theory, and thus could distinguish Coleman's analysis from more conventional economics. However, the concept of division rationality plays very little role in Coleman's subsequent analysis, as I discuss below in Section II.D.

The early sections of *Risks and Wrongs* also introduce what Coleman labels the "market paradigm." As defined by Coleman, the market paradigm holds that legal, political, and moral institutions "are to be understood as rational responses to the

22. *See id.* at 6-8.
23. *See id.* at 4-6.

generic problem of market failure, and are justified to the extent that they replicate the outcomes of competitive markets."[24] The market paradigm, Coleman says, is committed to two basic postulates: The first is the principle of rationality; the second is the economist's conception of the perfectly competitive market as its ideal institutional embodiment.[25] As examples of this view, Coleman mentions not only law and economics,[26] but also David Gauthier's view that moral and other constraints are unnecessary under conditions of perfect competition, thus making a perfectly competitive market "a morally free zone."[27]

Coleman ultimately rejects the market paradigm, however, because the notion of perfect competition itself presupposes certain constraints on individual action. Perfect competition presupposes a system of entitlements or property rights; it further presupposes limits on certain forms of predation, such as force or fraud.[28] It also presupposes rules defining the means by which entitlements can be transferred—in other words, the body of rules normally thought of as contract law. As a result, Coleman argues, moral and legal principles requiring certain modes of cooperation cannot be viewed as mere secondary principles that are needed only when and to the extent competition fails for some reason. Instead, moral and legal restraints have just as much claim to be considered as logically prior to the notion of perfect competition—or, more precisely, neither has any claim to be considered logically prior to the other.[29]

As an aside, I should note that standard economic analysis would also reject the market paradigm as Coleman states it. In the standard view of economics described earlier, Kaldor-Hicks efficiency, or some other social welfare function, is the logically prior goal, and the question of which institution will best achieve that goal is a contingent, empirical question. Admittedly, most American economists believe that markets serve that goal fairly well, but they hold that view (or should hold it) as an empirical belief, not as a first premise or as a logical entailment of their "paradigm."

24. *Id.* at xvi.
25. *See id.* at xiii.
26. *See id.*
27. *Id.* at xv (citing DAVID GAUTHIER, MORALS BY AGREEMENT (1986)).
28. *See id.* at 57.
29. *See id.* at 62.

Indeed, most economic research bearing on contract and products liability law need not even take a position on this question, for the central questions in contract and products liability law concern the kinds of background rules with which a market should be supplied, not whether we should have a market at all. Typical questions in these fields ask whether our products markets would operate better under a negligence rule or a rule of strict liability, or whether contracts should come with a specific performance remedy or with expectation damages. Any of these rules leave sellers free to decide what price to charge, and to compete for buyers' business in various other ways, so these rules all permit the operation of what would normally be described as a "market." The question of interest is what rules these markets will operate under, not whether to have a market at all.

In short, Coleman's reasons for rejecting the market paradigm are perfectly sound. Every market does require some set of background rules, so the choice between competing background rules cannot be made simply by adopting "the market" as a prior normative benchmark. My only concern here is that the reader should not interpret Coleman's criticisms of the market paradigm as criticisms of law and economics, for most scholarship in law and economics does not use the market paradigm in this manner.

B. *The Selection of Background Rules*

In any event, having rejected the market paradigm, Coleman offers a different defense of markets: "[T]hey allow interaction among individuals without first requiring or presuming the existence of broad agreement about fundamental values, goods or ends . . . among exchange partners."[30] In this way, Coleman argues, markets make it more likely that individuals will be able to realize some or all of the potential gains from cooperation, especially in heterogeneous societies whose members are very likely *not* to agree about fundamental values and ends. By doing so, markets may also contribute to the overall stability of the society, thereby facilitating cooperation in an even more important way by warding off the anarchy or civil war that might otherwise result. Thus, Coleman concludes, the strongest justi-

30. *Id.* at 59.

fication of markets "has more to do with a desire to finesse or to avoid articulating the nature and scope of fundamental disagreements that may lead to instability than it has to do with the efficiency properties of such arrangements."[31]

This defense of markets is undoubtedly intriguing. Even if we accept this defense, however, law or morality must still determine the background rules under which markets should operate in any particular society. For example, should we have a regime of strict liability or negligence? A regime of specific performance or of expectation damages? Coleman's analysis to this point in the book leaves him with (at least) two possible strategies for making choices such as these.

One strategy is to endorse whatever secondary or background rules best serve the goal of finessing fundamental disagreements that might lead to instability—the goal that, for Coleman, provides the ultimate justification of a market system. Under this strategy, for example, the remedy of specific performance might be preferable to the remedy of expectation damages because specific performance does not require a court or any other public institution to set a value on the nonbreacher's loss, and thus could be administered even in a society marked by profound disagreements regarding loss valuation. Similarly, strict liability might be preferable to negligence because, while both require a court to set a value on the victim's loss, strict liability at least does not require a court or other public institution to make an authoritative announcement about what counts as reasonable behavior. In other words, under this strategy the choice of particular legal rules—as well as the choice of the market as a basic institution—could be placed on a footing "that has more to do with a desire to finesse . . . fundamental disagreements that may lead to instability than it has to do with the efficiency properties"[32] of particular rules. If Coleman had followed this strategy, his analysis would almost certainly have diverged from the standard economic analysis described in Section I of this paper, for this strategy would endorse specific performance and strict liability for their stability-preserving properties even when those rules were not the most efficient ones.

31. *Id.* at 61.
32. *Id.*

This is not, however, the strategy Coleman follows in *Risks and Wrongs*. As noted earlier, his justification for markets was that markets make it *more likely that individuals will be able to realize the potential gains from cooperation* without requiring public decisions that would risk social instability in societies whose members disagree about fundamental goals. Thus, rather than endorsing particular background rules on the basis of warding off social instability, it is also open to Coleman to endorse background rules on the basis of their contribution to individuals' ability to realize the potential gains from cooperation. In other words, Coleman can choose the appropriate background rules on the basis of their contribution to the first half of his justification for markets, rather than for their contribution to the second. This is the strategy Coleman adopts for the remainder of the book, at least with respect to the law of contracts and products liability.

In pursuit of this strategy, Chapter 5 identifies three phases of contracting, and three possible types of "contract failure," which may lead individuals to fail to realize the potential gains from cooperation. These three types of contract failure correspond to the three kinds of rationality discussed earlier. Individuals may fail to identify an opportunity for potential gains (a failure of collective rationality), or fail to agree on how the gains should be divided (a failure of division rationality), or fail to ensure that both parties will have a reason to comply with any agreement that is reached (a failure of individual rationality). In this view, the role of contract and products liability law is to help individuals overcome these sources of contract failure, thereby helping them realize more of the potential gains from cooperation.

Once Coleman takes this approach, however, he moves much closer to the standard economic analysis described in Section I of this paper. Economists, too, are concerned with the potential gains that individuals can achieve by cooperation. Indeed, in simple contractual settings the rule that is Kaldor-Hicks efficient can also be described (at least when no externalities are present) as the rule that maximizes the sum of the seller's surplus and the buyer's surplus. The sum of the seller's and buyer's surpluses—also known as the gains from trade—is simply another term for the potential gains from cooperation.

In short, once Coleman decides not to select particular legal

rules on the basis of their contribution to social stability, and to select them instead on the basis of their contribution to realizing the gains from cooperation, any differences between his approach and conventional efficiency analysis vanish. While portions of *Risks and Wrongs* occasionally attempt to distinguish his analysis from conventional efficiency analysis, those attempts seem to me to be unsuccessful, for reasons I discuss below. The first subsection below considers Coleman's use of rational bargaining theory to distinguish his analysis from that of conventional economics; the second considers his emphasis on the concept of division rationality.

C. *Rational Bargaining Theory*

Coleman begins Chapter 8 by conceding that legal economists have defended a theory of contract law that is "at least as sweeping and often considerably more detailed than the one outlined here."[33] Nevertheless, Coleman argues "even within these alternative accounts, the theory of rational bargaining presented here, or one very similar to it, appears to play a central role."[34] In other words, Coleman might be claiming that economists who invoke traditional notions of Kaldor-Hicks efficiency and Pareto superiority are committed, perhaps without realizing it, to some form of rational bargaining theory. This claim, however, is incorrect.

To support his claim, Coleman points to Alan Schwartz's analysis of products liability law.[35] Coleman summarizes Professor Schwartz's analysis in the following fashion:

> How, in other words, ought we think about who should bear the safety risks associated with product manufacturing . . . ? Unsurprisingly, the economist's answer is: impose the risks efficiently.
>
> But how are we to determine what constitutes an efficient allocation of risk . . . ? Schwartz argues that to promote efficiency, the rules of products liability should impose on consumers and producers the terms to which they would have

33. *Id.* at 267.

34. *Id.* In addition, Coleman argues that consent or autonomy theorists, like legal economists, must also rely on a theory of rational bargaining similar to his own. I leave that argument for others to comment on. *See* Randy E. Barnett, *Rational Bargaining Theory and Contract: Default Rules, Hypothetical Consent, the Duty to Disclose, and Fraud*, 15 HARV. J. LAW & PUB. POL'Y 783 (1992).

35. *See* Alan Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353 (1988) (discussed in COLEMAN, *supra* note 2, at 277-86).

> agreed under conditions of *full information* and *rationality*. These rules would be spelled out in terms of a hypothetical rational bargain or contract among the parties, and the conditions or terms of the contract would, by definition, be efficient . . . .[36]

Coleman is correct that Schwartz characterizes his products liability recommendations as the rules to which rational buyers and sellers would agree. In doing so, however, Schwartz is merely using the shorthand description described earlier in Section I.C. That is, Schwartz does not independently identify the rules to which rational consumers would agree and then conclude that such rules would therefore ("by definition") be efficient. Instead, Schwartz determines the rules that would be Kaldor-Hicks efficient and then concludes that those are the rules to which rational buyers and sellers would agree. In Schwartz's view, hypothetical consent follows from Kaldor-Hicks efficiency, rather than efficiency following from hypothetical consent.

The logical structure of Schwartz's argument is most easily seen by referring to the economic writings on which Schwartz relies. Two of Schwartz's key conclusions are: (1) that if consumers underestimate the difference in safety between different manufacturers' products (or would underestimate such differences if there were any), manufacturers should be held strictly liable for all pecuniary losses caused by their products; and (2) that manufacturers should not be liable for consumers' nonpecuniary losses. The first recommendation rests on conclusions drawn from the economics of imperfect information, primarily the work of Michael Spence.[37] The second recommendation rests on conclusions drawn from the economics of insurance, most notably the work of Philip Cook and Daniel Graham.[38] The logic used in these articles, like that used in most other writings on economics, is essentially that of Kaldor-

36. COLEMAN, *supra* note 2, at 278.

37. *See* Michael Spence, *Consumer Misperceptions, Product Failure, and Producer Liability*, 44 REV. ECON. STUD. 561 (1977) (cited by Schwartz, *supra* note 35, at 374 n.41, 376 n.43).

38. Philip J. Cook & Daniel A. Graham, *The Demand for Insurance and Protection: The Case of Irreplaceable Commodities*, 91 Q.J. ECON. 143 (1977) (cited by Schwartz, *supra* note 35, at 362 n.13). For other articles building on the work of Cook and Graham (and also relied on by Schwartz), see Daniel A. Graham & Ellen R. Peirce, *Contingent Damages for Products Liability*, 13 J. LEGAL STUD. 441 (1984); Samuel A. Rea, Jr., *Nonpecuniary Loss and Breach of Contract*, 11 J. LEGAL STUD. 35 (1982).

Hicks efficiency. That is, the authors identify various respects in which a rule would benefit buyers by more than it would harm sellers, or vice versa, and conclude *on that basis* that rational contracting parties would agree to such a rule. Thus, this example does nothing to show that some form of rational bargaining theory must play "a central role" in conventional law and economics.

As some of Schwartz's examples involve heterogeneous products and imperfectly-informed buyers, Coleman next turns to the possibility that not all parties would have agreed to the rule that Schwartz identified as most efficient. For example, buyers who underestimate the risk of a defective product might agree to waive their right to collect damages from the seller, even if a rule of strict liability would be more efficient. To Coleman, this represents a problem for conventional economic analysis, which rational bargaining theory may be able to solve. As Coleman puts it:

> Economic analysts accept the principle that incomplete contracts should be completed by the use of the *ex ante* rational contract. I argued that such an approach may lead courts to impose inefficient terms *ex post* [if the parties' *ex ante* agreement would have been warped by imperfect information]. That is inconsistent with economic analysis's commitment to efficiency.[39]

As I hope is clear by now, economists are *not* committed to the idea that the law should replicate whatever terms actual parties would have agreed to *ex ante*, even when those terms would have been inefficient. Such a view confuses economists' use of hypothetical consent as an occasionally accurate metaphor, or shorthand description, with a view that elevates hypothetical consent to a first principle of analysis. The latter view might be held by some non-orthodox economists, such as Buchanan—or perhaps by a rational bargaining theorist such as Coleman—but it is not the view of conventional economics.

Nevertheless, having framed the dilemma in this way, Coleman considers two strategies that economists might adopt to try to meet this perceived challenge. The first, which Coleman rejects, is to switch to an alternative gap-filling premise, under which courts would adopt whatever rule *fully informed* parties—

39. COLEMAN, *supra* note 2, at 283.

rather than the actual, imperfectly informed parties—would have agreed to. Coleman rejects this premise as abandoning any link to the notion of consent or bargaining because it does not even purport to consider what bargain would have been agreed to by the parties who are being governed. In Coleman's words, such a premise represents "not the requirement that a court replicate a bargain between the parties, but that, in the absence of an explicit bargain between the parties, courts should promote efficiency, plain and simple."[40] A conventional economist, of course, would see nothing wrong with attempting to promote "efficiency, plain and simple." This approach is unacceptable to Coleman, however, because he is intent on building some link between conventional economic analysis and rational bargaining theory.

The alternative strategy, which Coleman apparently prefers, is to imagine the parties agreeing not to any particular rule, but rather to a method of selecting a rule. That is, rather than agreeing that the seller will (or will not) be strictly liable for any defects in the product, the parties could agree that they would like a court to select whatever rule would in fact be most efficient, given their actual circumstances.[41] So long as the courts are likely to do a better job at picking the efficient rule than the parties themselves would do, parties who are aware of their own ignorance should be able to do better by delegating the task of rule-selection to courts, under a mandate that the court select whatever rule would in fact be most efficient. Used in this way, Coleman argues, "the theory of rational bargaining under ideal conditions is neither irrelevant nor insincerely

40. *Id.* at 282. Though nothing in the text turns on this, Coleman is not quite correct in implying that an economist who wants to promote "efficiency, plain and simple" will always endorse whatever rule would be most efficient for perfectly informed parties. If the parties to whom the rule is going to be applied are not perfectly informed, and if this information problem is not going to be cured directly, second-best considerations will often make some other rule more efficient. *See, e.g.*, Samuel A. Rea, Jr., *Workmen's Compensation and Occupational Safety Under Imperfect Information*, 71 AM. ECON. REV. 80 (1981); Craswell, *supra* note 7, at 395-96. Indeed, if the parties do not know what rule is most efficient, and therefore do not know what rule the court will in fact adopt, second-best problems are almost certain to arise, because much of efficiency analysis concerns prospective effects (for example, the incentive to take precautions) that work best if the parties know the rule to which they will be subjected. This objection is not crucial, though, for Coleman could restate his recommendation as follows: Uninformed parties would prefer the court to adopt whatever rule would in fact be most efficient given the parties' lack of information.

41. *See* COLEMAN, *supra* note 2, at 284.

deployed."[42] As it is possible to imagine the parties who are actually being governed—not some hypothetical, ideal parties—consenting to such a rule, the link with rational bargaining theory has been preserved.

Unfortunately, this strategy is insufficient to link standard efficiency analysis with rational bargaining theory in all cases in which the two might diverge. Consider one of the examples discussed earlier, involving the liability of sellers of relatively safe and relatively risky plots of land. The efficient rule for such transactions might well be one of strict seller liability, but sellers who own relatively risky plots will end up worse off if such a rule is adopted. Such sellers therefore have no reason to consent to the particular rule of strict liability— and they also have no reason to consent to the general principle of letting courts select whatever rule turns out to be most efficient.

In this example, the problem that must be overcome is not the one discussed by Coleman, in which some parties misperceive the rule that is *ex post* efficient. The problem, instead, is that the rule that is *ex post* efficient will leave some parties worse off, so those parties have no reason to consent to any mechanism that would lead to that rule. More precisely, sellers of risky plots could agree to a rule of strict liability only if the negotiations took place in some sort of society-wide bargaining process, and only then if (a) buyers and other sellers participating in the bargaining were allowed to make side-payments to compensate the risky sellers for agreeing to such a rule, or (b) all parties participating in the bargaining were placed behind a suitably tailored veil of ignorance, so that they would not know whether they would end up owning relatively safe or relatively risky plots of land. As Coleman does not seem to be envisioning this sort of Rawlsian bargaining, I will not pursue that possibility here.[43]

D. *Division Rationality*

Coleman's other apparent departure from conventional efficiency analysis concerns what he calls division rationality. Conventional economic analysis, Coleman tells us, is concerned

42. *Id.* at 285.

43. For brief (and critical) discussions of this approach, see Charny, *supra* note 17, at 1843-44; Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudicaiton*, *supra* note 1, at 497-99.

only with the productive dimension of legal rules, without regard to the distribution of the costs and benefits produced by those rules.[44] As a result, conventional economic analysis has nothing to say respecting the choice between two legal rules that produce the same total benefits but distribute those benefits differently. Instead, that choice must be made on the basis of some external theory of fairness, "where fairness is to be understood as stating some independent criterion of assessment outside the domain of rationality."[45] While most economists would be perfectly happy to accept this characterization of their theories, Coleman regards it as a serious criticism, as it prevents those theories from "providing a plausible interpretation and justification of our ordinary notions of political authority and of the social practices that exemplify them."[46] A complete rational choice theory, Coleman says, must include a rationality criterion for selecting among different distributions of the costs and benefits of social cooperation.[47] It is this criterion that Coleman terms "division rationality."[48]

Indeed, in the early chapters of the book Coleman seems to regard the concept of division rationality as his most important contribution to previous theories. His argument, he says, "is not just that ignoring the division problem renders analyses of rational cooperation incomplete. Rather it has been that failure to countenance the centrality of the division problem is to misunderstand the nature of rational cooperation completely."[49] Significantly, though, the concept of division rationality largely disappears later in the book when Coleman analyzes specific legal problems. For example, division rationality plays no role at all in Coleman's analysis of products liability issues in Chapters 8 and 20. Nor does it play any role in Coleman's analysis of mandatory disclosure rules and *Laidlaw v. Organ*,[50] which is the

44. *See* COLEMAN, *supra* note 2, at 11.
45. *Id.*
46. *Id.* at 12.
47. *See id.* at 14.
48. The terminology may be slightly misleading, for Coleman never argues that it would be positively *irrational* for an individual to agree to some distribution of gains other than that specified by whatever theory of division rationality is ultimately accepted. Whether Coleman's theory of division rationality can still qualify as a theory of "rationality"—rather than, say, a theory of observable regularities in the way that individuals in fact divide gains—is a question I leave for others. For convenience, I will continue to use Coleman's terminology in this essay.
49. COLEMAN, *supra* note 2, at 34.
50. 15 U.S. (2 Wheat.) 178 (1817) (discussed in COLEMAN, *supra* note 2, at 247-65).

only issue of contract law discussed at any length.

The reasons why division rationality disappears from Coleman's application of his theory to contractual relations are not hard to find. First, most gap-filling issues concern responsibility for risks whose *ex ante* likelihood is low. Thus, even if a court feels compelled to adjust a party's recovery to account for a proper division of the *ex ante* gains from trade between the parties now before it, only a very small adjustment (if any) will generally be needed. For example, if a product poses a 0.1% risk of a $100,000 accident, and if it is more efficient for the seller to assume responsibility for such accidents, an appropriate division of the gains would probably pay the seller something on the order of $100 (.001 × $100,000) for assuming that risk. In practical terms, this means at most that buyers who suffer an accident and are awarded compensation would have to deduct that $100 from their recovery, so that they would collect $99,900 rather than $100,000. Given the other expenses and imprecisions involved in measuring damages, such finely-tuned adjustments are hardly worth arguing over.

Second, and far more important, if the applicable legal rules are known to the parties at the time they sign their contract, even such minor adjustments as these will not be necessary. For example, a seller who knows that he will be liable for the $100,000 accident described above will automatically add $100 to the contract price, so the adjustment will already have been made by the time the case comes to court. Indeed, if a court were to try to force some other division of gains, by requiring an offset to buyers' damages in the manner described above, the amount of this offset (if it were known in advance) would itself be taken into account in the seller's price. The probable result—subject to a qualification discussed below—would be to cancel out the court's attempt to force some other division of gains.

Coleman appears to recognize this problem when he notes the argument of conventional law-and-economics scholars that "in the case of contracting . . . whatever distributive issues arise can be dealt with by side payments."[51] He explains, however, that rational bargaining theory is to be distinguished from conventional law and economics, because rational bargaining the-

51. COLEMAN, *supra* note 2, at 241.

ory offers a different reason for not having to worry about the division of gains in such cases. Rational bargaining theory's explanation is that "[i]n many contexts in which contracting occurs . . . the division problem is solvable by transaction resources endogenous to the framework of exchange. The rational choice approach, therefore, *downplays*, but does not *downgrade* the distributive aspects of contracting."[52] Coleman does not explain what difference there is between "downplaying" and "downgrading" problems involving the division of gains from cooperation. Nor does he explain the difference between dealing with division problems "by side payments," on the one hand, or by "transaction resources endogenous to the framework of exchange," on the other.

It might be possible to defend the importance of division rationality in contractual settings by noting that the costs of contract rules are not always completely passed on to buyers, so that in certain circumstances legal rules can have distributive effects.[53] However, a careful consideration of the circumstances likely to produce distributive effects suggests a rather different focus for any concern with the distribution of gains and losses. In simple contractual settings, where all transactions are homogeneous (or each individual transaction is regulated separately), attempts to alter the distribution of gains will benefit either or both parties to the transaction if, and only if, the attempt increases Kaldor-Hicks efficiency. This is because when all buyers and sellers are homogeneous, any legal change that benefits buyers will shift the entire demand curve up by the amount of buyers' benefits, and will shift the entire supply curve up by the entire amount of sellers' costs. It is easy to show, under these assumptions, that the resulting price increase will be less than the benefit to buyers (meaning that buyers will end up as net gainers) if and only if the buyers' gains

52. *Id.* at 241-42 (emphasis in original).

53. The seminal analysis of these issues in the legal literature is Bruce Ackerman, *Regulating Slum Housing Markets on Behalf of the Poor: Of Housing Codes, Housing Subsidies and Income Redistribution Policy*, 80 YALE L.J. 1093 (1971). More recent theoretical treatments include Richard S. Markovits, *The Distributive Impact, Allocative Efficiency, and Overall Desirability of Ideal Housing Codes: Some Theoretical Clarifications*, 89 HARV. L. REV. 1815 (1976); Duncan Kennedy, *Distributive and Paternalist Motives in Contract and Tort Law, With Special Reference to Compulsory Terms and Unequal Bargaining Power*, 41 MD. L. REV. 563 (1982); Richard Craswell, *Passing on the Costs of Legal Rules: Efficiency and Distribution in Buyer-Seller Relationships*, 43 STAN. L. REV. 361 (1991). For discussions of some experimental evidence bearing on this question, see Stewart Schwab, *A Coasean Experiment on Contract Presumptions*, 17 J. LEGAL STUD. 237 (1988).

exceed the sellers' losses—in other words, if and only if the change is Kaldor-Hicks efficient.[54] This implies that any attempt to change the division of gains in a way that is purely distributive, without increasing Kaldor-Hicks efficiency, will not be successful in benefitting buyers, and therefore will not have the desired effect of changing the division of the gains.

In more complex contractual settings, where buyers and sellers are not homogeneous, some buyers or sellers can be benefitted by changes that are not Kaldor-Hicks efficient. In these settings, though, the heterogeneity of buyers guarantees that different buyers will gain or lose by different amounts, and similarly for heterogeneous sellers. In most cases, some buyers will lose only if other buyers gain (ditto for sellers), so the redistribution will be between different classes of buyers, rather than between buyers as a class and sellers as a class.[55] To force a more appropriate pattern of distribution, therefore, a court would have to redistribute from some buyers *to other buyers*, or from some sellers *to other sellers*. It is not at all clear how this could be managed under the current system of litigation, in which the only parties before the court are the buyer and seller who agreed to a particular contract. Nor is it clear what point ought to be selected as the disagreement point (that is, the point defining the utility the bargaining parties would receive if no agreement is reached) once the bargaining game is expanded, even hypothetically, to include multiple buyers and sellers. As the location of the disagreement point plays a crucial role in the particular theory of division rationality that Coleman tentatively accepts,[56] his failure to define that point in such multi-party bargaining games is particularly unfortunate.

III. Conclusion

The objections I have raised here should not be taken as a damning criticism of *Risks and Wrongs,* for there is much that is

54. *See* Craswell, *supra* note 53, at 368-72. Note that the fact that buyers gain from such a change does not mean that sellers lose. As discussed in Section I.A.2. of this essay (and demonstrated more formally in Craswell, cited above), in simple contractual settings any change that is Kaldor-Hicks efficient will also be Pareto superior, meaning that sellers too will benefit from the change (or, at worst, will break even).

55. *Id.* at 372-84. Even the most extreme result, under which all sellers lose and all buyers either gain or break even, cannot be obtained unless some buyers benefit by more than others. *See id.* at 380-82. As a result, the argument in the text would still apply even to this case.

56. *See* Coleman, *supra* note 2, at 127-32.

good in the book that I have not even discussed. Coleman's analysis of *Laidlaw v. Organ,* for example, is a perfectly good piece of economic analysis standing on its own, which corrects an important mistake in a widely-read piece of law-and-economics scholarship.[57] Moreover, nothing I have said in this essay detracts from the corrective justice theories that Coleman applies to tort issues as they arise in non-contractual settings.

Instead, my focus here has been on the application of Coleman's rational bargaining theory to issues of contract law and products liability law. In these cases, Coleman's analysis suffers from a failure to properly appreciate the distinct problems raised by laws that regulate homogeneous transactions, on the one hand, and laws that must be applied to a broader class of heterogeneous transactions, on the other. When the law is regulating homogeneous transactions, any rule that is Kaldor-Hicks efficient is also a Pareto-superior improvement. When Kaldor-Hicks efficiency and Pareto superiority thus converge, most of the problems that rational bargaining theory is designed to address—problems with which Coleman has often wrestled in his criticisms of economic analysis of tort law—simply do not arise. As a result, there is little that Coleman's rational bargaining theory can add to the economic analysis of these simplest of contracting situations.

When the law must regulate heterogeneous transactions—as is usually the case—the rule that is Kaldor-Hicks efficient generally will not represent a Pareto-superior improvement. In these circumstances, most of the problems raised by a divergence between the Kaldor-Hicks and Pareto criteria reappear. In this context, though, the net winners and losers are usually distributed across different classes of buyers and sellers, rather than being neatly aligned on opposite sides of each individual transaction. As Coleman's use of rational bargaining theory focuses entirely on the bargaining that could have taken place between the parties to a single transaction, his theory has little to add to the economic analysis of these situations. It may be that further development of Coleman's theory will allow it to

57. *See id.* at 247-65 (criticizing Anthony T. Kronman, *Mistake, Disclosure, Information, and the Law of Contracts,* 7 J. LEGAL STUD. 1 (1978)). For more conventionally economic criticisms of Kronman—criticisms which partially overlap with Coleman's—see ROBERT COOTER & THOMAS ULEN, LAW AND ECONOMICS 258-61 (1988) and Steven Shavell, *Acquisition and Disclosure of Information Prior to Economic Exchange,* Harvard Law School Program in Law and Economics Discussion Paper No. 91 (Apr. 1991).

address these problems—for example, by analyzing the hypothetical bargaining that would take place if all potential buyers and sellers negotiated collectively to agree on a set of contract rules, or by identifying those legal rules that contribute most to the stability of heterogeneous societies. At present, though, the analysis that would permit such an expansion of Coleman's arguments lies entirely in the future.