

# Florida State University Law Review

---

Volume 43 | Issue 1

Article 1

---


Fall 2015

## Privity's Shadow: Exculpatory Terms in Extended Forms of Private Ordering

Mark P. Gergen

*University of California-Berkeley*

Follow this and additional works at: <https://ir.law.fsu.edu/lr>

 Part of the [Contracts Commons](#), and the [Legal Remedies Commons](#)

---

### Recommended Citation

Mark P. Gergen, *Privity's Shadow: Exculpatory Terms in Extended Forms of Private Ordering*, 43 Fla. St. U. L. Rev. 1 (2017) .  
<https://ir.law.fsu.edu/lr/vol43/iss1/1>

This Article is brought to you for free and open access by Scholarship Repository. It has been accepted for inclusion in Florida State University Law Review by an authorized editor of Scholarship Repository. For more information, please contact [bkaplan@law.fsu.edu](mailto:bkaplan@law.fsu.edu).

# PRIVITY'S SHADOW: EXCULPATORY TERMS IN EXTENDED FORMS OF PRIVATE ORDERING

MARK P. GERGEN\*

I.	INTRODUCTION AND OVERVIEW .....	1
II.	GENERAL PRINCIPLES AND ILLUSTRATIVE CASES .....	6
	A. <i>Strength of the Reasons for Negligence Liability</i> .....	6
	B. <i>Quality of the Victim's Assent to an Exculpatory Term</i> .....	9
	C. <i>Illustrative Cases</i> .....	12
III.	THE PRINCIPLES AT WORK: THIRD-PARTY BENEFICIARY LAW .....	17
IV.	THE PROBLEMS WITH CURRENT LEGAL DOCTRINE .....	21
	A. <i>Two Rules</i> .....	22
	B. <i>The Premise the Rules Share with the Old Privity Doctrine</i> .....	24
	C. <i>Changes in Negligence Law Make This Premise Untenable</i> .....	27
V.	PRIVITY RULES IN CONTRACT LAW AND INFORMATION COSTS .....	34
	A. <i>Privity Rules in Modern Contract Law</i> .....	34
	B. <i>The Information Cost Rationale</i> .....	40
	C. <i>Exculpatory Terms and Information Costs</i> .....	44
	D. <i>Contractual Workarounds to Obtain a Liability Shield</i> .....	48
VI.	EXCULPATORY SERVITUDES (EQUITABLE NOTICE).....	49
VII.	TORT LAW .....	55
	A. <i>Negligence Involving Physical Harm</i> .....	56
	1. <i>The Power to Determine Who Has a Duty to a Nonparty</i> .....	57
	2. <i>The Power to Disclaim a Duty to a Nonparty (Physical Harm)</i> .....	60
	B. <i>Negligence Involving Pure Economic Loss</i> .....	68
	1. <i>Duty and Predicted Intent</i> .....	69
	2. <i>The Power to Disclaim a Duty to a Nonparty (Pure Economic Loss)</i> ..	83
	C. <i>Negligent Misrepresentation, Invited Reliance, and Information Costs</i> ...	84
VIII.	CONCLUSION .....	89

## I. INTRODUCTION AND OVERVIEW

This Article addresses a set of important and unsettled legal questions on which there has been scant theoretical scholarship.<sup>1</sup> A few examples suggest the nature, importance, and difficulty of the questions:

- Tenant suffers substantial lost income as a result of a careless error by Contractor in renovating a commercial building. A term in

---

\* Professor, Berkeley Law School. I thank participants at the Second North American Workshop on Private Law Theory, the Obligations VI Conference, the 10th International Conference on Contracts, and workshops at the Bar-Ilan Faculty of Law, Berkeley Law School, and the Hebrew University Faculty of Law for comments on drafts. I owe a special debt to Shawn Bayern and Amnon Lehavi for their extensive comments on drafts and to Adam Nguyen for invaluable editorial assistance.

1. The most relevant theoretical literature concerns the choice between contract law and tort law as a legal regime to determine when a party to a contract is liable to a nonparty for harm caused by negligence that occurs in performing the contract. See John G. Fleming, *Tort in a Contractual Matrix*, 33 OSGOODE HALL L.J. 661 (1995); Israel Gilead, *Non-Consensual Liability of a Contracting Party: Contract, Negligence, Both, or In-Between?*, 3 THEORETICAL INQUIRIES L. 511 (2002); Simon Whittaker, *Privity of Contract and the Tort of Negligence: Future Directions*, 16 OXFORD J. LEGAL STUD. 191 (1996).

Tenant's contract with Owner, who hired Contractor, absolves Owner from liability for the loss. Does the term also absolve Contractor from liability to Tenant? What if the exculpatory term is in the contract between Owner and Contractor?<sup>2</sup>

- Buyer overpays for goods as a result of Appraiser's careless error. Seller hired Appraiser. A term in the contract between Buyer and Seller makes the appraisal "final and binding." Does this term bar a claim by Buyer against Appraiser?<sup>3</sup>
- Creditor detrimentally relies on Accountant's report in extending credit to Company. Company hired Accountant. A term in Accountant's contract with Company limits the scope of Accountant's duty to investigate accuracy of Company's financial information. Does this term also define the scope of Accountant's duty to Creditor?<sup>4</sup>
- A building has a defective foundation as a result of Builder's mistake. Years later, after Owner sells the building to Purchaser, the defect becomes manifest. The contract between Owner and Builder absolves Builder from liability for the defect. Does this term bar a claim by Purchaser against Builder?<sup>5</sup>

2. *J'Aire Corp. v. Gregory* implicitly answers both questions no. 598 P.2d 60 (Cal. 1979). *Berschauer/Phillips Construction Co. v. Seattle School District* answers both questions yes. 881 P.2d 986 (Wash. 1994). Neither case suggests any weight is given to the presence or absence of an exculpatory term in either contract. *Lutz Engineering Co. v. Industrial Louvers*, answers the second question yes, giving some weight to the exculpatory terms. 585 A.2d 631 (R.I. 1991). This case is addressed in Section VII.B.2, *infra*.

3. *Dressel Assocs., Inc. v. John A. Welsch Real Estate Appraisers, Inc.* explicitly answers the question yes. 632 A.2d 906, 908 (Pa. Super. Ct. 1993). *Glanzer v. Shepard* gives the same answer implicitly. 135 N.E. 275 (N.Y. 1922). Victor P. Goldberg argues that the correct answer in the case was no. Victor P. Goldberg, *A Reexamination of Glanzer v. Shepard: Surveyors on the Tort-Contract Boundary*, 3 THEORETICAL INQUIRIES L. 475 (2002). See *infra* Part III, for an explanation about why the Appraiser is not a third-party beneficiary of the term. See *infra* Section VII.B.2, for a discussion of the handling of the case in negligence law.

4. Most cases answer yes, if the limitation is communicated to the creditor. See *Quinn v. McGraw-Hill Cos.*, 168 F.3d 331 (7th Cir. 1999) (applying Illinois law); *First Nat'l Bank of Newton Cty. v. Sparkmon*, 442 S.E.2d 804 (Ga. Ct. App. 1994); *Dakota Bank v. Eiesland*, 645 N.W.2d 177 (Minn. Ct. App. 2002); *First Nat'l Bank of Bluefield v. Crawford*, 386 S.E.2d 310 (W. Va. 1989). In New York, if the court followed the lead of *Ossining Union Free School District v. Anderson*, then the question would be answered no. 539 N.E.2d 91 (N.Y. 1989). Section V.A, *infra*, explains why the term is not enforceable against the plaintiff under the privity rules in contract law. Section VII.C, *infra*, explains the relevance of the term to the duty issue in the law of negligent misrepresentation.

5. *Newman v. Tualatin Development Co.* answers no. 597 P.2d 800, 803 (Or. 1979). *Aronsohn v. Mandara* answers yes, if there is an exculpatory term. 484 A.2d 675, 680-81 (N.J. 1984). Apparently this is without regard to whether the buyer knows or has reason to know of the term. See *id.* *Crowder v. Vandendeale* precludes the claim whether or not there is an exculpatory term. 564 S.W.2d 879, 881-82 (Mo. 1978). Robert L. Cherry collects additional cases, which come out different ways. Robert L. Cherry, Jr., *Builder Liability for Used Home Defects*, 18 REAL EST. L.J. 115 (1989). Part VI considers the possibility of enforcing the term using the law of equitable servitudes. Section VII.B.2, *infra*, explains the relevance of the term to the duty issue in the law of economic negligence.

- Alarm Service has a term in its agreement with Building Owner absolving Alarm Service from liability for consequential damages. The alarm fails in a fire. As a result of the failure of the alarm, Tenant is injured. Does the term limit the liability of Alarm Service to Tenant?<sup>6</sup>

In the simplest case, three parties are connected through two concurrent contracts. One contract connects a harm-doer and a third party. The harm-doer, in performing this contract, carelessly harms a victim. The victim is in harm's way because of the second contract, which connects him with the same third party. One of the two contracts contains a term that clearly shows the parties to that contract—the third party and either the harm-doer or the victim—intended to exculpate the harm-doer from liability to the victim for the harm in question. This simple case presents what I will call the Basic Issue: does the exculpatory term bear on the harm-doer's liability to the victim even though it is not in a contract between the two of them?

More complicated cases can involve four or more parties, with the harm-doer and the victim connected through a chain of three or more contracts. Rather than being concurrent, the making and performance of the contracts may be separated by many years. A non-contractual link, such as a gift, may form part of the chain of relationships or transactions that connects the harm-doer and victim. Further complicating matters, the relevant term may be ambiguous, or the absence of liability may be implicit in a contract, transaction, or relationship in the chain.

The Basic Issue and these more complicated iterations could not arise under the old form of the privity doctrine, which largely shielded an actor from liability to a nonparty for careless performance of a contract. The absence of a third-party beneficiary claim meant that only the other party could recover on a contract claim, while the privity doctrine shielded that same party from any duty in

---

6. *Sommer v. Federal Signal Corp.* answers no, 593 N.E.2d 1365, 1373 (N.Y. 1992), (this logically follows from holding the exculpatory term does not bar a contribution claim by co-defendants because of the absence of privity). *Fretwell v. Protection Alarm Co.* answers yes. 764 P.2d 149, 151 (Okla. 1988). Marjorie A. Shields collects additional cases, which come out both ways. Marjorie A. Shields, Annotation, *Validity, Construction, and Application of Exculpatory and Limitation of Liability Clauses in Burglary, Fire, and Other Home and Business Monitoring Service Contracts*, 36 A.L.R. 6th 305 (2008). This type of case is addressed in Section VII.A.2, *infra*. It proposes a no-duty rule that would cover many such claims.

tort to a nonparty. The privity doctrine thus made a contract a “perfect circle” of obligation in which obligation could exist only between the parties to the contract.<sup>7</sup>

The old form of the privity doctrine was demolished by the middle of the twentieth century, but because negligence liability was still tightly constrained to misfeasance causing fairly direct physical harm,<sup>8</sup> its demolition did not immediately give rise to the issues at hand.<sup>9</sup> The narrow ambit of negligence liability limited the frequency of cases in which parties might have valid reasons to contract out of the background liability rules. And when such cases did arise, courts could use the restrictive rules in negligence law to deny liability if its absence seemed warranted. Consequently, there was never a need to explain the absence of liability by reference to an exculpatory term that was not in a contract between the harm-doer and the victim.

However, as the ambit of negligence liability has expanded during the second half of the twentieth century on several dimensions—to reach nonfeasance, remote physical harm, and pure economic harm—a new dynamic has made the questions more pressing. As the potential ambit of negligence liability expands on these dimensions, it becomes increasingly questionable whether imposing liability for carelessly caused harm is in the interest of the parties, or the interest of society.<sup>10</sup> It also becomes increasingly questionable whether liability is justifiable as a matter of fairness.

These increasing questions justify greater deference to private arrangements that provide less protection than the background liability rules. Deference may be warranted even though private ordering is imperfect, as it manifestly is when participants in a multi-person project order their affairs through separate contracts. Conversely, and importantly, creating mechanisms to enable people to opt-out of the background liability rules makes it possible to have broader background liability rules.<sup>11</sup>

---

7. Percy H. Winfield, *The Restatement of the Law of Torts—Negligence*, 13 N.Y.U. L.Q. REV. 1, 15 (1935) (“Contract was the perfect circle that must be marred by no indentation or protuberance.”).

8. During this period, negligence liability was generally confined to instances of misfeasance causing fairly direct physical harm.

9. John Goldberg and his co-authors harken back to this era when they define “easy duty cases” as “ones in which the plaintiff’s allegation is that the defendant *carelessly pursued an affirmative course of conduct that directly caused the plaintiff physical harm.*” JOHN C.P. GOLDBERG ET AL., *TORT LAW: RESPONSIBILITIES AND REDRESS* 51 (2d ed. 2008).

10. See *infra* Section IV.C, which lays out how and why negligence law’s expansion has led to these doubts.

11. See *infra* Section VII.C, for an example. In many states, firms that supply widely disseminated financial information, such as auditors and credit rating agencies, have no duty of care to users of the information. These firms have no legal incentive to warn people

This Article proceeds as follows. Part II sets forth the principles that courts should use to resolve these issues. The two relevant general principles are straightforward: courts should consider the strength of the reasons for negligence liability and the quality of the victim's assent to the exculpatory term. These familiar principles are taken from negligence law and contract law, and they implicate familiar factors in each body of law. Part III concerns cases in which the exculpatory term is in the victim's contract, and the legal issue is whether the harm-doer is a third-party beneficiary of the term. The results in these cases generally are consistent with the principles in Part II. In these cases, tort principles that bear on the strength of the reasons for negligence liability inform contractual analysis in determining whether the harm-doer is a third-party beneficiary of the exculpatory term.

Most of the problems in existing law arise in cases in which the exculpatory term is in the harm-doer's contract with a third party. Part IV explains the problems with current law. Part V explains the privity rules in modern contract law and their rationale, which is reducing nonparty information costs. The privity rules in contract law preclude using contract law to implement the principles in Part II when the victim is not a party to the contract with the exculpatory term. However, as Part V explains, exculpatory terms generally do not implicate the concern for information costs. Thus, we should be open to using bodies of law other than contract to give effect to an exculpatory term against a nonparty victim, when this is justified under the principles in Part II.

Parts VI and VII explain how courts should go about solving these problems using property and tort law. Part VI explains how property law and the law of equity can be used to implement the principles in Part II when the harm is caused by a defect in property and the exculpatory term covering the defect can be enforced as an equitable servitude that runs with the property. Part VII explains how tort law can be used to implement the principles in Part II. Courts have had the greatest difficulty with cases in which the defendant negligently inflicts a pure economic loss on the plaintiff. I show how contract principles can and should inform tort's no-duty analysis in these hardest of cases. Courts have had an easier time with cases in which

---

not to rely on the information they supply and a strong economic incentive to invite reliance because it makes the service supplied more valuable. Immunity from liability might be conditioned on information being delivered in a way that warns recipients that the information supplier is not willing to stand by its carefulness in checking the accuracy of the information. This is possible only if there is a legal basis for giving effect to an exculpatory term.

the quality of the victim's assent to the exculpatory term is irrelevant to duty analysis. Familiar principles of tort law suffice to explain the absence of a duty in these easier cases.

## II. GENERAL PRINCIPLES AND ILLUSTRATIVE CASES

In deciding whether an exculpatory term precludes a negligence claim, a court generally should consider the strength of the reasons for imposing negligence liability for the act and harm in question, absent the exculpatory term, and the quality of the victim's assent to the exculpatory term. This Part explains these two general principles and identifies relevant factors under each. Just to be clear, I am not arguing that courts should actually resolve most cases by a direct balancing of the two principles and relevant factors. Typically the principles and factors will operate at a meta-level to explain a rule in contract or tort law that resolves a case.<sup>12</sup>

### A. *Strength of the Reasons for Negligence Liability*

Familiar factors in negligence law determine the strength of the reasons for negligence liability. The principal reasons for imposing negligence liability are compensation and deterrence.<sup>13</sup> Negligence law rests on the premise that compensation and deterrence are warranted when the elements of a negligence claim are established. These elements are: (1) the harm-doer acted unreasonably; (2) his unreasonable action was a factual cause of harm to the victim; (3) the risk of such harm is among the risks that made the harm-doer's action unreasonable; (4) the harm can appropriately be quantified as damages; and (5) neither the victim nor another wrongdoer more appropriately bears responsibility for the harm.<sup>14</sup> Obviously, the ability of a plaintiff to establish these elements is an important factor bearing on the strength of the reasons for negligence liability. If a claim involves bodily harm or physical harm to property, and if a reasonable juror could find the plaintiff established the first three

---

12. Nor am I arguing that either principle can be reduced to a linear spectrum. There are legal discontinuities (e.g., the different significance accorded actual intent, manifest intent, and predicted intent in contract law and the different protection afforded against bodily harm and pure economic loss in tort law) that may map on to normative discontinuities.

13. See MARK A. GEISTFELD, *ESSENTIALS OF TORT LAW* 42-44 (2008).

14. This list omits the element of duty, because these factors are being used in duty analysis.

elements—an unreasonable act, factual cause, and legal cause or scope of duty, respectively—then a plaintiff generally is entitled to have a negligence claim go to the jury.<sup>15</sup>

However, even when a claimant may satisfy all of these elements, a negligence claim is sometimes disallowed under a no-duty rule because of two general countervailing factors. One general countervailing factor is the availability of other mechanisms to achieve the goals of compensation and deterrence, or to otherwise avoid similar harm in the future. In short, a court asks how vulnerable people in the victim's position would be to the risk of such harm without negligence liability.<sup>16</sup> The other general countervailing factor is the cost and risk of error in using negligence liability as a mechanism for compensation and deterrence.<sup>17</sup> These two factors work together. The first factor bears on the need for negligence liability to achieve compensation and deterrence, while the second bears on negligence liability's efficacy to achieve those goals.<sup>18</sup> For example, the no-duty rules that apply to claims involving pure economic loss are generally explained either by the availability of other mechanisms to achieve compensation and deterrence, or by the inefficacy of negligence liability to achieve these goals, or by the combination of the two factors.

The proximity between the arguably wrongful act and the resulting harm is often stated as a primary factor.<sup>19</sup> An act and resulting harm are considered proximate when the act and the harm are close in time and space and when the harm did not involve other unusual human conduct, particularly other wrongful human conduct that occurs subsequent to the act (such an act is often referred to as a superseding cause). While important, the factor of proximity is best un-

---

15. See *infra* Section IV.C, for authority on this point. In some states this statement needs to be qualified to account for rules on superseding cause and implied assumption of risk. Rules on superseding cause generally absolve an actor from liability when the immediate cause of the harm is another person's unusual criminal or intentional wrongful conduct. Rules on implied assumption of risk generally absolve an actor from liability when the plaintiff makes a knowing, voluntary, and reasonable choice to confront the risk created by the actor's negligence.

16. See Jane Stapleton, *Comparative Economic Loss: Lessons from Case-Law-Focused "Middle Theory"*, 50 UCLA L. REV. 531, 554-58 (2002); Jane Stapleton, *The Golden Thread at the Heart of Tort Law: Protection of the Vulnerable*, 24 AUSTL. B. REV. 135, 143-46 (2003); see also Mark P. Gergen, *The Ambit of Negligence Liability for Pure Economic Loss*, 48 ARIZ. L. REV. 749, 763-71 (2006).

17. Gergen, *supra* note 16, at 768-71.

18. See *id.*

19. Proximity is one of six factors in the *Biakanja* balancing test. See *Biakanja v. Irving*, 320 P.2d 16, 19 (Cal. 1958) (in bank). It is one of two factors in the two-part test for determining duty in *Anns v. Merton*. *Anns v. Merton* LBC [1978] AC 728 (HL) (appeal taken from Eng.). It is one of three factors in *Canadian National Railway Co. v. Can. Nat'l Ry. v. Norsk Pac. S.S. Co.*, [1993] 1 F.C. 67, 72 (Can.).



derstood as being of secondary importance and relevant only insofar as the proximity of the act and the harm bears on the strength of the reasons for liability under some other factor.<sup>20</sup> The temporal and physical proximity of an act and the resulting harm, and the involvement of other unusual human conduct in the harm, can bear on all of the primary factors: the unreasonableness of the harm-doer's act, whether the harm is among the risks that made the act unreasonable, whether primary responsibility for the harm is appropriately allocated to the victim or to another wrongdoer, the victim's vulnerability to the harm, the risk of error in determining causation, and whether the harm-doer's act is considered a moral wrong against the victim.<sup>21</sup> Other factors of secondary relevance include the indeterminacy of the liability the claimant seeks to impose on the harm-doer and the proportionality of the liability to the harm-doer's degree of fault.<sup>22</sup>

Yet other factors that may also bear on the strength of the reasons for imposing liability are of contested relevance. An important contested factor is whether the harm-doer's act is considered a moral wrong against the victim.<sup>23</sup> Another important contested factor is the character of the victim's harm. Many people believe bodily harm to be more deserving of legal protection than pure economic loss.<sup>24</sup> As a descriptive matter, when harm is unintentional, tort law generally affords people significantly greater protection from bodily harm and physical harm to property than from pure economic loss.

---

20. Clarity on this point is important because while proximity generally increases the strength of the reasons for negligence liability, proximity also generally increases the possibility of a plaintiff's knowledge and assent to an exculpatory term.

21. Many of these factors are present when a victim of an intentional criminal act sues a remote actor for having carelessly set the stage for the crime. For a discussion and criticism of the handling of the general problem by the Third Restatement, see John C.P. Goldberg & Benjamin C. Zipursky, *Intervening Wrongdoing in Tort: The Restatement (Third)'s Unfortunate Embrace of Negligent Enabling*, 44 WAKE FOREST L. REV. 1211 (2009).

22. The concerns for imposing indeterminate and disproportionate liability are often cited as reasons for not imposing liability for far-flung economic losses. *Ultrameres Corp. v. Touche*, 174 N.E. 441, 444 (N.Y. 1931), is a leading case expressing the concerns in a claim involving pure economic loss. *H.R. Moch Co. v. Rensselaer Water Co.*, 159 N.E. 896 (N.Y. 1928), expresses the same concerns to justify absolving a water company from liability to private individuals for failure to supply water to hydrants.

23. See, e.g., John C.P. Goldberg & Benjamin C. Zipursky, *Torts as Wrongs*, 88 TEX. L. REV. 917, 928-32 (2010). For authority on the point that this is a contested consideration, see Michael L. Rustad, *Twenty-First-Century Tort Theories: The Internalist/Externalist Debate*, 88 IND. L.J. 419, 421-23 (2013).

24. See *Mesiar v. Heckman*, 964 P.2d 445, 451 (Alaska 1998) (stating that negligence resulting in solely pecuniary harm is not morally blameworthy).

### B. *Quality of the Victim's Assent to an Exculpatory Term*

Familiar factors in contract law generally determine the quality of the victim's assent to an exculpatory term. Assent to an exculpatory term is of the highest quality when the term is a "dickered term" in the victim's contract (i.e., the term is understood to have been subject to negotiation or factored into price), the victim understands the risk she bears under the term, and the harm-doer proceeds with the transaction in reliance on the victim bearing the risk.<sup>25</sup> Assent may still be of fairly high quality when these factors are absent. In particular, there can be a fairly high quality of assent to an implied term (or to a boilerplate term in a form contract) when the term covers a low probability risk that is not salient or worth the parties' focusing on when the contract is made; the term is customary in a trade; the victim and harm-doer are regular participants in the trade; and the allocation of the risk in question to the victim is sensible in light of the overall transaction.<sup>26</sup>

Other factors of contested relevance in contract law may also bear on the quality of a victim's assent to an exculpatory term. Disagreements over how the law should treat boilerplate in consumer form contracts implicate the most important contested terrain in contract law for the immediate purposes.<sup>27</sup> U.S. law generally gives presumptive effect to boilerplate in consumer form contracts even though we know consumers almost never read boilerplate.<sup>28</sup> A criticism of this

---

25. Karl Llewellyn juxtaposes "dickered term[s]" and boilerplate to make the point that assent is genuine only with respect to the former. KARL N. LLEWELLYN, *THE COMMON LAW TRADITION: DECIDING APPEALS* 362 (1960). Most analysis of boilerplate focuses on the absence of genuine assent by a form-taker. But sometimes a form presenter uses a premade form that includes boilerplate terms the form presenter did not intend to be part of the agreement. This becomes an issue when a form presenter tries to exploit a term when a dispute arises. Under modern rules of contract interpretation, a court may decline to give effect to the term by finding neither party intended it to apply. *See, e.g., Morin Bldg. Prods. Co. v. Baystone Constr., Inc.*, 717 F.2d 413, 416 (7th Cir. 1983) (holding that it was appropriate for a lower court to decline to give effect to artistic-effect and quality-fitness clauses in a form contract when it was likely neither party intended the terms to cover the aluminum factory wall).

26. *See infra* Section VII.B.1, for development of this point.

27. When a transaction is routinized, low probability risks are usually covered by boilerplate in a pre-made form. Often an exculpatory term is boilerplate.

28. RESTATEMENT (SECOND) OF CONTRACTS § 211(1) (AM. LAW INST. 1981) (stating general rule that a party who signs or otherwise manifests assent to a writing "adopts the writing as an integrated agreement with respect to the terms included in the writing"); *see also* RESTATEMENT OF THE LAW, CONSUMER CONTRACTS (AM. LAW INST. Preliminary Draft No. 1, at 12, 2014) (on file with author) ("[C]redible empirical evidence, as well as common sense and experience, suggests that consumers rarely read standard contracts no matter how these terms are disclosed. . . . Informed assent, which is a basic requirement in classical contract law, is, by and large, absent in the typical consumer contract, at least with respect to the standard contract terms.").

policy asserts that contractual assent ideally involves a party's subjective, considered, and uncoerced consent to a transaction and all its material terms.<sup>29</sup> Clearly, such "true assent" is an ideal. Practical considerations require that contract law determine assent objectively (often using rules that provide an advantage to people who know how to use approved forms to secure their preferred terms). Practical considerations also require that contract law imply some material terms and that contract law tolerate much coercive use of economic power. Despite these real-world constraints, true assent is an important and persistent ideal in contract law. It has deep roots in both a libertarian and a liberal ethos. A policy giving presumptive effect to boilerplate in consumer form contracts is difficult to square with this ideal. This is particularly true when the consumer might have objected to the term had the term been brought to the consumer's attention when the contract was made, for the policy denies the consumer a meaningful opportunity to object.

The argument for giving presumptive effect to boilerplate in consumer form contracts dismisses the idealized notion of assent as not worth pursuing even as an aspirational goal.<sup>30</sup> Instead, this argument views the relevant question as whether enforcing boilerplate is in the interest of consumers as a group and society at large. The argument treats as unimportant the quality of consumer assent in any specific case. What matters is the aggregated assent of consumers as a class, as this aggregated assent is mediated through competition in the market. Further, aggregated assent matters because it is a signal that a term is in the interests of consumers generally and in the interest of society. The fact that some consumers may object to the term if it were brought to their attention is beside the point because the relevant question is assumed to be whether on-balance the term is in the interest of consumers as a group.<sup>31</sup>

This argument's underlying ethos is utilitarian, not liberal or libertarian.<sup>32</sup> The disagreements over the policy giving presumptive effect to boilerplate in consumer form contracts are not entirely normative (about relevant values). Indeed the primary disagreements may be empirical (about the facts). People disagree about the likelihood that markets actually deter firms from exploiting boilerplate to profit

---

29. MARGARET JANE RADIN, *BOILERPLATE: THE FINE PRINT, VANISHING RIGHTS, AND THE RULE OF LAW* (2013).

30. See Omri Ben-Shahar, *Regulation Through Boilerplate: An Apologia*, 112 MICH. L. REV. 883, 884 (2014).

31. If assent is a factor in the analysis in the cases discussed *infra* Section VII.A.2, then it is in this way.

32. The argument shares with libertarianism a distrust of public ordering and a preference for private ordering.

at the expense of consumers.<sup>33</sup> And people disagree about the capacity of courts to identify and improve upon socially undesirable terms.<sup>34</sup> These empirical disagreements reflect pervasive disagreements about the capacity of people to protect themselves from the carelessness and cupidity of others and the capacity of courts to improve the world.

But there is also much common ground on boilerplate. Critics of the policy of giving presumptive effect to boilerplate in consumer form contracts concede form contracts can be a useful mechanism for self-governance, particularly when forms are used in a trade. Karl Llewellyn explains when and why courts should defer to boilerplate. At their best, Llewellyn observes, pre-made forms are “a triumph of private attention to what is essentially private self-government in the lesser transactions of life or in those areas too specialized for the blunt, slow tools of the legislature.”<sup>35</sup> Llewellyn continues:

[Where] two-fisted bargainers on either side of the table have worked out in the form of a balanced code to govern the particular line or trade or industry, there is every reason for a court to assume both fairness and wisdom in the terms, and to seek in the first instance to learn, understand, and fit both its own thinking

---

33. Florencia Marotta-Wurgler summarizes the prior literature, debating the role of competition in shaping boilerplate. See Florencia Marotta-Wurgler, *Competition and the Quality of Standard Form Contracts: The Case of Software License Agreements*, 5 J. EMPIRICAL LEGAL STUD. 447 (2008). The paper reports the results of an empirical study of boilerplate in End User Licensing Agreements (EULAs) in the software industry. *Id.* at 467-75. A principal finding is that “most EULA terms do not appear to depend on competitive conditions in a measurably important way.” *Id.* at 451. In other words, there was no evidence that sellers with market power exploited this power to obtain more advantageous EULA terms. See Florencia Marotta-Wurgler & Robert Taylor, *Set in Stone? Change and Innovation in Consumer Standard-Form Contracts*, 88 N.Y.U. L. REV. 240, 244 (2013) (examining changes in EULA terms over time (2003 to 2010) and finding “that most of the terms that changed have become more pro-seller relative to the original contract”).

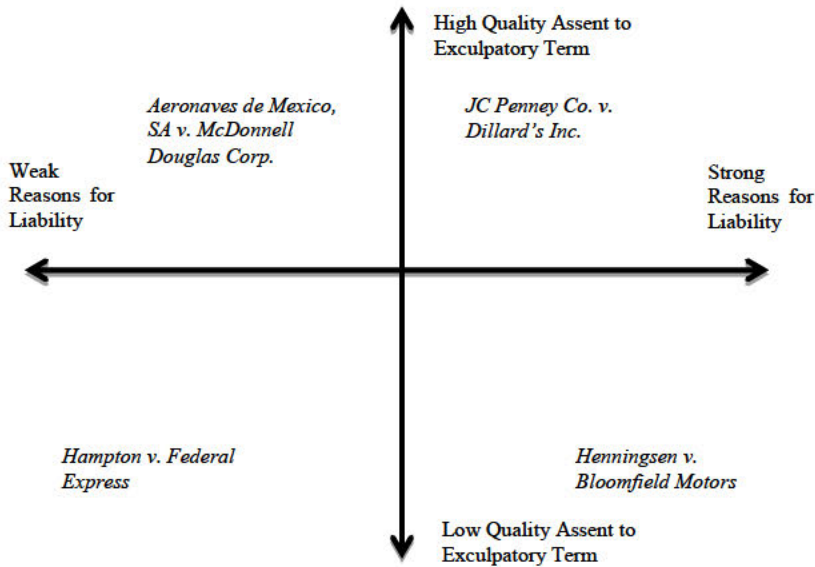
34. Skepticism about the ability of courts to improve upon the market in regulating boilerplate terms underpins the argument made by Douglas Baird that courts should generally enforce boilerplate while developing rules targeting specific terms that clearly have an anti-competitive effect or otherwise violate well-established public policy. DOUGLAS G. BAIRD, *RECONSTRUCTING CONTRACTS* 134-40 (2013). Robert Scott makes the general point that a strategy that directs courts to develop default rules “to direct the ex post efficient result . . . may thus be assuming a level of competency that courts cannot reasonably achieve,” Robert E. Scott, *The Case for Formalism in Relational Contract*, 94 NW. U. L. REV. 847, 858-59 (2000); see also Eric A. Posner, *A Theory of Contract Law Under Conditions of Radical Judicial Error*, 94 NW. U. L. REV. 749 (2000) (arguing that courts lack the genius and guidance necessary to properly decide disputes that arise between contracting parties). John Murray observes critically that “[f]ormalists insist that Llewellyn’s ‘functional’ contract law failed because it is based on an assumption of competent courts and incompetent parties while the actual empirical condition that is alleged to prevail reveals competent parties and incompetent courts.” John E. Murray, Jr., *Contract Theories and the Rise of Neoformalism*, 71 FORDHAM L. REV. 869, 899 (2002).

35. KARL N. LLEWELLYN, *THE COMMON LAW TRADITION: DECIDING APPEALS* 362 (1960).

and its action into the whole design. Contracts of this kind (so long as reasonable in the net) are a road to better than official-legal regulation of our economic life . . . .<sup>36</sup>

### C. Illustrative Cases

While outcomes in hard cases often turn on how a court views some of the contested issues just discussed, focusing on some easy cases helps identify common ground. Views on the contested issues may bear on the explanation of the result in these cases, but they do not affect the result. The diagram below plots four easy cases on two vectors, which represent the two principles.



In cases in the upper-left quadrant, the reasons for liability are weak, and the victim's assent to the exculpatory term is high quality. *Aeronaves de Mexico, S.A. v. McDonnell Douglas Corp.* illustrates.<sup>37</sup> Aeronaves purchased commercial passenger aircraft from McDonnell Douglas. The aircraft were grounded for substantial periods of time as a result of various problems. Aeronaves sued suppliers of parts to

36. *Id.* at 363. In a similar vein, Choi and Gulati analogize standard industry documents to legislation. They argue that when a court interprets terms that are standard across an industry, the court should treat the problem as akin to interpreting a statute, taking an industry-wide view and adopting the position of an industry-wide authority if there is one, and if there is not, analyzing the problem as would an industry-wide authority. Stephen J. Choi & G. Mitu Gulati, *Contract as Statute*, 104 MICH. L. REV. 1129 (2006).

37. 677 F.2d 771, 773-74 (9th Cir. 1982).

McDonnell Douglas, seeking to recover lost profits and claiming some of the problems with the aircraft were attributable to defects in the parts. Aeronaves could not recover its lost profits from McDonnell Douglas because its contract with McDonnell Douglas had an exclusive repair-and-replace remedy. The case holds the exclusive repair-and-replace remedy in the Aeronaves-McDonnell Douglas contract also shielded the parts suppliers from liability. This was correct. There was a high quality of assent: Aeronaves was a sophisticated party, and the exclusive repair-and-replace remedy was a material term in a negotiated contract. Had the tort claim been allowed, it would have negated the limitation of remedy in the Aeronaves-McDonnell Douglas contract for McDonnell Douglas would have ultimately borne the cost of damages paid by the suppliers to Aeronaves under indemnity terms in the contracts between McDonnell Douglas and the parts suppliers. Further, the reasons for liability were weak: Aeronaves was not left entirely vulnerable, for McDonnell Douglas did substantial free work under the warranty to repair the defects; the loss was purely economic; and the tort claims against the parts suppliers raised difficult issues of fault and causation.

In cases in the lower-left quadrant, the reasons for liability are weak, and the victim's assent to the exculpatory arrangement is low quality. The tragic case *Hampton v. Federal Express Corp.* illustrates.<sup>38</sup> A thirteen-year-old cancer patient died while waiting for a bone marrow transplant. It turned out the boy's blood type matched the blood type of a potential donor, but the match was not discovered in time because Federal Express failed to deliver samples of the boy's blood. The contract between Fed Ex and the shipper, the hospital where the boy was being treated, limited the carrier's liability to \$100. The court held Fed Ex's liability was capped at \$100. This was correct, but largely because the reasons for liability were very weak. The risk Fed Ex was being asked to assume was grossly disproportionate to the price it was paid. The hospital was in a better position to avoid the loss. Someone at the hospital should have followed up to ensure the package was delivered. And it was highly speculative whether the transplant would have succeeded, and the boy would have lived even if the match had been identified.

In cases in the lower-right quadrant, the reasons for liability are strong, and the victim's assent to the exculpatory arrangement is low quality. *Henningsen v. Bloomfield Motors, Inc.* illustrates.<sup>39</sup> Henningsen was seriously injured when the steering mechanism of a recently purchased Chrysler automobile failed. The small print of

---

38. 917 F.2d 1119, 1121 (8th Cir. 1990) (applying Missouri law).

39. 161 A.2d 69, 79-80 (N.J. 1960).

Chrysler's standard form agreement, which the dealer had the Henningsens sign, provided a limited warranty (90 days or 4000 miles) and limited Chrysler's obligation to "making good" defective parts.<sup>40</sup> The court correctly held the contract did not shield Chrysler from liability for Henningsen's injuries. The court reached this result by a contractual route, holding a purchaser from a dealer has a claim for breach of the implied warranty of merchantability against a manufacturer<sup>41</sup> and invalidating the disclaimer and limitation of liability clauses for unconscionability.<sup>42</sup>

In cases in the upper-right quadrant, the reasons for liability—ignoring for a moment the exculpatory term itself—seem strong, but the victim's assent to the exculpatory term is high quality. *J.C. Penney Co. v. Dillard's Inc.* illustrates.<sup>43</sup> The parties were two tenants in a mall, which had an operating agreement under which the tenants agreed to carry casualty insurance and "to release each other from liability from any loss or damage to property covered by the party's insurance policy."<sup>44</sup> The court held the exculpatory term barred a claim by one tenant against another for property damage resulting from the defendant's negligence.<sup>45</sup> The result is correct. This arrangement is fairly common in commercial leases: it makes the mall an island of no-fault liability in a sea of negligence liability, with respect to property damage disputes between tenants. Casualty insurance fulfills the compensation function of the tort system.<sup>46</sup> As a matter of legal principle, once compensation for a loss is secured, the law is indifferent about who bears the burden of funding compensation.<sup>47</sup> Other mechanisms, such as reputation and self-interest, may partly fulfill the deterrence function. And despite any shortfall in deterrence, commercial tenants may nevertheless prefer to opt out of the

---

40. *Id.* at 74.

41. *Id.* at 76-84.

42. *Id.* at 85-95.

43. 75 So. 3d 795 (Fla. 4th DCA 2011).

44. *Id.* at 797.

45. *Id.* at 798.

46. For a comparison of no-fault and liability insurance for auto accidents, see Gary T. Schwartz, *Auto No-Fault and First-Party Insurance: Advantages and Problems*, 73 S. CAL. L. REV. 611 (2000). After a careful review of the available evidence, Schwartz concludes: "Pure no-fault, then, should be dramatically less expensive than either tort or hybrid no-fault, partly because of reduced compensation for pain and suffering, but largely because of reduced litigation costs and reduced incentives for padded medical expenses." *Id.* at 636.

47. Thus, there is a general rule validating indemnity agreements. This rule is not restricted to insurance and does not preclude an actor from indemnifying himself against his own negligence. *Jones v. Strom Constr. Co.*, 527 P.2d 1115, 1118-19 (Wash. 1974) (en banc).

negligence system. They may determine that negligence law's increased deterrence is outweighed by its expected cost and risk of error.<sup>48</sup>

Cases in the upper-right quadrant may be interesting as a matter of policy because of the inconsistency of the private arrangement and background rules of negligence law. When people routinely contract out of the background rules of negligence law, it may be time to rethink the rules. However, as *J.C. Penney* illustrates, current doctrine can handle these cases without difficulty whenever the term is in a contract to which the victim is a party. As Part III explains, the modern law of third-party beneficiary is available to enforce an exculpatory term in the victim's contract to benefit a harm-doer who is not a party to the contract. These rules mostly give effect to manifested intent, but the rules are supple enough to allow a court to consider factors that bear on the strength of the reasons for liability, particularly when the term is ambiguous. In these cases tort principles inform contractual analysis.

Nor are cases in the extreme lower-right corner of the diagram, such as *Henningsen*, difficult to handle doctrinally. In these cases, courts can use the unconscionability doctrine and the public policy doctrine to invalidate exculpatory terms because there are strong reasons for liability and the quality of assent is weak. Often this will follow from a contextualized assessment of relevant factors. Clear rules also prohibit certain types of exculpatory terms. For example, manufacturers and distributors of new products generally cannot disclaim liability for defects that cause bodily harm.<sup>49</sup> These rules are complemented by amorphous standards that allow courts to make one-off determinations under criteria that roughly and generally get at the strength of the reasons for imposing liability and the quality of a victim's assent to a term.<sup>50</sup> The amorphousness of the standards is

---

48. For an argument that using negligence liability to compensate and deter is generally inefficient, see Paul H. Rubin, *Courts and the Tort-Contract Boundary in Product Liability*, in *THE FALL AND RISE OF FREEDOM OF CONTRACT* 119 (F.H. Buckley ed., 1999).

49. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 18 (AM. LAW INST. 1998). Under the U.C.C., "Limitation of consequential damages for injury to the person in the case of consumer goods is prima facie unconscionable." U.C.C. § 2-719(3) (AM. LAW INST. & NAT'L CONFERENCE OF COMM'RS ON UNIF. STATE LAWS 2014).

50. Many jurisdictions use the six factor test in *Tunkl v. Regents of the University of California* to determine whether an exculpatory term violates public policy. 383 P.2d 441, 444-46 (Cal. 1963) (in bank). The factor whether the "purchaser is placed under the control of the seller, subject to the risk of carelessness by the seller or his agents" goes directly to vulnerability. *Id.* at 446 (footnote omitted). Going to the quality of assent is the factor of a harm-doer's "decisive advantage of bargaining strength" and the factor whether "[i]n exercising a superior bargaining power the party confronts the public with a standardized adhesion contract of exculpation, and makes no provision whereby a purchaser may pay additional reasonable fees and obtain protection against negligence." *Id.* (footnote omitted).



both a vice and a virtue.<sup>51</sup> There is general consensus that the virtues outweigh the vices so long as the operation of these doctrines is confined to cases in the lower-right corner.<sup>52</sup> The judge makes necessary factual and normative determinations under these doctrines, not the jury, which reduces the worry about the amorphousness of the standards.

This leaves a large field of cases on which current legal doctrine offers less sure footing, if courts are to implement the principles identified in this Part in a coherent, consistent, and predictable way. *Hampton v. Federal Express* is emblematic of a recurring type of case that presents doctrinal difficulties, even though the outcome in many of these cases is easy to justify under general principles of tort law. In these cases, there are weak reasons for liability based on factors relevant under tort law, and the conclusion that liability is neither in the interest of people like the plaintiff generally, nor in the interest of society, is reinforced by the presence of exculpatory terms in standard form contracts, typically in the form of a liability cap. *Hampton* reappears in Section IV.C as an example to illustrate how modern rules of

---

Mark Geistfeld restates the relevant questions under these two factors—“Was the plaintiff a ‘weak bargainer,’ and did he or she ‘really acquiesce voluntarily in the contractual shifting of the risk?’”—using terms that even more clearly bear on the quality of assent. GEISTFELD, *supra* note 13, at 303. Three of the *Tunkl* factors do not correspond with the two general principles in any obvious way. These factors are whether a harm-doer is in “a business of a type generally thought suitable for public regulation”; whether a harm-doer “is engaged in performing a service of great importance to the public, which is often a matter of practical necessity”; and whether a harm-doer “holds himself out as willing to perform this service for any member of the public.” *Tunkl*, 383 P.2d at 445 (footnote omitted). These factors may get at whether negligence liability is routinely imposed for the conduct and harm in question, which one would hope relates to the efficacy of negligence liability. Geistfeld questions the relevance of the importance or necessity of the harm-doer’s activity. See GEISTFELD, *supra* note 13, at 304-05. The actual claim in *Tunkl* was for medical malpractice. *Tunkl*, 383 P.2d at 442. The defendant, a charitable research hospital, required patients to sign a release as a condition for admission. See *id.*

51. See ROBERT A. HILLMAN, *THE RICHNESS OF CONTRACT LAW: AN ANALYSIS AND CRITIQUE OF CONTEMPORARY THEORIES OF CONTRACT LAW* 129-43, 160-71 (1997), for a balanced and nuanced assessment of the vices and virtues of the unconscionability doctrine. Even critics of the doctrine concede the validity of its application in cases like *Henningsen* and the value of the doctrine’s flexibility. See, e.g., Richard A. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 295 (1975). The two principles roughly correspond with the substantive and procedural strands of the doctrine of unconscionability. Procedural unconscionability gets at the quality of assent. Substantive unconscionability gets at the fairness or reasonableness of a term. Because tort principles supply a basis for determining the reasonableness of an exculpatory term, this strand of unconscionability doctrine is less susceptible to the objection that it lacks guiding principles.

52. Victor Goldberg reports an oddity in this regard. VICTOR GOLDBERG, *FRAMING CONTRACT LAW: AN ECONOMIC PERSPECTIVE* 245-78 (2006). Courts have held an exculpatory term absolving a ship classification society from liability for consequential damages violated public policy, but then denied consequential damages based on contract law principles. *Id.* at 261-64.

negligence law invite weak claims in cases involving physical harm. Section VII.A.2 will explain why the result in *Hampton* nevertheless follows from general principles of tort law once these principles are properly understood. It proposes a no-duty rule that gives effect to ubiquitous liability caps in certain types of form contracts.

### III. THE PRINCIPLES AT WORK: THIRD-PARTY BENEFICIARY LAW

The principles identified in Part II can be seen at work in cases where the victim's contract contains an exculpatory term, and it is ambiguous whether a nonparty harm-doer is an intended third-party beneficiary of the term. It is well established under third-party beneficiary law that protection from a legal claim is one of the rights that can be granted to a third party by contract. The enforcement of a "Himalaya clause" in the maritime carriage trade is an example. When a carrier and a shipper want to extend a limitation of liability to other carriers who will handle the shipper's goods ("through carriers"), they express that intent with a Himalaya clause in the bill of lading.<sup>53</sup> A through carrier is treated as a third-party beneficiary of the clause.<sup>54</sup> The law on releases supplies another example. When a company negotiates a release, it typically wants the release to cover the company's officers, employees, and related parties, such as a parent company or a subsidiary. Third parties who are covered by the release can be identified individually by name, as a class, or by using global language. An identified third party is treated as a third-party beneficiary of the release.<sup>55</sup>

When an exculpatory term unambiguously covers a claim against a third party, U.S. courts are likely to enforce the term automatically, giving no consideration to the parties' actual intent, or to the reasonableness of applying the term. This is not consistent with the principles identified in Part II. Most U.S. courts use the "intent to benefit" test to determine third-party beneficiary status.<sup>56</sup> Courts will

---

53. Thomas R. Denniston et al., *Liabilities of Multimodal Operators and Parties Other Than Carriers and Shippers*, 64 TUL. L. REV. 517, 521 (1989). The leading U.S. cases involve terms that do not have this effect because they are ambiguous. See, e.g., *Robert C. Herd & Co. v. Krawill Mach. Corp.*, 359 U.S. 297, 302 (1959); *Brown & Root, Inc. v. M/V Peisander*, 648 F.2d 415, 417 n.5 (5th Cir. 1981) (discussing the English cases). For cases enforcing the clause to benefit a third party, see *La Salle Mach. Tool, Inc. v. Maher Terminals, Inc.*, 611 F.2d 56, 59-60 (4th Cir. 1979), and *De Laval Turbine, Inc. v. W. India Indus.*, 502 F.2d 259, 264-70 (3d Cir. 1974).

54. See, e.g., *La Salle Mach. Tool, Inc.*, 611 F.2d at 59-60; *De Laval Turbine, Inc.*, 502 F.2d at 264-70.

55. See, e.g., *Mayfield v. NASCAR, Inc.*, 674 F.3d 369 (4th Cir. 2012) (enforcing global exculpatory clause in NASCAR drug testing agreement).

56. RESTATEMENT (SECOND) OF CONTRACTS § 302(1)(b) (AM. LAW. INST. 1981).

usually treat an expression of intent to create a legal right in a third party as decisive under this test.<sup>57</sup> A good example of this is the way courts treat releases of legal claims against a class (as opposed to specific, named persons). Courts frequently ignore the fact that a party who procures a release does so only to minimize the risk of missing a claim that might ultimately redound to its own detriment, such as a claim against an employee. Instead of recognizing that point, U.S. courts generally enforce class releases literally, with no inquiry into whether applying the release to a claim against a third party actually benefits the party who paid for the release.<sup>58</sup> The victim consequently basically bears the risk that a class release will cover an unintended harm-doer or an unintended harm, unless the victim can persuade a court he is entitled to relief on the legal ground of mistake. This is a consequence of the literalist approach U.S. courts take in contract interpretation.<sup>59</sup>

---

57. For a critique of the intent to benefit test, see Melvin Aron Eisenberg, *Third-Party Beneficiaries*, 92 COLUM. L. REV. 1358, 1378-81 (1992). Eisenberg focuses on the problem of determining when a third party has the right to legal redress for non-fulfillment of a performance obligation. *See id.*

58. *Brinton v. Bankers Pension Servs., Inc.*, 90 Cal. Rptr. 2d 469 (Cal. Ct. App. 1999). Brinton was a party to a class action against a securities broker-dealer (Thon) and a dealership (Titan) involving failed investments in five limited partnerships (the Hill Williams entities). The class action litigation ended in a settlement in which Brinton released the defendants and their "principals" from:

[A]ll claims, demands, causes of action, suits or debts of any kind or nature . . . that [Plaintiffs] . . . now have or may ever have against [the named Defendants] by reason of any matter or thing arising from, related to, or affiliated with any cause, act, transaction, omission or event whatsoever that occurred prior to the date of this Agreement, . . . involving the Hill Williams Entities. . . .

*Id.* at 474. This release was held to bar a claim by Brinton against Bankers Pension Services ("BPS") also involving a loss on an investment in the Hill Williams entities because BPS was within the defined class as a "principal" of a named defendant, as Thon had served as a broker dealer for BPS. BPS had no other connection to the defendants in the class action and there was no claim that the defendants had an economic interest in releasing BPS. The court refused to consider evidence offered by Brinton that he had not understood the release to cover dealerships other than the defendant to the class action.

Global releases are handled differently. The problem typically arises when "[a]n injured party settles with an alleged tortfeasor's insurer, signing a general release agreement that appears to excuse everyone in the world from liability. Then the injured party proceeds against a different alleged tortfeasor, who raises the general release as a defense." *Neverkovec v. Fredericks*, 87 Cal. Rptr. 2d 856, 859 (Cal. Ct. App. 1999). *Neverkovec* supplies guidelines to resolve such claims. A person seeking benefit of a general release has the burden of affirmatively showing the parties intended to release him. *Id.* Intent is determined objectively by examining the terms of the contract and the circumstances surrounding the release. The ultimate question is "how a reasonable person in the releasing party's shoes would have believed the other party understood the scope of the release." *Id.* at 867. Key to this determination is whether the other party had any apparent motive to cover the alleged tortfeasor with the release.

59. As explained below, third-party beneficiary law has a party-centric focus. The interests of the nonparty harm-doer are irrelevant to interpreting the exculpatory term—

On the other hand, when a contract is ambiguous, U.S. courts will consider contextual factors in resolving the ambiguity, including the reasonableness of an interpretation. The outcomes in cases that require a court to interpret an ambiguous exculpatory term generally conform to the principles identified in Part II, except in one respect, which will be explained shortly.<sup>60</sup> Thus, the strength of the reasons for imposing negligence liability explain and support a rule of maritime law requiring that the intent to protect a nonparty carrier from a negligence claim be clearly expressed.<sup>61</sup> The rule grounds on a strong public policy against a carrier absolving itself from negligence liability. This policy is readily explained by a combination of vulnerability to carelessness without liability, and the absence of factors that justify not imposing negligence liability (i.e., the concerns for indeterminate liability or the difficulty of ascertaining breach and causation). Also, it generally is not in the interest of either the initiating carrier or the shipper to absolve a through carrier when this is not agreed to in advance.

The results in two Ninth Circuit cases also generally conform to the principles identified in Part II. The cases are noteworthy because they involve the same exculpatory term but reach opposite results, for reasons that conform to the principles identified in Part II. Both cases involve a claim by a commercial airline against an aircraft manufacturer and a part supplier for defective work. In both cases, the contract between the aircraft manufacturer and the airline had an exclusive repair-and-replace remedy. *Aeronaves de Mexico, S.A. v. McDonnell Douglas Corp.* holds the exclusive repair-and-replace term precludes a claim against a parts supplier, when the manufacturer does substantial free work under the warranty to repair the defects.<sup>62</sup> *Continental Airlines, Inc. v. Goodyear Tire & Rubber Co.*<sup>63</sup> holds the term does not preclude a claim against a parts supplier, when the

---

only the interests and purposes of the parties matter. If courts would keep this in mind, then courts would not interpret an exculpatory term literally when a literal interpretation leaves a party to the contract vulnerable to harm and when it does not advance the interests of the other party to the contract to absolve the nonparty harm-doer from liability.

60. It is uncontroversial that when parties engaged in a common enterprise are connected through a chain or web of contracts, the contracts "must be read and considered together" when interpreting an ambiguous term involving a third-party beneficiary claim. *Bristol Steel & Iron Works, Inc. v. Plank*, 178 S.E. 58, 60 (Va. 1935). For further authority, see Fabrizio Cafaggi, *Contractual Networks and Contract Theory: A Research Agenda for European Contract Law*, in CONTRACTUAL NETWORKS, INTER-FIRM COOPERATION AND ECONOMIC GROWTH 66, 75 (Fabrizio Cafaggi ed., 2011).

61. *Lucky-Goldstar Int'l (Am.), Inc. v. S.S. Cal. Mercury*, 750 F. Supp. 141, 144-45 (S.D.N.Y. 1990).

62. 677 F.2d 771, 773-74 (9th Cir. 1982).

63. 819 F.2d 1519 (9th Cir. 1987).

manufacturer is not contractually obligated to repair the work in question.<sup>64</sup> Both results conform to the principles identified in Part II.<sup>65</sup> In *Aeronaves de Mexico*, the repair-and-replace remedy gave the plaintiff some protection from the loss without the claim against the parts supplier; in *Continental Airlines*, the plaintiff's only possible recourse was against the parts supplier. In addition, in *Aeronaves de Mexico*, the manufacturer would have had to indemnify the parts supplier for any damages they paid to the plaintiff, and so allowing the claim would have defeated the purpose of the exclusive repair and replace remedy.<sup>66</sup>

When interpreting an ambiguous exculpatory term, courts deviate from the Part II principles in one respect. Principles of negligence law generally require a court to balance the interests of risk creators (i.e., people like the harm-doer) and risk bearers (i.e., people like the victim). Something like interest balancing is going on in *Aeronaves de Mexico* and *Continental Airlines*. However, there is an important difference between interest balancing in negligence law and interest balancing in third-party beneficiary law. In third-party beneficiary law, the only relevant interests are those of the parties to the contract. In cases like *Aeronaves de Mexico* and *Continental Airlines*, these are the interests of the airline and the aircraft manufacturer. The parts supplier's interests are irrelevant to interpreting the exculpatory term, except insofar as they implicate the interests of a party to the contract (i.e., the airline or the airline manufacturer). Third party-beneficiary law has this party-centric focus because people make contracts to achieve their own purposes. Consistent with this, third party status should be conferred if and only if it advances the purposes of the parties to the contract.

The party-centric focus of third-party beneficiary law reduces the risk that an ambiguous term will be construed in a way that leaves a

---

64. *Id.* at 1528-29. This is because the repair work was outside the scope of the manufacturer's repair-and-replace remedy. *Id.*

65. It may seem odd that the airline that bargained for greater contractual protection ends up having lesser rights once the third-party beneficiary claim is considered. The result follows from tort principles because the contractual protection makes the airline less vulnerable to the carelessness of the parts supplier. The result follows from contract principles because the contractual protection increases the likelihood the parties would have agreed that the airline would not have an additional third-party beneficiary claim against the parts supplier, if the parties had thought about the issue when the contract was made. Section VII.B.1, *infra*, explains this in more detail in the context of tort claims for pure economic loss.

66. *Aeronaves de Mex.*, 677 F.2d at 773. In *Continental Airlines*, the court suggested ways to handle the claims against the part suppliers to ensure that the manufacturer did not end up paying consequential damages, which the manufacturer was absolved from having to pay by the contract with the airline. *Cont'l Airlines, Inc.*, 819 F.2d at 1529.

victim vulnerable to harm by a nonparty.<sup>67</sup> *Dressel Associates, Inc. v. John A. Welsch Real Estate Appraisers, Inc.* illustrates.<sup>68</sup> An appraiser argued that a term in a real estate contract, which made the appraisal “final and binding,” shielded the appraiser from negligence liability for a loss resulting from an inaccurate appraisal. The court held the purpose of the term was to fix the vendor and purchaser’s obligations to each other, and not to protect the appraiser. This is plausible, for shielding the appraiser from negligence liability to the purchaser would impose a significant risk on the purchaser without providing a corresponding benefit to the seller.<sup>69</sup> You will see later that, in some states, a negligence claim probably is not available against the appraiser in a case like *Dressel Associates*.<sup>70</sup> There is no inconsistency here: negligence law’s interest balancing accounts for the interests not just of people like the harm-doer, but also of society generally. A court might conclude from this fuller accounting of interests that no claim should be available under negligence law, even though third-party beneficiary law’s narrower, party-centric focus suggests otherwise.

#### IV. THE PROBLEMS WITH CURRENT LEGAL DOCTRINE

Most of the problems with current legal doctrine involve cases in which an exculpatory term is in the harm-doer’s contract with a third party. Section IV.A explains that courts often determine the effect of an exculpatory term by applying one of two rules, which make the term’s effect depend on the classification of the plaintiff’s claim as either a tort claim or a contract claim on a third-party beneficiary theory. Section IV.B explains that the rules share the same basic

---

67. Because of the party-centric focus of third-party beneficiary law, reliance by a nonparty harm-doer on being shielded by the exculpatory term should be a reason to confer third-party beneficiary status on the harm-doer only if at least one of the parties to the contract invited the harm-doer’s reliance to induce the harm-doer to deal with them, or to secure some other benefit from the harm-doer. An explicit indication by one of the parties that they want the harm-doer to be able to rely on the term should satisfy this requirement. See Eisenberg, *supra* note 57, at 1384 n.99.

68. *Dressel Assocs., Inc. v. John A. Welsch Real Est. Appraisers, Inc.*, 632 A.2d 906, 908 (Pa. Super. Ct. 1993). *Conway v. Icahn & Co.* is further authority for the point. 16 F.3d 504, 509 (2d Cir. 1994). An investor sued his stockbroker for liquidating an account without permission to satisfy a margin call, claiming this was a breach of fiduciary duty and negligence. There was an agreement between the investor and the clearing broker permitting what the investor’s stockbroker had done. But the stockbroker was not a party to the agreement, and there was no express language indicating he was an intended beneficiary. The court refused to treat him as a beneficiary by implication. *Id.*

69. There is no suggestion the absence of liability was factored into the price the appraiser charged the seller.

70. See *infra* Section VII.B.1, for a discussion of these rules and an explanation of the reasons that may justify the rule.

premise as the old privity doctrine, which is that contract is either conclusive or irrelevant to the issue of the availability of a tort claim. Section IV.C explains how changes in negligence law make the premise untenable. To deal with these problems sensibly, the analysis must incorporate tort and contract considerations.

### A. *Two Rules*

Courts often apply one of two rules to determine an exculpatory term's effect when it is in the harm-doer's contract with a third party. The rules make the effect of the term turn on whether the victim's claim against the harm-doer is classified as a third-party beneficiary contract claim or as a tort claim. Classifying the victim's claim as a third-party beneficiary contract claim brings into play the rule *a third-party beneficiary cannot have greater rights than a contract creates*.<sup>71</sup> The rule makes the exculpatory term effective without regard to the victim's interests and assent. Classifying the victim's claim as a tort claim brings into play the rule *a contract cannot destroy rights of a nonparty*.<sup>72</sup> The rule makes the contract between the harm-doer and the third party irrelevant to the harm-doer's duty to the victim.

---

71. The rule has been invoked to hold that a harm-doer cannot be liable to a third-party beneficiary for failing to take a precaution outside the scope of the harm-doer's performance commitment in the contract. *Doe v. Grosvenor Props. (Haw.) Ltd.*, 829 P.2d 512, 518-19 (Haw. 1992) (dismissing an elevator passenger's assault claim against a maintenance company for negligently failing to connect the stop button and alarm because the contract had absolved the company from its obligation to modify the design to comply with safety regulations).

The rule has been invoked to hold a third-party beneficiary to a valid term limiting liability. *Fretwell v. Prot. Alarm Co.*, 764 P.2d 149, 151 (Okla. 1988) (holding that homeowners—as third party beneficiaries of a contract between their insurance company and alarm company—were subject to the limitation of liability clause in the contract); see also *Lane-Detman, L.L.C. v. Miller & Martin*, 82 S.W.3d 284, 294 (Tenn. Ct. App. 2002) (enforcing an exculpatory term against a third-party beneficiary).

The rule has been invoked to hold a victim to a valid choice-of-forum term. *A.P. Moller-Maersk A/S v. Comercializadora de Calidad S.A.*, 429 F. App'x 25, 29 (2d Cir. 2011); *Am. Patriot Ins. Agency, Inc. v. Mut. Risk Mgmt., Ltd.*, 364 F.3d 884, 890 (7th Cir. 2004); *Consol. Bathurst, Ltd. v. Rederiaktiebolaget Gustaf Erikson*, 645 F. Supp. 884, 887 (S.D. Fla. 1986). Sometimes the point is expressed in a more convoluted way. See, e.g., *Anwar v. Fairfield Greenwich Ltd.*, 728 F. Supp. 2d 372, 417-18 (S.D.N.Y. 2010). And the rule has been invoked to hold a victim to a mandatory arbitration term. *Am. Patriot*, 364 F.3d at 890.

72. See, e.g., *Young v. Tri-etch, Inc.*, 790 N.E.2d 456, 459 (Ind. 2003) (“Since Young was not a party to the contract, and thus never consented to the terms of the contract, the contract simply does not impose any obligations or limitations on him.”); see also RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 21 cmt. f (AM. LAW INST. 1998) (acknowledging the power of a seller to disclaim liability for property harm, adding “[o]f course, such contractual limitations would be effective only between the parties themselves”); DAVID G. OWEN, PRODUCTS LIABILITY LAW 840 (2005) (“Even if a products liability defendant effectively avoids negligence responsibility toward the user who signed

The two rules typically are stated as being self-evident. Indeed, the rules seem self-evident. The rule *a third-party beneficiary has no greater rights than a contract creates* seems self-evidently correct when the harm-doer's duty to the victim has no basis other than the harm-doer's contract.<sup>73</sup> Conversely, the rule *a contract cannot destroy a right of a nonparty* seems self-evidently correct because "rights" bring to mind rights we have that are good against the world, such as the right to decide who may touch your body in a way that is potentially harmful or offensive, or who may use your property. You can give others the right to use your property. You can even relinquish certain aspects of control over your body. But, if you are a competent adult, no one else has the power to do these things. Only you do.<sup>74</sup>

An immediate and obviously unfortunate consequence of this state of affairs is that it makes an exculpatory term's effect turn on whether the victim's claim against the harm-doer is classified as a third-party beneficiary contract claim or as a tort claim. This is indefensible as the classification of a claim is often arbitrary.<sup>75</sup> Often a claim's classification is a product of the relative pace at which negligence law and third-party beneficiary law have developed in a jurisdiction. The foreign experience is instructive. Courts that were late in embracing

---

the contractual disclaimer, such a provision will not bar a negligence action brought by an injured third party against the manufacturer or other seller.").

73. The qualifications to the rule in contract law are minor. The most pertinent qualification is the constraint on the general power of parties to a contract to cut back on the rights of a third-party beneficiary who relies on performance. This "power terminates when the beneficiary . . . materially changes his position in justifiable reliance on the promise." RESTATEMENT (SECOND) OF CONTRACTS § 311(3) (AM. LAW INST. 1981).

74. The question-begging character of the rule becomes apparent if you think instead of rights as derived from other people, as most impersonal rights are. For example, most rights in tangible property derive from other people by acquisition. When property is acquired, the acquirer's rights in the property are limited by the terms of prior conveyances. A contract can thus delimit the rights of a nonparty. But we do not think of this as a prior conveyance "destroying" a right, because we think of a limitation in a prior conveyance as preventing a right from coming into being.

75. For example, in some states the claim by a purchaser of a home against an inspector hired by the owner is treated as a tort claim. *See, e.g., Hardy v. Carmichael*, 24 Cal. Rptr. 475, 480-81 (Cal. Dist. Ct. App. 1962). Alternatively, other states treat the claim as a third-party beneficiary claim. *See, e.g., Buchanan v. Ga. Boy Pest Control Co.*, 287 S.E.2d 752, 754 (Ga. Ct. App. 1982); *Davis v. New England Pest Control Co.*, 576 A.2d 1240, 1242 (R.I. 1990). For additional cases, see Francis M. Dougherty, Annotation, *Liability of Termite or Other Pest Control or Inspection Contractor for Work or Representations*, 32 A.L.R. 4th 682 (1984). The claim of a disappointed heir harmed by an estate planner's negligence has been classified both as a negligence claim and as a third-party beneficiary claim. For authority which straddles the two theories, holding the beneficiary has a tort claim for malpractice as a third-party beneficiary of the estate planner's contract with the client, see *Hale v. Groce*, 744 P.2d 1289, 1292 (Or. 1987). While classification often is arbitrary, it need not be. A claim might be classified as a third-party beneficiary claim when the parties to the contract have a general power to disclaim a duty to a nonparty under the analysis in Sections VIII.A.2 and VIII.B.2, *infra*.



a robust law of third-party beneficiary tend to handle claims in tort, which has the unintended consequence of making an exculpatory term ineffective. This is roughly the position of English law today, where third-party beneficiary claims were not recognized until 1999.<sup>76</sup> German law, on the other hand, long ago recognized third-party claims. Thus, third-party claims against a lawyer for a mistake in drafting a will or against an appraiser are handled in Germany as contract claims. It has been argued that “[t]he advantage of such an approach—as indeed all contractually-flavoured solutions—is that the plaintiffs take the claim subject to equities so that the sub-contractor can set up all defences against the owner that would have been available to him in a suit brought by the main contractor.”<sup>77</sup> This position potentially suffers from the opposite weakness of the English position, because it may make the term effective against the owner regardless of non-contractual considerations. Apparently this has not been a problem in German law because the interests of the third party victim can be considered under the doctrine of “contract protecting the interests of a third party.”<sup>78</sup>

### B. *The Premise the Rules Share with the Old Privity Doctrine*

The two rules are a product of the rejection of the old privity doctrine, but ironically they share the same mistaken basic premise as the old doctrine. This premise is that contract is either conclusive or irrelevant to the issue of the availability of a tort claim. The connection and the shared premise is near the surface of a passage from an article published in 1905 by Francis Bohlen, a leading torts scholar of the first third of the twentieth century. Bohlen wrote: “While it is true that no one’s rights can be enlarged by a contract to which he is

---

76. I say roughly because English courts seem to have done a pretty decent job taking account of the contractual nexus of a negligence claim making particularized duty determinations. Thus in *Leigh & Silavan Ltd. v. Aliakmon Shipping Co.*, Lord Goff held that a plaintiff-buyer’s tort claim against a ship owner when goods were damaged in transit was subject to a customary exculpatory term in the contract of carriage between the ship owner and the seller. *Leigh & Silavan Ltd. v. Aliakmon Shipping Co.*, [1986] AC 785 (HL) (Eng.).

77. BASIL S. MARKESINIS ET AL., *THE GERMAN LAW OF CONTRACT: A COMPARATIVE TREATISE* 209 (2d ed. 2006).

78. Hein Kötz, *The Doctrine of Privity of Contract in the Context of Contracts Protecting the Interests of Third Parties*, 10 TEL AVIV U. STUD. L. 195, 195 (1990). In German law, the greater flexibility of the contract rule has enabled courts to overcome a defect in an inflexible tort rule. Professor Kötz reports that the flexibility of the doctrine enabled German courts to allow a cleaning woman injured when a defectively repaired water heater exploded to recover from the repairman’s employer on a contract claim when recovery in tort was barred by “the unfortunate provision of Section 831 of the Civil Code, which permits an employer to escape tort liability if he proves that the servant has been carefully selected and supervised.” *Id.* at 196.

no party, it is equally true that they cannot be restricted or destroyed thereby.<sup>79</sup> There are two propositions here. The first—"no one's rights can be enlarged by a contract to which he is not a party"—captures one premise of the old privity doctrine that has since been rejected. Bohlen may be forgiven for accepting this premise, as the point he was making did not depend on its accuracy, and he was a torts scholar who simply accepted conventional wisdom about contract law.

Bohlen's first proposition was tendentious even in 1905, at the heyday of classical theories of contract. Though classical contract law treated it as true as an axiomatic matter, the axiom never jibed with actual contract law. Prior to the rise of classical theories of contract in the late twentieth century, courts in England and the U.S. regularly recognized third-party beneficiary contract claims. In 1905, the axiom did fairly accurately describe the law in places like England and Massachusetts, where the logic of classical theory overcame common sense for a while (in England, this was for a long while).<sup>80</sup> But the axiom did not reflect the law in places like New York, where third-party claims remained available in limited categories of cases.<sup>81</sup> Today, the error in Bohlen's first proposition is universally acknowledged.<sup>82</sup> U.S. courts now regularly enforce third-party beneficiary claims in a wide range of situations. The old premise has been replaced by the modern rule: *a third-party beneficiary has no greater rights than a contract creates.*

Bohlen's second proposition, that one's rights cannot be restricted or destroyed by a contract to which he is not party, is his attempt at correcting another premise of the old privity doctrine that also is no longer accepted. This is the premise that a contract cuts off any duty of care in tort that one owes a nonparty. Bohlen was right to challenge this premise, and his second proposition is today's conventional wisdom. The proposition is embodied in the rule *a contract cannot destroy a right of a nonparty.* But the second proposition is a clumsy way of expressing the correct point, and the clumsiness of the proposition involves the mistaken basic premise that modern law shares

---

79. Francis H. Bohlen, *The Basis of Affirmative Obligation in the Law of Tort*, 53 AM. L. REG. 273, 284 (1905).

80. Third-party beneficiary claims have been available in England since the enactment of the Contracts (Rights of Third Parties) Act of 1999. See Contracts (Rights of Third Parties) Act, 1999, c. 31 (Eng.).

81. Eisenberg, *supra* note 57, at 1360-71.

82. See Eisenberg, *supra* note 57, at 1359, 1373-74 (describing development of modern law of third-party beneficiary out of classical contract law).

with the old privity doctrine. This premise is that contract is either conclusive or irrelevant to the issue of the availability of a tort claim. Some context helps explain why Bohlen made this mistake.

The quoted passage appears in Bohlen's discussion of the "generally misunderstood case of *Winterbottom v. Wright*."<sup>83</sup> Bohlen's aim was to challenge conventional wisdom of the day about tort law: that a contract cut off any possible duty of care to a nonparty. In *Winterbottom*, an injured carriage driver sued a supplier for breach of a contract to supply a safe carriage. The driver pled only a contract claim because he could establish nonfeasance, but not misfeasance, on the supplier's part.<sup>84</sup> Bohlen argued the absence of privity between the two parties bore only on the claim that was actually pled—breach of contract. According to Bohlen, the absence of privity should not have barred a claim by the driver that the supplier was negligent in supplying a defective carriage, if the driver could have established an act of misfeasance by the supplier.<sup>85</sup>

Bohlen's underlying point was that a contract should not absolve a party of a duty of care it owes under tort law to a nonparty, independent of the contract. The contrary view seems an obvious error, and hardly worth correcting. Correction was needed because U.S. and U.K. courts committed this obvious error in handling defective products claims for much of the nineteenth century and the early years of the twentieth century. Bohlen's second proposition, that a contract cannot "restrict or destroy" the rights of a non-party, corrects the obvious error. However, the second proposition goes farther than is necessary to correct the error. The overreach lies in the difference between saying that a contract is always irrelevant to the duty owed a nonparty under tort law (this is how Bohlen's second proposition is stated and commonly understood) and that a contract cannot conclusively negate such a duty if non-contract considerations justify imposing one (this is the correct point).

Bohlen was not alone in thinking that, in a given case, a contract must be either conclusive or irrelevant to the existence of a legal duty. Indeed, this way of thinking persists in the modern rules that make the effect of an exculpatory term depend on the classification of a claim as third-party beneficiary or tort. For Bohlen at least, this

---

83. Bohlen, *supra* note 79, at 281 (citing *Winterbottom v. Wright*, [1842] 10 M. & W. 109 (Eng.)).

84. A negligence claim was not available for nonfeasance at the time.

85. Bohlen, *supra* note 71, at 283-84. Frederick Pollock makes a similar point in his torts treatise. FREDERICK POLLOCK, *THE LAW OF TORTS: A TREATISE ON THE PRINCIPLES OF OBLIGATIONS ARISING FROM CIVIL WRONGS IN THE COMMON LAW* 349 (1st ed., Philadelphia, Blackstone Publishing Co. 1887). The agreement of Bohlen and Pollock suggests this point may have been well understood by more sophisticated legal theorists.

way of thinking can be explained by how contract and tort law were viewed in his day: contract was thought of as the realm of privately determined obligation or “private legislation,” and tort was viewed as the realm of publicly imposed obligation.<sup>86</sup> Judges were not thought to have much discretion in either realm. In classical contract law, the rules were designed to give parties who could afford good legal advice the ability to determine their contractual obligations with a high degree of confidence. If a contract ended up in litigation, a court would enforce the contract as written, using the established rules. Tort law inevitably gave courts somewhat greater discretionary power because duties are imposed by law and are not a product of manifested intent, but great pains were taken to limit this power. Courts and legal theorists insisted these public obligations be derived from established legal rules or broadly accepted norms of custom or morality.

When we place a high value on legal certainty and predictability, or if we distrust judges to exercise discretion wisely, having judges and lawyers think about contract and tort in this way can be a positive. But this way of thinking about contract and tort—as perfectly distinct, minimally discretionary bodies of law—is an impediment to solving the immediate problem intelligently. It leads to the view that a contract must be either conclusive or irrelevant to the existence of a duty. This is a better view than the old premise that a contract cuts off a duty in tort, even if that duty is independent of the contract, but it similarly makes the analysis too mechanical. Treating an exculpatory term in a relevant contract as conclusive gives too much weight to the term, while treating a term as irrelevant gives too little. But, like Bohlen, courts continue to find it difficult to strike a balance between the competing claims of tort and contract, and the competing claims for public ordering versus private ordering.

### *C. Changes in Negligence Law Make This Premise Untenable*

Changes in negligence law make the premise of the two rules untenable. The problems with the rule *a contract cannot destroy the rights of a nonparty* begin with terminology. Negligence law is not really about protecting rights any more. If rights are implicated in modern negligence law, then it is only in a thin sense. Whatever right a person has not to be inadvertently harmed is qualified, and it gives way if the harm-doer has an excuse because the harm could not

---

86. Mark P. Gergen, *Negligent Misrepresentation as Contract*, 101 CALIF. L. REV. 953, 968-82, 995-96 (2013).

reasonably have been avoided.<sup>87</sup> In the U.S., negligence law generally is not thought of as implicating rights even in this thin sense. Negligence law is thought of as a product of balancing the interests of risk-creators in liberty of action and the interests of risk-bearers in security from harm.<sup>88</sup>

If we think of negligence law as a matter of interest balancing, and we acknowledge that a contract can delimit the rights of a nonparty, then the rule *a contract cannot destroy the rights of a nonparty* is a colorful and strong way to express a per se rule of nullity when an exculpatory term is not in a contract to which the victim is a party. This rule could be placed alongside other rules that limit the effectiveness of exculpatory terms; for example, the per se rule against terms protecting a harm-doer from liability for bodily harm caused by his gross negligence. The question then becomes whether such a per se rule is justified.

A per se rule might be justified if the background rules of negligence law are very likely to be in people's interest. If we believe that is the case, we might allow individuals to relinquish the rules' protection—to have their rights “destroyed”—only in ways that minimize the risk of mistaken or improvident waiver. We would want the background rules to be “sticky,” or hard to opt out of. This could be done by requiring a risk-creator to obtain a risk-bearer's agreement to an exculpatory term in a way that satisfies the formal requirements for a contract, such as by bargaining for a release signed by the risk-bearer.

An influential example of this thinking is an argument made by William Prosser in *Assault upon the Citadel (Strict Liability to the Consumer)*.<sup>89</sup> He argued that the “tort theory” (strict liability) is preferable to the “contract warranty theory” for handling a claim by a consumer who is physically injured by a defective product. Prosser briefly touched on the power of the seller to disclaim liability under the contract warranty theory. He observed that while “[t]he courts have done what they could to obviate the dangerous power which this places in the hands of the seller,”<sup>90</sup> the possibility that a court might

---

87. See ROBERT STEVENS, *TORTS AND RIGHTS* (2007), for an account of the law along these lines. Stevens strenuously opposes describing the field as negligence law.

88. See GEISTFELD, *supra* note 13.

89. William L. Prosser, *The Assault upon the Citadel (Strict Liability to the Consumer)*, 69 *YALE L.J.* 1099 (1960). Prosser focuses on first-party claims, in which privity is not an issue. See *id.*

90. *Id.* at 1132.

err and enforce a disclaimer “remains as a very obvious and a very large hole in the warranty theory.”<sup>91</sup> Prosser argued the tort theory is preferable because it reduces this risk.<sup>92</sup>

But this feature of tort law—its ability to preserve the background rules of liability by undercutting exculpatory terms—quickly became problematic. Though Prosser limited his argument to defective products that caused bodily harm to consumers,<sup>93</sup> products liability law quickly expanded to also encompass claims by businesses.<sup>94</sup> Businesses accordingly sought to use products liability claims as a mechanism for circumventing contractual terms that barred recovery for a loss resulting from a product defect. Courts responded to these claims by limiting the products liability action to claims involving physical harm and precluding claims for what has come to be described as “pure economic loss.”<sup>95</sup> When a negligence claim involves pure eco-

---

91. *Id.* at 1133.

92. *See id.* at 1120. Driving Prosser’s argument is an assumption that it is an “unreasonable thing” for a manufacturer to disclaim liability for physical harm its defective product causes a consumer. *Id.* at 1133.

93. Prosser limited his argument to defective products causing bodily harm to consumers because he thought courts generally should respect exculpatory terms in contracts between businesses.

94. Privity is now never required for a products liability claim, though it remains an issue in defective product cases where the downstream party sues on a breach of warranty claim as a third-party beneficiary. *See, e.g.,* *Hyundai Motor Am., Inc. v. Goodin*, 822 N.E.2d 947, 948 (Ind. 2005) (holding a downstream consumer has claim against a manufacturer for a manufacturing defect in an automobile based on the implied warranty of merchantability). U.C.C. section 2-318 provides three optional rules on privity for a breach of warranty. U.C.C. § 2-318 (AM. LAW INST. & NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 2014). These rules are understood to speak only to the issue of horizontal privity (e.g., a claim by a passenger in an automobile against the seller) and not to the issue of vertical privity (e.g., a claim of a downstream purchaser). This leaves courts free to adopt a less restrictive rule than the legislatively approved rule when the relationship between the plaintiff and the buyer, who is in privity with the defendant, is vertical and not horizontal. In *Goodin*, this cut in the plaintiff’s favor because the Indiana legislature had adopted the most restrictive rule on privity in section 2-318. The Indiana Supreme Court adopted a less restrictive rule on privity to allow a downstream purchaser to bring a breach of warranty claim. Christopher C. Little claims *Goodin* represents a “trend,” citing other cases in which “courts have concluded that the vertical privity requirement is simply no longer viable given contemporary commercial practices.” Christopher C. Little, Comment, *Suing Upstream: Commercial Reality and Recovery for Economic Loss in Breach of Warranty Actions by Non-Privity Consumers*, 42 WAKE FOREST L. REV. 831, 845 & n.83 (2007).

95. *Fla. Power & Light Co. v. Westinghouse Elec. Corp.*, 510 So. 2d 899, 901 (Fla. 1987); *Moorman Mfg. Co. v. Nat’l Tank Co.*, 435 N.E.2d 443, 453 (Ill. 1982). Today, in many states, the “economic loss rule” bars both negligence and strict liability claims involving pure economic loss by both businesses and individuals. These rules vary in scope. In some states, the bar is global and precludes a negligence claim involving pure economic loss unless a claim can be made under a cause of action that is an exception to the rule, such as the exception for the negligent misrepresentation action. In some states, the bar is more limited and applies only to cases in which the plaintiff reasonably may be expected to

conomic loss, courts often instinctively refuse to apply principles of negligence liability, instead deferring to contract and to the possibility of private ordering as the appropriate mechanisms to address the risk of carelessly caused harm.<sup>96</sup> But typically courts defer to contract thoughtlessly without inquiring whether contractual principles actually justify denying the negligence claim.

Courts take a much different approach with negligence claims involving bodily harm. They tend to ignore the contractual context of a claim entirely. *Tanguay v. Marston* illustrates.<sup>97</sup> The plaintiff slipped and fell on a greasy patch in his employer's parking lot. After recovering medical expenses and lost wages from his employer through a worker's compensation claim, he sued the employer's landlord. The landlord asserted as a defense a term in the lease absolving it from any obligation to maintain the premises and placing that obligation on the employer as tenant. The court refused to give effect to the term, citing earlier cases holding that a landlord had a general non-delegable duty of care to maintain safe premises,<sup>98</sup> and explaining: "While exculpatory clauses in leases of commercial real estate are binding on the parties to the lease, they have no effect on non-signers, such as the plaintiff."<sup>99</sup> The result is wrong: the employer undertook responsibility for maintaining the area. The employee's

---

protect himself from the risk by contract. Section VII.B, *infra*, concerns this body of law. It focuses on the approaches that best implement the principles identified in Part II, *infra*.

Something similar occurred in cases involving defects in used goods. Courts gave effect to an "as is" clause in an upstream sales agreement against a downstream buyer, who was a party to the agreement, by adopting a general rule precluding products liability claims for defects in used goods. *See, e.g.,* *Wilkinson v. Hicks*, 179 Cal. Rptr. 5 (Cal. Ct. App. 1981); *Sukljian v. Charles Ross & Son Co.*, 503 N.E.2d 1358, 1364 (N.Y. 1986) (finding no duty to serve as a basis for a negligence claim); *Tillman v. Vance Equip. Co.*, 596 P.2d 1299, 1301 (Or. 1979) (declining to reach the issue of what the effect of the as is term would be were a products claim available). *Gaumer v. Rossville Truck & Tractor Co.* takes the contrary position, holding a seller of used farm equipment is subject to strict liability, and it collects authority on both sides of the issue. 257 P.3d 292 (Kan. 2011).

96. Often is not always. *Ossining Union Free School District v. Anderson*, 539 N.E.2d 91 (N.Y. 1989), shows how the "tort" label can blind judges to the contractual context of a claim even when a claim involves pure economic loss. Under New York law, a claim is available for negligent misrepresentation only if the victim and the harm-doer are in "near privity," which literally means a near-contractual relationship. The New York Court of Appeals allowed a negligent misrepresentation claim in the case, finding that the parties were in near privity, without saying a word about the contractual context of the claim. It is bizarre to condition liability on the parties being in a near-contractual relationship and then to ignore the contractual context of a claim in deciding whether negligence liability is appropriate. Had the Court examined the contractual context, either it would have found a contract claim was available to the plaintiff, making the negligent claim redundant, or that a contract claim was barred by an exculpatory term in either or both of the two relevant contracts, making it difficult to justify the negligence claim.

97. 503 A.2d 834, 837-38 (N.H. 1986).

98. *Id.* at 837.

99. *Id.* at 838.

worker's compensation claim against the employer provides compensation and some deterrence. The landlord may have an implied right to indemnity from the employer, which would cast the loss back on the employer and undercut the worker's compensation scheme. And, whatever the rule on implied indemnity, landlords are likely to demand express indemnification in the future, with the same ultimate effect.

This tendency to disregard the contractual context of a negligence claim concerning bodily harm is understandable. The rules of modern negligence law were developed to address cases in which the plaintiff and defendant were strangers, and so the plaintiff could not be expected to protect himself from a risk by contract. Further, even in cases where the plaintiff and defendant are in privity of contract, or are connected through a chain of contracts, the general assumption is that the risk of carelessly caused bodily harm is best dealt with by negligence law, and not by contract. There are good reasons for this assumption. Often it is not in people's interest to agree to waive the protection of tort law.

But the expansive rules of liability in modern negligence law test the assumption that negligence law strikes the correct balance between the interests of risk creators and the interests of risk bearers in all cases involving physical harm. The expansive rules of liability in modern negligence law can make a claim that is weak both as a matter of fairness and as a matter of policy seem legally colorable. *Hampton v. Federal Express* illustrates.<sup>100</sup> This is the tragic case in which Fed Ex failed to deliver a blood sample shipped by a hospital, and as a result a potential marrow donor for a young boy with cancer was not identified. The contract between Fed Ex and the shipper, the hospital where the boy was being treated, limited the carrier's liability to \$100. The court held Fed Ex was not liable for its negligence because the carrier owed no duty of care to the boy. To reach this result, the court invoked *Palsgraf v. Long Island Railroad*,<sup>101</sup> reasoning that Fed Ex owed no duty to the boy because the carrier "did not know the package contained blood samples" and could not "reasonably foresee any injury to [him], or the nature and extent of the injury."<sup>102</sup>

The court reached the correct result in *Hampton*, but the legal ground the court gave for the result is unpersuasive under modern rules of tort law, as those rules are stated in the Third Restate-

---

100. 917 F.2d 1119 (8th Cir. 1990) (applying Missouri law).

101. *Id.* at 1124.

102. *Id.* at 1124-25.



ment.<sup>103</sup> Under the Third Restatement, the foreseeability of harm has no bearing on the issue of duty.<sup>104</sup> Duty hinges on whether an actor's conduct has created a risk of harm.<sup>105</sup> Foreseeability of harm in general bears on the issue of breach (whether the harm-doer acted unreasonably), and foreseeability of the specific harm that occurred bears on the issue of legal causation or scope of liability (whether the risk of the specific harm that occurred is among the risks that made the harm-doer's conduct unreasonable). These are jury issues, if a reasonable juror can find for the plaintiff on the issues. That Fed Ex "did not know that the package contained blood samples" and could not "reasonably foresee any injury to [him]"<sup>106</sup> is thus pertinent only to the issues of breach and scope of liability.

The familiar facts in *Palsgraf* can be used to illustrate these points.<sup>107</sup> Palsgraf was injured while standing on a railroad platform when an explosion caused a top-heavy scale to fall on her. The explosion was caused by a package of fireworks, which another passenger dropped when two railroad employees pushed and pulled him as he tried to jump aboard a departing train. Under the Third Restatement, it is clear the railroad owes a duty of care to Palsgraf, a paying customer who was standing on the railroad's platform waiting for one of its trains. It is also clear under the Third Restatement that the railroad employees' conduct—trying to help someone carrying a package to jump aboard a moving train—was unreasonable enough in a general way to require submitting the issue of breach to a jury. The railroad's best defense under the Third Restatement is that Palsgraf's harm is not among the risks that made the conduct of the railroad's employees negligent (i.e., the harm is not within the scope of liability). If Palsgraf only offers proof that the railroad's employees were negligent in allowing or assisting a passenger to leap aboard a departing train, the court could take the case away from the jury. No reasonable person could think the harm to Palsgraf is among the harms that make shoving a passenger who is trying to board a moving train while carrying a package unreasonable.<sup>108</sup> But the claim

103. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 29 (AM. LAW. INST. 2010).

104. *See id.* at cmt. n.

105. *See id.* § 6. A court may still opt not to find a duty, even if it finds that the harm-doer's actions created a risk of harm. As mentioned in Section II.A, countervailing factors may warrant a finding of no duty or a modified duty in such cases.

106. *Hampton*, 917 F.2d at 1125.

107. *Palsgraf v. Long Island R.R.*, 162 N.E. 99 (N.Y. 1928).

108. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 29, cmts. f, n (AM. LAW. INST. 2010). Illustration 9 is based on *Palsgraf*. *Id.* at illus. 9. It characterizes the only unreasonable conduct as assisting a passenger who was carrying a package jump aboard a departing train. *Id.*

could not be taken from the jury if Palsgraf offers sufficient proof that the railroad acted unreasonably in allowing the platform to be overcrowded, or in having a top-heavy scale on the platform. It is then for the jury to decide if the bizarre nature of the events leading up to the accident take the harm outside the scope of liability for the railroad allowing the platform to be unreasonably overcrowded, or in having an unreasonably top-heavy scale on the platform.

Returning to the facts in *Hampton*, the Third Restatement seems quite clear that foreseeability of harm to the boy was a scope of liability issue, and so a matter for the jury.<sup>109</sup> Failure to deliver a hospital's package may foreseeably harm its patients in any number of ways. In *Hampton*, the court made the harm seem unforeseeable by defining the relevant risk narrowly. The court reasoned Fed Ex could not have foreseen the package contained blood samples, or the purpose for which the samples were being shipped.<sup>110</sup> Making a harm seem unforeseeable by defining the relevant risk narrowly is a familiar casuistic device. Cardozo's opinion in *Palsgraf* is a brilliant example of the use of this device. But the Third Restatement tells courts not to use this casuistic device to take a claim from a jury. It warns that sometimes "there will be contending plausible characterizations [of the type of harm that occurred] that lead to different outcomes and require the drawing of an evaluative and somewhat arbitrary line. Those cases are left to the community judgment and common sense provided by the jury."<sup>111</sup>

The Third Restatement allows a court to take a claim away from the jury, even if the plaintiff presents evidence on which a reasonable person could find the elements of a negligence claim satisfied (breach, cause-in-fact, scope of liability, and damages). A court can always take a claim away from the jury by creating a special no-duty rule.<sup>112</sup>

---

109. *Id.* at cmt. q.

110. 917 F.2d at 1125.

111. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 29, cmt. i (AM. LAW INST. 2010) ("[u]nderstanding and characterizing the risk of harm").

112. *Id.* § 7(b) ("In exceptional cases, when an articulated countervailing principle or policy warrants denying or limiting liability in a particular class of cases, a court may decide that the defendant has no duty or that the ordinary duty of reasonable care requires modification."). A no-duty rule must be categorical in two respects. First, the rule must be framed in categorical terms to cover a "particular class of cases." *Id.* Second, under U.S. negligence law, if a rule is to justify taking a case from the jury, then that result has to clearly follow from the rule. No factual or normative issue should be left in doubt. Under U.S. negligence law, if an issue of fact or a normative issue is fairly contested under the applicable rule, then either party has the right to have the issue resolved by a jury. Mark P. Gergen, *The Jury's Role in Deciding Normative Issues in the American Common Law*, 68 FORDHAM L. REV. 407, 409-10 (1999).

This is what the *Hampton* court should have done. Section VII.A.2 will propose a no-duty rule to cover cases like *Hampton*. The rule gives presumptive effect to an exculpatory term in the defendant's contract in cases that are within the rule. Before I explain how and why tort law can be used to solve this problem, I need to go back and explain why contract law cannot, at least in the United States. Part V explains. When I return to *Hampton*, I will explain that the no-duty rule in *Hampton* follows entirely from general principles of tort law and does not depend on contractual considerations. On the other hand, in negligence cases involving claims for pure economic loss, contractual considerations can play an important role by informing the no-duty analysis.

## V. PRIVACY RULES IN CONTRACT LAW AND INFORMATION COSTS

This Part considers privity rules in contract law. The rules preclude using *contract law* to implement the principles in Part II, when the victim is not a party to the contract with the exculpatory term. This does not preclude contract *considerations* from weighing on the availability of a nonparty's tort claim. But it does mean that bodies of law other than contract must be used to account for such considerations.<sup>113</sup> This Part also explains the information cost rationale for the privity rules in contract law.

### A. Privity Rules in Modern Contract Law

Privity remains an important concept and an important boundary in modern contract law. A family of rules maintains the boundary. The most important of these is the general rule that a contract can

---

A no-duty rule must exclude liability in a category of cases, and in categorical terms, which leave no factual or normative issue in doubt, if the rule is to serve the channeling and screening functions of no-duty rules in U.S. law. Duty rules identify the types of cases in which a negligence claim is available, and identify the facts and normative criteria relevant to resolving a claim. Conversely, no-duty rules enable courts to dismiss a negligence claim early in the process, generally on a motion for failure to state a claim or on a motion for summary judgment, based on facts that can be readily ascertained, and based on normative criteria that cannot be fairly contested, in the cases the rule is meant to exclude.

These rules are generally called no-duty rules though some might better be called no-liability rules. The difference between a no-duty and a no-liability rule is more than terminological. Duty rules are forward looking. They command action. Liability rules are backwards looking.

113. This relates to the proposal in Section VII.B.1, *infra*. One of the most intractable issues in the law of economic negligence is determining when a negligence claim should be unavailable because the plaintiff can protect himself from a risk by contract. See *infra* Section VII.B.2, for a proposal to treat this as a problem of contract interpretation and contract construction. Nominally, this inquiry would be part of duty analysis under negligence law, so it would not violate the privity rules of contract law.

never bind a nonparty. The rule has been described as “elementary,”<sup>114</sup> as “so fundamental that it rarely receives mention,”<sup>115</sup> and as something that “goes without saying.”<sup>116</sup> Also as a general rule, a nonparty has no right to enforce a contract unless it is a third-party beneficiary or it acquires the right by assignment.<sup>117</sup> Because of these two general rules, contractual obligations generally run only between the parties to a contract. Sub rules in the law of third-party beneficiary and the law of assignment ensure the contract defines the obligation owed to the nonparty. Among these sub rules is the rule a third-party beneficiary cannot have greater rights than a contract creates.<sup>118</sup>

The privity rules in contract also serve the important function of defining when contract law will apply to determine people’s obligations to each other. While contract is a mechanism for private ordering, much of contract law exists to resolve mistakes in private ordering, such as misunderstandings and oversights. Contract rules used to resolve misunderstandings, and to address oversights, generally come into play only when the misunderstanding or oversight is contractual, which requires privity of contract. Thus, the contractual duty of good faith only comes into play once people are in privity of contract.<sup>119</sup>

Furthermore, rules of contract interpretation and contract construction do not apply to establish privity between parties who are connected through a chain of contracts. *Harding Co. v. Sendero Resources, Inc.* illustrates.<sup>120</sup> The plaintiff acquired a corporate-owned

---

114. *Gambles v. Perdue*, 572 P.2d 1241, 1243 (Mont. 1977) (“It is elementary law that a contract binds no one but the contracting parties.”).

115. *FCM Grp., Inc. v. Miller*, 17 A.3d 40, 54 (Conn. 2011) (“Before turning to those cases, however, we set forth a general principle so fundamental that it rarely receives mention in case law or commentary, namely, that only parties to contracts are liable for their breach.”).

116. *EEOC v. Waffle House, Inc.*, 534 U.S. 279, 294 (2002) (“It goes without saying that a contract cannot bind a nonparty.”).

117. *Pike v. Deutsche Bank Nat’l Trust Co.*, 121 A.3d 279, 282 (N.H. 2015) (“Generally, a non-party to a contract . . . lacks standing to enforce the contract . . .”).

118. See *supra* text accompanying note 69.

119. *Matana v. Merkin*, 957 F. Supp. 2d 473, 493 (S.D.N.Y. 2013) (“There being no contractual relationship, neither can there be any ‘covenant of good faith and fair dealing’ implied which itself is based on the existence of a legal contractual obligation.”).

120. See *Harding Co. v. Sendero Res., Inc.*, 365 S.W.3d 732, 740 (Tex. Ct. App. 2012); see also *B&H Nat’l Place, Inc. v. Beresford*, 850 F. Supp. 2d 251, 259 (D.D.C. 2012) (holding no-compete clause in franchise agreement does not bind franchisor, nor stockholders and officers of franchisees, who did not sign the contract); *Primary Invs. LLC v. Wee Tender Care III, Inc.*, 746 S.E.2d 823, 826-27 (Ga. Ct. App. 2013) (holding members of LLC are not bound to no-compete clause in purchase agreement made by LLC, where the clause covered “Seller” and “its agents”; one member signed in capacity as LLC’s representative, the other two did not sign).

business. The purchase agreement included a covenant not to compete. The owner of the business signed the agreement in his capacity as owner and president of the corporation, and not in an individual capacity. Later the plaintiff sought to enforce the covenant against the owner, arguing the formal capacity in which the owner signed the agreement should be ignored under a general rule of contract construction, which rejects an interpretation that renders a term meaningless. In fact, the covenant was valueless if it did not bind the owner. The court concluded this rule did not apply because “[a] general rule of contract construction cannot be used to bind a party to a contract it did not sign.”<sup>121</sup>

These rules should preclude using contract law to enforce an exculpatory term in a contract against a nonparty victim even when the victim has notice of the term, and even when the victim’s conduct in placing itself in harm’s way can reasonably be interpreted as tacit assent to the term. *Ossining Union Free School District v. Anderson LaRocca Anderson* illustrates, if you allow me to fill in a few factual gaps to make the argument for finding tacit assent to the term as strong as possible.<sup>122</sup> A school district hired an architect as a consultant for a project, and the architect hired two engineers as subconsultants. The district incurred an unnecessary expense as a result of a careless error by the engineers. The New York Court of Appeals held that the district had a cause of action against the engineers for negligent misrepresentation, finding the parties were in near privity.<sup>123</sup> The opinion says nothing about the terms of the district’s contract with the architect or the architect’s contracts with the engineers. There is a passing mention of the fact that the engineers had worked directly with the district in the past (this is cited as further support for the conclusion the parties were in near privity), but the opinion says nothing about the terms of these prior contracts.

To make the argument that the school district tacitly agreed to waive the tort claim as strong as possible, let me fill in some of the holes in the reported facts with assumptions. Often architects and engineers use a form contract promulgated by the American Institute

---

The rule has been weakened to subject a nonsignatory to a forum selection clause when not doing so defeats the purpose of the clause. *See Marra v. Papandreou*, 59 F. Supp. 2d 65, 77 (D.D.C. 1999) (applying the rule that a nonsignatory is bound by a contract term if it is closely related to dispute such that it becomes foreseeable that it will be bound). The rule also has been weakened to subject a nonsignatory to a merger clause when the nonsignatory attempts to establish a side/oral agreement. *See Baroid Equip., Inc. v. Odeco Drilling, Inc.*, 184 S.W.3d 1, 15-16 (Tex. Ct. App. 2005).

121. *Harding*, 365 S.W.3d at 740.

122. *Ossining Union Free Sch. Dist. v. Anderson*, 539 N.E.2d 91, 95-96 (N.Y. 1989).

123. *See id.* at 94-96.

of Architects (“AIA”), which has a term that provides for reciprocal waiver of consequential damages.<sup>124</sup> Assume the district, the architect, and the engineers used the AIA form contract in all of their construction dealings, including the transactions giving rise to this claim. Also assume use of the AIA form is ubiquitous in New York’s construction trade.

If we put aside the absence of privity between the district and the engineers, then the assumed facts present a very strong argument for finding a tacit contractual waiver of liability. Multiple types of evidence that are usually treated as indicative of contractual intent—express terms, course of dealing, and trade practice<sup>125</sup>—indicate the district and the engineers intended there to be no liability for consequential damages.<sup>126</sup>

There is another twist in the case: it is clear that the engineers and the district considered privity to be a formality. The engineers submitted their bills directly to the district, they were paid directly by the district, and they delivered their reports directly to the district. If in fact the district and the engineers routinely used the AIA form contract in all of their construction dealings, then the engineers would have been surprised to find that the formality of contracting with the architect, and not the district directly, exposed them to a greater risk of liability—it exposed them to an unexpected tort

---

124. AM. INST. OF ARCHITECTS, AIA DOCUMENT B141-1997, STANDARD FORM OF AGREEMENT BETWEEN OWNER AND ARCHITECT WITH STANDARD FORM OF ARCHITECT’S SERVICES § 1.3.6 (1997), <http://wvhepcdoc.wvnet.edu/resources/pmanualforms/A&EServices/AIAB141-97AgreementBetweenOwner&Architect.pdf> (providing for limitation of liability). For the background and history of the term, see Gregory K. Morgan & Albert E. Phillips, *Design Professional Contract Risk Allocation: The Impact of Waivers of Consequential Damages and Other Limitations of Liabilities on Traditional Owner Rights and Remedies*, 33 J.C. & U.L. 1, 7-9 (2006).

125. For a definition of these terms, see U.C.C. § 1-303(b)-(c) (AM. LAW INST. & NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 2014).

126. The point can be made even clearer if I tweak the facts in two more respects. Assume first that the district dealt directly with the engineers in the transaction that gave rise to the claim so that the engineers and the district were in privity of contract. But assume further that the district and the engineers dealt informally in this particular transaction, and the district’s representative never actually signed the standard contract. On these facts, a court should find the parties intended there to be a waiver of liability for consequential damages, and thus uphold the waiver. This result follows from course of dealing and trade practice, including the local construction trade’s assumed ubiquitous use of the AIA form and its waiver of liability. U.C.C. section 2-207, comment 5 is a clear authority for the possibility of tacit assent to a liability waiver based on custom. U.C.C. § 2-207 cmt. 5 (AM. LAW INST. & NAT’L CONFERENCE OF COMM’RS ON UNIF. STATE LAWS 2014). It provides “[e]xamples of clauses which involve no element of unreasonable surprise and which therefore are to be incorporated in the contract unless notice of objection is seasonably given,” referring to section 2-207(2). *Id.* at cmt. 5. The concluding example in the sequence is “a clause limiting the right of rejection for defects which fall within the customary trade tolerances for acceptance ‘with adjustment’ or otherwise limiting remedy in a reasonable manner.” *Id.* (emphasis added).

claim<sup>127</sup> while stripping them of the contractual waiver of liability.<sup>128</sup> But the rule applied by the court in *Harding* makes it impossible to overlook the formality to use contract law to subject the engineers to a liability waiver in the contract between the district and the architect.

The rule applied by the court in *Harding* may seem incongruous alongside other rules in contract law. While the signature formality remains strong when the issue is who is a party to a contract,<sup>129</sup> the signature formality has been diluted to almost nothing in the law of consumer form contracts. The results in the “shrinkwrap” and “click-wrap” agreement cases are two important steps in this direction. In the shrinkwrap agreement cases, a consumer purchases a good in a box that includes a form with terms. The form tells the consumer he has the right to return the good if he does not assent to the terms in

---

127. The decision allowing the claim came out of the blue; it could not have been predicted based on prior New York cases. The claim’s novelty is evident from the brief opinion of the Appellate Division, which asserts “a long-standing general rule, that recovery will not be granted to a third person for pecuniary loss arising from the negligent representations of a professional with whom he or she has no contractual relationship.” *Ossining Union Free Sch. Dist. v. Anderson*, 521 N.Y.S.2d 747, 749 (N.Y. App. Div. 1987). The sole exception to this rule is accountants. *Id.* at 750. *Widett v. U.S. Fidelity & Guaranty Co.* comes to the same conclusion and cites further New York authority. 815 F.2d 885, 887 (2d Cir. 1987). In *Viscardi v. Lerner*, the court relied on the same rule to hold a disappointed heir could not sue an attorney for malpractice in preparing a will, which is harder to justify. 510 N.Y.S.2d 183, 185 (N.Y. App. Div. 1986). This rule was affirmed by the New York Court of Appeals while carving out an exception to allow the estate to sue. *Estate of Schneider v. Finmann*, 933 N.E.2d 718, 720 (N.Y. 2010).

128. Hopefully the facts are not as I have assumed and the engineers were contractually liable for the district’s loss under their contract with the architects. The holding that a negligence claim is available is still wrong as a matter of policy, as Section VI.B.2, *infra*, will explain, but the New York Court of Appeals is guilty only of the lesser sin of allowing a redundant tort claim.

129. *See, e.g., Alliance Data Sys. Corp. v. Blackstone Capital Partners V L.P.*, 963 A.2d 746, 760 (Del. Ch. 2009) (“[T]he ordinary rule is that only the formal parties to a contract are bound by its terms.”). There are several legal theories available to bind a nonsignatory to a contract. They include the agency theory, the alter ego theory, and the adoption theory. Under the agency theory, a nonsignatory is bound if someone signed as his or her agent. *Interbras Cayman Co. v. Orient Victory Shipping Co.*, 663 F.2d 4, 6 (2d Cir. 1981). The alter ego theory may apply when the nonsignatory is a corporation and a corporate parent or subsidiary is a signatory. *MBIA Ins. Corp. v. Royal Bank of Can.*, 706 F. Supp. 2d 380, 396-97 (S.D.N.Y. 2009). The adoption theory was applied in *A.P. Moller-Maersk A/S v. Comercializadora de Calidad S.A.*, 429 F. App’x 25, 28 (2d Cir. 2011) (applying New York law). A nonsignatory to a bill of lading was held to have agreed to submit to a forum selection clause in the bill of lading when it brought an action based on the bill of lading and when it agreed to waive a term in the bill of lading in return for cash security. *See also Flying Phx. Corp. v. Creative Packaging Mach., Inc.*, 681 F.3d 1198, 1200-01 (10th Cir. 2012) (applying Wyoming law). For an account of these and a few other theories and the point that a nonsignatory can be bound to an agreement to arbitrate only on these theories, see *Int’l Paper Co. v. Schwabedissen Maschinen & Anlagen GMBH*, 206 F.3d 411, 416-17 (4th Cir. 2000). *First Options of Chicago, Inc. v. Kaplan* holds a decision by an arbitrator that a nonsignatory to the arbitration agreement had implicitly submitted to arbitration is subject to independent review by the courts. 514 U.S. 938, 942-47 (1995).

the form. Under U.S. law, the consumer's act of keeping the good is treated as the legal equivalent of signing the form.<sup>130</sup> In the clickwrap agreement cases, a business requires a consumer who engages in an electronic transaction with the business to click a box saying "I agree" to linked terms and conditions before completing the transaction. Under U.S. law, the consumer's act of clicking the box is treated as the legal equivalent of signing a form containing the linked terms and conditions. This is so even though it is common knowledge that virtually no consumers actually read the terms and conditions and even in circumstances where it is impossible for the consumer to read the terms and conditions before clicking "I agree."<sup>131</sup>

But there is no real incongruity here. Privity is not an issue in the shrinkwrap and clickwrap cases. This is important; for the consumer knows he is engaging in a contractual transaction with the seller. If the consumer worried about his legal position in the transaction, then he would know to consult contract law, and the contract documents presented to him, to determine his legal position. Shrinkwrap and clickwrap agreements are troublesome because consumers almost never bother to investigate the contract documents presented to them.<sup>132</sup> Because privity is not an issue, these are handled as misunderstanding cases within contract law. For example, if the dispute is over a consumer's assent to an arbitration term in a form, then the consumer's argument is that he did not understand that by keeping the good (or clicking "I agree") he agreed to arbitrate any disputes with the seller. Meanwhile the seller will argue that it intended to hold the consumer to its boilerplate, including the arbitration term. For good or ill, the law of consumer form contracts generally resolves these misunderstandings against consumers.<sup>133</sup> When there is privity of contract, then the rules of contract interpretation and contract construction apply to resolve a misunderstanding. But these rules do not come into play when parties are not in privity of contract.

---

130. The leading cases are *Hill v. Gateway* and *ProCD, Inc. v. Zeidenberg*. *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147 (7th Cir. 1997); *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996). For a recent case adopting the theory, see *DeFontes v. Dell, Inc.*, 984 A.2d 1061, 1071 (R.I. 2009). The theory has received a mixed reception. See John E. Murray, Jr., *The Dubious Status of the Rolling Contract Formation Theory*, 50 DUQ. L. REV. 35 (2012).

131. *Hancock v. American Telephone & Telegraph Co.* is clear authority for all of these points, including the last point. 701 F.3d 1248, 1258-59 (10th Cir. 2012). The opinion collects other cases enforcing clickwrap agreements. See *id.* at 1256-58.

132. The information cost rationale for the privity rules assumes people make an effort to ascertain their legal position before choosing to engage in a transaction that has legal consequences to them.

133. See, e.g., cases cited *supra* notes 130-31.



### B. *The Information Cost Rationale*

Should the privity rules in contract law be changed? What might justify the rules? It is well known that the privity rules in contract law reduce nonparty information costs. Nonparty information costs refer to the costs nonparties would incur to acquire information about contract terms to avoid inadvertently running afoul of a term. The scholarly literature on the point focuses on contract terms that potentially affect numerous nonparties who are remote in time from the making of a contract and who are likely to find it costly to investigate a contract term. Merrill and Smith's *The Property/Contract Interface* is a leading article.<sup>134</sup> Merrill and Smith observe several features that distinguish property and contract as legal mechanisms for private ordering. Among the differences they observe are that property rights are exigible (good against the world), while contract rights are good only against a party to the contract.<sup>135</sup> Another difference they observe is that there are limited forms property rights can take, while contract rights can take virtually any form.<sup>136</sup> Merrill and Smith explain these differences are related. The exigible nature of property rights creates a concern for information costs imposed on nonparties. Rules that restrict the forms property rights can take, and that require property rights generally take visible forms with clear boundaries, reduce these nonparty information costs.

This explanation of the privity rules in contract law cannot explain their application in a case like *Harding Co. v. Sendero Resources, Inc.*, where the parties are in near privity. In *Harding*, the nonparty knows of the term and he is the only person who might inadvertently run afoul of the term.<sup>137</sup> But the concern for information costs still justifies the rules. In "near privity" cases, the privity rules reduce information costs by reducing the need for a nonparty to monitor contract documents, contract performance, and interactions between the parties to the contract to avoid inadvertently subjecting herself to an obligation. When the rules of contract interpretation and contract construction apply, a party can find herself subject to an obligation she did not intend to undertake, if the other party reasonably understood she did undertake the obligation. Indeed, a party to a contract may find herself subject to an obligation she clearly did not intend to

---

134. Thomas W. Merrill & Henry E. Smith, *The Property/Contract Interface*, 101 COLUM. L. REV. 773 (2001).

135. *See id.* at 780.

136. *Id.* at 776-77.

137. *See Harding Co. v. Sendero Res., Inc.*, 365 S.W.3d 732, 745 (Tex. Ct. App. 2012). A nonparty may be liable for intentional interference with contract. RESTATEMENT (SECOND) OF TORTS § 766 (AM. LAW INST. 1979).

undertake. The court may imply an obligation after concluding the issue was not material when the contract was made and after predicting the parties would have agreed to the obligation had the question of its existence been presented to them before the problem arose.

As a consequence of these rules, a party to a contract has an incentive to monitor contract documents, contract performance, and interactions with the other party to ensure she does not inadvertently undertake a contractual obligation. But these rules come into play only between parties who are in privity of contract. A nonparty, who is not in privity of contract, is not subject to these rules. Thus, when a transaction or project involves the performance of three or more parties, and it is possible to partition the performances into two or more contracts, the privity rules reduce information costs by reducing the need for a party to closely monitor parts of the transaction or project to guard against an unintended obligation. Each party need worry about inadvertently undertaking a contractual obligation by transmitting or receiving a communication from another party, receiving a benefit from another party (or rendering a benefit to another party), or otherwise interacting with another party only if the two parties are in privity of contract, or their interactions are such that a court could find manifest assent to contract.

Consider a project involving three parties—*A*, *B*, and *C*—who partition the project into two binary contracts (the *AB* and *BC* contracts). Each contract is reduced to a written contract document. Under the privity rules, *A* can focus her attention on the contents of the *AB* contract document, the performances under the *AB* contract, and her interactions with *B*. Apart from an assignment, nothing that may appear in the *BC* contract document, nothing that may occur in the performances by *B* and *C* of the *BC* contract, and nothing that may occur in the interactions between *B* and *C* may put *A* under a performance obligation to *C*. Thus, if *A* pays *B* for work done by *C* that is delivered through *B*, then *A* need not monitor whether *B* pays *C*. *A* cannot be made to pay twice for work regardless of what happens between *B* and *C*.<sup>138</sup> A simple way to grasp the magnitude of the saved

---

138. For a limited exception to cover the case in which *A* has not paid *B* for work requested by *A* and done by *C*, and *C* is unable to collect from *B* because *B* is insolvent, see RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 31 (AM. LAW INST. 2011). *C* may also be protected by a lien on *A*'s property under state law. See generally Doug Rendleman, *Quantum Meruit for the Subcontractor: Has Restitution Jumped off Dawson's Dock?*, 79 TEX. L. REV. 2055 (2001) (discussing the history of the restitution claim). This is an exception to a general rule in the law of restitution that "[a] person who has conferred a benefit upon another as the performance of a contract with a third person is not entitled to restitution from the other merely because of the failure of performance by the third person." RESTATEMENT OF THE LAW OF RESTITUTION § 110 (AM. LAW INST. 1937). *Thimjon Farms Partnership v. First International Bank & Trust* illustrates the application of this fundamental rule. 837 N.W.2d 327, 336-37 (N.D. 2013). The plaintiffs were

information costs is to consider how much more effort *A* would expend—to monitor the *BC* contract documents, the performances of *B* and *C* under that contract, and the interactions between *B* and *C*—if *B* were acting as *A*'s agent. The reduction in information costs increases as the number of parties involved in a transaction or project increases,<sup>139</sup> but the savings can be significant even in a transaction or project involving only three parties and two contracts.

To be clear, the contents of the *BC* contract documents, and the performances by *B* and *C* under the *BC* contract, may affect the extent of *A*'s liability for damages for breach of *A*'s performance obligation under the *AB* contract.<sup>140</sup> For example, if *A*'s breach of the *AB*

customers of Northern Grain who had made down payments to Northern Grain for work that was never done. Northern Grain used some of the down payments to reduce its line of credit with First International Bank & Trust. The bank then withdrew the line of credit, putting Northern Grain out of business. The plaintiffs sued the bank on a theory of unjust enrichment, seeking to recover the amount of their down payments used to pay down the letter of credit. The court conceded that the bank may have profited as a result of the transactions but held there was no claim for unjust enrichment.

139. Call the savings to *A* from not having to closely monitor the *B-C* part of the project a single unit of contract monitoring. In the example, the total savings are two units of contract monitoring because *C* also does not have to closely monitor the *A-B* part of the project. Assuming binary contracts, in a four-party project the total savings are six units of contract monitoring. In a five-party project the total savings are twelve units of contract monitoring.

More generally, if *n* is the number of participants in a project, then the unit savings equals  $(n-1)*(n-2)$ . Thus, in a six party project the total savings are twenty units of contract monitoring. This is easiest to see if you imagine a hub and spoke configuration, with the participant at the hub contracting with the spoke participants. Only spoke participants realize savings  $(n-1)$ , and each realizes savings equal to the number of other spoke participants  $(n-2)$ . The savings are the same if the participants are arranged in a chain. The two participants at the ends of the chain save  $(n-2)$  while all other participants save  $(n-3)$ . Shawn Bayern supplies the general derivation. E-mail from Shawn Bayern, Professor, Florida State University College of Law, to Mark P. Gergen, Professor, Berkeley Law School (Jan. 27, 2015) (on file with author). With *n* contracting parties there are  $n*(n-1)$  total relationships and  $(n-1)$  contracts so long as each contract has two parties. Thus the savings equal  $n*(n-1) - 2*(n-1)$ , or  $(n-1)*(n-2)$ .

140. Fabrizio Cafaggi describes several mechanisms parties use when they want to work around the privity rule to link obligations across two or more contracts. Cafaggi, *supra* note 60, at 66, 77-84. For example, the *AB* and *BC* contracts may impose mutual obligations on *A* and *C* to coordinate their performance, making each a third-party beneficiary to the term in the other's contract. Or, the *AB* and *BC* contracts may impose mutual exclusivity clauses to prevent each from the risk of the other defecting from the project. Each may be a third-party beneficiary to the term in the other's contract. Or a term in the *AB* contract may require *A* to indemnify *C* for a loss caused by *A*. All of these mechanisms create an obligation to a nonparty by making them a third-party beneficiary. This was not possible under English law until recently. In the same monograph Simon Whittaker describes the contractual mechanisms developed by English lawyers and judges to create obligations to a nonparty. Simon Whittaker, *Contract Networks, Freedom of Contract and the Restructuring of Privity of Contract*, in *CONTRACTUAL NETWORKS, INTER-FIRM COOPERATION AND ECONOMIC GROWTH*, *supra* note 60, at 179, 183-88. These seem quite crude. For example, one of the mechanisms was for *A* to make *B* its agent so that *B* could undertake an obligation to *C* that would bind *A*. *Id.* at 187-88.

contract predictably causes *B* to incur a loss under the terms of the *BC* contract, then *B* will be able to recover this loss from *A*. The loss may include consequential damages paid by *B* to *C*, which depend on *C*'s particular circumstances. But *A*'s exposure to losses involving the *BC* contract is mediated through the *AB* contract. This makes it possible for *A* to control his exposure by putting a liability waiver in the *AB* contract. The contents of the *BC* contract, and *B* and *C*'s performances of it, may also create insecurity to *A* that *B* will be unable to perform the *AB* contract. And the contents of the *BC* contract, and *B* and *C*'s performance of it, may affect *A*'s ability to perform its contract with *B* or otherwise create a risk of loss to *A*. But again these effects are mediated through the *AB* contract. Thus, *A* may insist on terms in the *AB* contract to minimize insecurity regarding the *BC* contract and to protect against the risk of loss.

Section V.C will argue that exculpatory terms are unlike many other types of contract terms because enforcing them against nonparties does not significantly implicate the concern for nonparty information costs. There is no inconsistency between this claim and the claim just made about how the privity rules reduce information costs. The example assumed away the possibility of a negligence claim between *A* and *C* under the rules of tort law. If *A* has a possible negligence claim against *C* in the event of a loss, then *A* has an incentive to investigate facts involving *C* that bear on the risk of loss and that bear on *C*'s ability to satisfy a claim. *A* also has an incentive to investigate tort law to determine the likelihood of recovery. *A* may discover the exculpatory term in the *BC* contract in the course of these investigations, and once that knowledge is acquired, *A* has no incentive to further investigate the law or to monitor *C*'s ability to satisfy a claim. Meanwhile, if *A* secures protection against the risk in the *AB* contract, then *A* has less incentive to monitor *C*'s performance.<sup>141</sup>

---

141. A corollary to this point is that allowing parties who are not in privity of contract to recover off the contract, on a negligence claim, imposes information costs. The point focuses on a risk-bearer (*A* in the example) because making a negligence claim available has an ambiguous effect on a risk-bearer's information costs. The point made in text is modest, which is that conditioning a negligence claim on the absence of an exculpatory term in the harm-doer's contract will not impose significant additional information costs on a risk-bearer and may actually reduce a risk-bearer's information costs in some cases. The major effect of making a negligence claim available is the imposition of information costs on a risk creator (*C* in the example), who has an incentive to monitor the actions of a risk-bearer (*A*) and an intermediary (*B*), to determine what precautions are worth taking and to gauge the liability risk. These information costs are a central concern of negligence law. They are addressed by the element of foreseeability, for example.

### C. Exculpatory Terms and Information Costs

Exculpatory terms do not implicate the concern for imposing information costs on nonparties. Why is best explained using a real world example: waiver of subrogation clauses in construction contracts.<sup>142</sup> In a typical construction project, the owner of the building will obtain insurance to cover the risk of property damage caused by the contractor. The construction contract will have a waiver of subrogation clause. In the absence of the clause, an insurer that pays for damages caused by a contractor could seek to recover its payment by bringing a contract or tort claim in subrogation.<sup>143</sup> Typically, a waiver of subrogation clause also precludes a claim by the owner's insurer against a subcontractor, employee, or agent of the contractor, as well as a claim against other persons hired by the owner, such as an architect. Often the general contractor will include a waiver of subrogation in the contract with a subcontractor. This prevents the subcontractor's insurer from recovering from the general contractor or from another subcontractor.<sup>144</sup> If every participant in a construction project insures its own people and property against construction-related hazard, and there is universal waiver of subrogation, then the effect is to make the construction site a contractual pocket of no-fault liability.

Courts routinely enforce waiver of subrogation clauses.<sup>145</sup> Some respects in which the clauses are enforced are strikingly unusual. Exculpatory terms are typically construed not to immunize a defendant from liability for gross negligence.<sup>146</sup> But a waiver of subrogation clause does exactly that.<sup>147</sup> Further, although an insurer typically

---

142. A mutual waiver of a subrogation term in a commercial lease raises similar issues. See Sidney G. Saltz, *Allocation of Insurable Risks in Commercial Leases*, 37 REAL PROP. PROB. & TR. J. 479, 482-85 (2002).

143. See AM. INST. OF ARCHITECTS, AIA DOCUMENT A201-2007, GENERAL CONDITIONS OF THE CONTRACT FOR CONSTRUCTION § 11.3.7 (2014) (providing a standard form clause). See Gary E. Snodgrass, *Waiver of Subrogation and Allocation of Risk in Construction Contracts*, 62 DEF. COUNS. J. 95 (1995), for a collection of cases enforcing the clause. Snodgrass reports that “[i]f an owner fails to obtain the necessary coverage, then it is estopped from proceeding against an architect, contractor, subcontractor or other consultant as a matter of law.” *Id.* at 98.

144. See David Arditì & Ranon Chotibhongs, *Issues in Subcontracting Practice*, 131 J. CONSTRUCTION ENGINEERING & MGMT. 866, 872 (2005); Terrence L. Brennan, *Construction Insurance: A General Perspective*, 15 CONSTRUCTION L. 1, 46 (1995).

145. Snodgrass, *supra* note 143, at 95 (“There has been no hesitancy in upholding and enforcing the AIA’s and similar waiver provisions in both federal and state courts throughout the United States. The courts also have applied the waiver provisions to all parties identified in the clause.”).

146. See, e.g., *St. Paul Fire & Marine Ins. Co. v. Universal Builders Supply*, 317 F. Supp. 2d 336, 341 (S.D.N.Y. 2004).

147. See *id.* at 341-42.

agrees to waive subrogation in its contract with the insured, this is not required to bind the insurer. Even when the insurance contract does not provide for waiver of subrogation, a term in the construction contract requiring the owner to secure a policy providing for waiver of subrogation eliminates an insurer's right to subrogation. This is one of the rare instances in which it is acknowledged that a contract can have an adverse legal impact on a person who is not a party to the contract.<sup>148</sup>

Waiver of subrogation is unobjectionable because casualty insurers should know the risk they bear, and should seek compensation accordingly. But this rationale raises the concern for information costs. Casualty insurers must determine whether a construction contract waives subrogation in order to determine the risks they bear. Should we be concerned this imposes excessive information costs on insurers? The answer clearly is no. Some reasons are context specific. The ubiquity and standardization of waiver of subrogation clauses reduces information costs. An insurer who cares about waiver of subrogation should know to look for a clause, where a clause is likely to be found in a construction contract, and what a clause means once it is found.

There are also other more generalizable reasons not to be concerned that enforcing waiver of subrogation clauses will impose excessive information costs on insurers. A casualty insurer who cares about waiver of subrogation will care even more about other factors that affect its exposure to risks covered by a clause. These factors include the value of property exposed to construction-related hazard, the nature of the construction-related hazard, liability law, and the financial ability of a contractor to satisfy a claim. Often investigation of these other factors by an insurer will yield information about a waiver of subrogation clause at little additional cost. It is possible that waiver of subrogation actually reduces insurers' total information costs with respect to construction-related hazards. While waiver of subrogation makes an insurer marginally more sensitive to information bearing on the hazard it insures against, it makes an insurer indifferent to liability law, and it makes an insurer indifferent to the financial ability of a contractor to pay a liability. Need for this information, which bears on the likelihood of recovering from a negligent contractor, dissipates once a waiver of subrogation clause is discovered.

---

148. See *Cont'l Ins. Co. v. Boraie*, 672 A.2d 274, 278 (N.J. Super. Ct. Law Div. 1995). The technical justification for the result is that as a subrogee, the insurer stands in the same shoes as the insured subrogor. Sections VIII.A and VIII.B, *infra*, show this is not as rare as it is generally supposed.

These reasons apply to exculpatory terms more generally. The universe of potentially affected persons, who have an incentive to investigate the possible existence of an exculpatory term, is generally limited to risk-bearers (potential victims) who have a potential legal claim against a risk-creator (a potential harm-doer) under the background liability rules, absent an exculpatory term. A risk-bearer who has a potential legal claim against a risk-creator has reason to investigate the situation independent of the possible existence of an exculpatory term. The risk-bearer will have reason to gauge the magnitude of the risk and to gauge the financial ability of the risk-creator to satisfy a claim. Sometimes the risk-bearer will be able to obtain information about the exculpatory term at little additional cost. And similar to how the existence of waiver of subrogation clauses may benefit an insurer *ex ante* by reducing its total information costs, the existence of an exculpatory term may reduce the total information costs of a risk bearer by making him indifferent to liability law and the risk-creator's ability to satisfy a liability.

Let me be clear about the limited point I am making. The information costs to which I refer are not the sort of information costs usually of concern in negligence analysis. The usual concern is the cost to a risk-bearer and the cost to a risk-creator of acquiring information about the risk itself, and not the cost to a risk-bearer of acquiring information about a risk-creator's liability for the risk under negligence law, or the cost of acquiring information about a risk-creator's ability to satisfy a liability. Sometimes negligence analysis is concerned with information costs borne by a risk-creator to ascertain its potential liability under a liability rule. But negligence analysis is not concerned with information costs borne by a risk-bearer to ascertain the prospects for recovery under negligence law. This is as it should be. Potential negligence victims do not usually investigate their potential legal claims against potential harm-doers in advance. The possibility that potential negligence victims may investigate their potential legal claims against potential harm-doers typically is a product of the parties being engaged in a joint enterprise in which the potential victim is aware of the risk and the identity of the potential harm-doer.

The relative significance of my limited point is best explained with an example. Owner hires Contractor to construct a building, agreeing to absolve Contractor from liability for construction defects to get the job done quickly and cheaply. Worrying about his liability to later purchasers, Contractor has Owner record the liability waiver. We would call the recorded waiver an exigible grant of immunity if it precluded a negligence claim against Contractor by future owners and users of the building, when the future owners and users would otherwise have a claim against Contractor for harm caused by his

careless building mistakes under negligence law. The immunity granted would be good against the world and would not be limited to Owner.

An exigible grant of immunity may seem to raise two general concerns that are raised by all servitudes.<sup>149</sup> One is the concern that creators of the servitude will ignore the interests of future owners and users of property, and so create a servitude that is undesirable to future owners and users (and may be socially undesirable).<sup>150</sup> Call this the concern for externalities. The other is the concern for information costs that future prospective purchasers and users incur to identify undesirable servitudes.<sup>151</sup> An exigible grant of immunity clearly raises the concern for externalities. Returning to the example, Owner may be trying to profit at the expense of future owners of the property when he grants Contractor immunity for slipshod work. Owner may anticipate that the problems from slipshod work will not manifest for several years, long after Owner has sold the building to an unwitting purchaser.<sup>152</sup> My limited point is that an exigible grant of immunity does not raise the concern for imposing information costs on future prospective purchasers and users.

The privity rules in contract are so well established that it is difficult to imagine courts creating an exception to the privity rules to cover exculpatory terms, even though the concern motivating the privity rules is not implicated when the issue is whether an exculpatory may be enforced against a nonparty. Thus we must look outside of contract law for tools to give effect to an exculpatory term when the term is not in a contract to which the victim is a party. But we should not be surprised to find that contractual considerations may justify giving effect to an exculpatory term under these other bodies of law. Part VI considers the most obvious tool for this task: property law and the law of equity.

---

149. See Molly Shaffer Van Houweling, *The New Servitudes*, 96 GEO. L.J. 885, 893-905 (2008) (describing these concerns as “notice and information costs,” “the problem of the future,” and negative externalities). Exigible immunities obviously do not raise concerns for fragmenting ownership of property, for an arrangement outliving its purposes, and for clouding the status of title.

150. See *id.* at 904.

151. See *id.* at 893-900.

152. Indeed, exigible grants of immunity have the potential to inflict greater costs on nonparties than easements and covenants on real property. The potential cost of an easement or covenant on real property generally is capped by the price paid for the burdened property or, more precisely, by what the value of the property would be without the servitude. On the other hand, a defect in property can have catastrophic consequences, and an exigible grant of immunity would deny the victim compensation for that loss.



#### D. Contractual Workarounds to Obtain a Liability Shield

Before we leave contract law, one more point bears noting. Sometimes it is possible for a risk-creator who is not in privity of contract with a risk-bearer to work around the privity rules and to make an exculpatory term binding on the risk-bearer.<sup>153</sup> But this requires some effort. *Rosenstein v. Standard & Poor's Corp.* illustrates both the possibility and the effort that is required.<sup>154</sup> An option trader on the Chicago Board of Exchange ("CBOE") sued Standard & Poor's ("S&P"), for an error in calculating the S&P index at the close of trading. The miscalculation resulted in a loss for the trader on options that closed on the day the error was made. The court concluded the plaintiff would have had an action against S&P under tort law, but the court held this claim to be precluded by an exculpatory term in the license agreement between S&P and CBOE. To achieve this outcome, S&P required that CBOE include the exculpatory term in its rules and regulations, which were explicitly incorporated by reference in every option traded on the CBOE.<sup>155</sup> This worked only because CBOE did what it promised. The exculpatory term would not have been enforceable against the option trader if CBOE had neglected to include the term in its rules and regulations, or if CBOE

---

153. *The Pioneer Container* illustrates another possibility when the risk-creator is a subcontractor who is engaged by a contractor with whom the risk-bearer is in privity. [1994] 2 AC 324 (PC) (appeal taken from Hong Kong). The case involves an accidental loss of bailed goods being carried by sea. *Id.* The initial carrier subcontracted the carriage to the defendants whose bill of lading provided that any dispute would be governed by Chinese law and resolved in Taipei. *Id.* at 332. The term in the defendants' bill of lading was held to bind the plaintiffs because their contracts with the initial carriers had a clause providing "[t]he Carrier shall be entitled to sub-contract on any terms the whole or any part of the [carriage]." *Id.* at 333. For a discussion of the case, see Andrew Phang, *Sub-Bailments and Consent*, 58 MOD. L. REV. 422, 422 (1995). Phang considers the possibility the plaintiffs might have been bound to the sub-bailee's term even if the contract with the initial carrier had not empowered it to sub-contract on any terms. *Id.*

154. 636 N.E.2d 665, 671-72 (Ill. App. Ct. 1993). Assent to terms in an unsigned writing may also be manifested by a party's conduct, but the cases where this has been found involve strong facts, such as conduct by the party unambiguously showing he understands the unsigned writing to be a source of both rights and duties. *A.P. Moller-Maersk A/S v. Comercializadora de Calidad S.A.*, 429 F. App'x 25, 28 (2d Cir. 2011) (applying New York law), illustrates what constitutes strong facts to establish adoption of a writing. A nonsignatory to a bill of lading was held to have agreed to submit to a forum selection clause in the bill of lading when it brought an action based on the bill of lading and when it agreed to waive a term in the bill of lading in return for cash security. *Id.* at 28.

155. This satisfied the high standard for incorporating the terms of an unsigned writing into a signed writing by reference: there must be a "clear and unequivocal" reference to the incorporated writing in the signed writing, and the incorporated writing must be readily available to the party. *Peterson & Simpson v. IHC Health Servs., Inc.*, 217 P.3d 716, 721 (Utah 2009).

had neglected to incorporate the rules and regulations in its contracts with option traders. S&P would have been left with a breach of contract claim against CBOE.

In cases where negligent performance of a contract involves a risk of physical harm to a nonparty, the usual contractual workaround to obtain a liability shield is an indemnity clause. The indemnity clause requires the other party to the contract to indemnify the protected party (the risk-creator) for defense and settlement costs on claims arising from the contract. For example, burglary and fire alarm contracts often have both an exculpatory clause, which limits liability on first-party claims, and an indemnity clause, which requires the purchaser of the service to indemnify the service provider for defense and settlement costs on all claims arising from the contract. While they are ubiquitous, indemnity clauses offer poor protection because the value of the indemnity right depends on the indemnitor being able to satisfy the indemnity obligation.

## VI. EXCULPATORY SERVITUDES (EQUITABLE NOTICE)

The privity rules in contract law make it close to impossible to use contract as a mechanism for extended forms of private ordering when more than a handful of people want to establish collective governance,<sup>156</sup> or when people want to establish a collective obligation (i.e., an obligation with multiple obligors and/or multiple obligees).<sup>157</sup>

---

156. Contract is possible only when people are willing to work under a rule that requires unanimous consent of persons whose rights are impaired by a collective decision.

157. There have been occasional attempts to account for some simpler forms of collective private ordering using contract law, but contract law is usually found inadequate even to these simple tasks. Thus, classical contract theory had difficulty accounting for the partnership. Frederick Pollock wrote that the legal power of a partnership to admit new partners "may seem to involve the anomaly of a floating contract between all members of the partnership for the time being, who by the nature of the case are unascertained persons when we look to any future time." FREDERICK POLLOCK, *PRINCIPLES OF CONTRACT: A TREATISE ON THE GENERAL PRINCIPLES CONCERNING THE VALIDITY OF AGREEMENTS IN THE LAW OF ENGLAND* 233-34 (7th ed. 1902). The anomaly was solved by treating the admission of a new partner by a partnership as a new contract, and not as a transfer of rights and obligations under an existing contract.

Classical contract theory also had difficulty accounting for collective obligation more generally. For discussions of the problems, see WALTER HUSSEY GRIFFITH, *A TREATISE ON JOINT RIGHTS AND LIABILITIES: INCLUDING THOSE WHICH ARE JOINT AND SEVERAL* (1897); Samuel Williston, *Releases and Covenants Not to Sue Joint, or Joint and Several Debtors*, 25 HARV. L. REV. 203 (1912).

For much of the twentieth century, legal theorists struggled to find a basis in contract law for a worker to sue an employer for breach of a collective bargaining agreement. See David E. Feller, *A General Theory of the Collective Bargaining Agreement*, 61 CALIF. L. REV. 663, 663 & n.1 (1973). The possible theories are suggestive. They were "the custom or usage theory," whereby an agreement is regarded as incorporated by reference; "the agency theory"; and "the third party beneficiary theory." *Id.* at 663 n.1. Eventually these theorists gave up looking for a solution in contract law. They adopted a new paradigm that

Thus, owners of firms use the law of business organizations to determine matters of firm governance and sharing of profits and losses. Debtors and creditors use the law of secured credit to determine the relative priority amongst creditors to the debtor's assets. The law of agency determines when one person has the power to undertake a legal obligation for another. And so on.

This Section concerns one such mechanism for collective private ordering: the law of servitudes. It also concerns the equitable doctrine of notice, which is the original legal source of the law of servitudes. Real estate developers often use servitudes as a mechanism for collective private ordering in a development, which allows for establishment and enforcement of collective obligations among owners of property in the development.<sup>158</sup> The possibility of using the law of servitudes to enforce an exculpatory term covering a defect in land against downstream purchasers has not been lost on lawyers.<sup>159</sup> A Washington Supreme Court case, *1515—1519 Lakeview Boulevard Condominium Ass'n v. Apartment Sales Corp.*, holds this to be a permissible use of servitudes.<sup>160</sup> A city permitted the construction of housing in a landslide-prone area. Concerned for its potential liability, the city conditioned the permits on the developer warning purchasers of the risk and the developer granting and recording a covenant waiving claims against the city resulting from soil movement. The Washington Supreme Court held this to be a valid servitude, applying the "touch or concern" test.<sup>161</sup>

---

analogizes a collective agreement to a government code. Karl E. Klare, *The Public/Private Distinction in Labor Law*, 130 U. PA. L. REV. 1358, 1359 (1982).

158. It is taken as a given in these cases that the absence of privity between the party seeking to enforce the servitude and the party opposing its enforcement precludes enforcement on the basis of contract law. *See, e.g.,* *Riley v. Bear Creek Planning Comm.*, 551 P.2d 1213, 1217 (Cal. 1976) (in bank) ("Inasmuch as there is no privity of contract between defendants and plaintiffs,[] [defendants'] right to enforce use restrictions against plaintiffs depends upon whether or not the restrictions sought to be enforced are comprehended within mutually enforceable equitable servitudes for the benefit of the tract.") (alterations in original).

159. *See* Bennett J. Hansen & Alexander S. Wylie, *Options are Limited: Can the Defense Turn to Contract?*, 50 FOR DEF. 47, 49-50 (2008) (proposing that builders incorporate exculpatory terms in the real estate deed to try to eliminate the liability to which they would otherwise be exposed); *see also* Newman v. Tualatin Dev. Co., 597 P.2d 800 (Or. 1979) (holding that at least 125 nonprivity townhouse owners who purchased townhouses from someone other than builder could prevail against builder upon showing of builder's negligence).

160. 43 P.3d 1233, 1237 (Wash. 2002) (en banc).

161. *Id.* at 1238-39. For a discussion of the case, *see* Susan F. French, *Can Covenants Not to Sue, Covenants Against Competition and Spite Covenants Run with Land? Comparing Results Under the Touch or Concern Doctrine and the Restatement Third, Property (Servitudes)*, 38 REAL PROP. PROB. & TR. J. 267, 276-80 (2003). French also discusses two other cases that come out the opposite way, holding a covenant not to sue for damages on account of soil contamination does not touch or concern land. *Id.* at 279.

Nothing is objectionable about using servitudes as a legal mechanism to enforce exculpatory terms covering real property defects against purchasers of the property. In most states, downstream purchasers of residential real property do not have a negligence claim against an upstream party in the first place. In these states there is no possibility of the claim that was precluded by the exculpatory term in *1515–1519 Lakeview Boulevard*. In some states, a downstream purchaser may have a third-party beneficiary claim, typically on an implied warranty theory, but this claim is subject to an otherwise valid exculpatory term in the upstream contract. Washington is one of a few states that allow a downstream purchaser to recover against an upstream party on a negligence claim absent bodily harm or physical harm to other property.<sup>162</sup> The effect of allowing these claims is to create a background liability rule for upstream parties whose activities involving real property create a risk of pure economic harm to a downstream owner or user of property. People should be allowed to opt out of this background liability rule by creating an exculpatory servitude, unless the court determines it is unreasonable for the defendant to absolve itself from liability for the act and harm in question. One way to think about the legal arrangement in Washington is that by allowing people to try to opt out of the background liability rule with an exculpatory servitude, the Washington Supreme Court gave courts an opportunity to rethink the need for the liability rule in cases in which people do try to opt out.

The law of servitudes gives courts more powerful tools to police unreasonable servitudes than would the law of contracts if the right of the downstream party to compensation for defective work were determined by the law of third-party beneficiary. The *Restatement (Third) of Property: Servitudes* abolishes the old “touch and concern” test for a valid servitude.<sup>163</sup> Under the Restatement, a properly created servitude “is valid unless [the term] is illegal or unconstitutional or violates public policy.”<sup>164</sup> The public policy test involves stricter

---

French, who was reporter for the Third Restatement, argues that the public policy test permits a more candid discussion of the relevant considerations, which is whether it is in the public interest to enforce such terms against downstream purchasers. See *id.* at 279-80.

162. *Casa Clara Condominium Ass'n v. Charley Toppino & Sons, Inc.*, 620 So.2d 1244 (Fla. 1993), is a leasing case denying the claim. See William K. Jones, *Product Defects Causing Commercial Loss: The Ascendancy of Contract over Tort*, 44 U. MIAMI L. REV. 731, 799-803 (1990) (concluding that an “overwhelming majority of courts deny recovery, in negligence and in strict liability”); see also Sean M. O'Brien, *Caveat Venditor: A Case for Granting Subsequent Purchasers a Cause of Action Against Builder-Vendors for Latent Defects in the Home*, 20 J. CORP. L. 525, 545-47 (1995) (collecting cases allowing the claim, while noting that a majority of states have rejected the claim).

163. RESTATEMENT (THIRD) OF PROPERTY: SERVITUDES § 3.2 (AM. LAW INST. 2000).

164. *Id.* § 3.1.

scrutiny of servitudes than a standard of unconscionability or the public policy rules that apply to exculpatory terms in a contractual setting. The comments in the Restatement explain that public policy determinations involve general interest balancing.<sup>165</sup> Thus, a court could invalidate an exculpatory servitude if the reasons for negligence liability seemed particularly strong, even if the term was not so egregious as to be unconscionable or to violate public policy under those bodies of law.<sup>166</sup>

There are possibilities beyond real servitudes for enforcing an exculpatory term in the absence of privity of contract between a plaintiff and defendant based on the plaintiff having notice of the term before he stepped in harm's way. The law of servitudes originates in the equitable doctrine of notice, which is a venerable exception to the rule that limits the legal effect of a contract to parties to the contract.<sup>167</sup> Application of the doctrine does not depend on the availability of formal channels for providing a nonparty notice, like land records. The equitable doctrine of notice was used in *Tulk v. Moxhay* to enforce a covenant restricting the use of land against a purchaser of the land who had actual notice of the covenant, but who may not have understood the covenant to bind him.<sup>168</sup> The case long predates the recording system for land transfers. The equitable doctrine of notice is used for purposes other than enforcing servitudes in land. It has been used to subject a purchaser of an asset to a third party's claim to the asset when the purchaser acquires the asset with notice of the claim. For example, if a purchaser knows the seller acquired an asset fraudulently, then the purchaser takes the asset subject to the equitable claim of the defrauded prior owner.<sup>169</sup> And a purchaser

---

165. See *id.* at cmt. i (resolving public policy claims requires balancing interests).

166. Some cases suggest courts should generally defer to private ordering through a servitude when assent to the servitude is of reasonably high quality because the servitude is clear, it is properly recorded, and other property owners rely on the existence of the servitude. *Nahrstedt v. Lakeside Vill. Condo. Ass'n, Inc.*, 878 P.2d 1275 (Cal. 1994) (in bank). *Nahrstedt* adopts a rule of deference according presumptive validity to clear use restrictions in a common interest community when the use restrictions are contained in the community's originating documents, which are recorded, emphasizing that some purchasers may have relied on the restrictions. *Id.* at 1290-92. The decision suggests that restrictions that are later imposed by majority vote or by a rulemaking power should be tested under a more demanding reasonableness requirement. See *id.*

167. The doctrine should not be confused with equitable estoppel, which requires a representation by an estopped party and reliance by a party claiming estoppel. In cases involving equitable notice, the party invoking the doctrine has not relied on any act or representation by the party against whom the doctrine is being invoked.

168. (1848) 41 Eng. Rep. 1143, 1144.

169. For chattels, the rule is codified in the Uniform Commercial Code and gives someone who wrongfully acquires title to a chattel in a consensual transaction (such as by fraud) "voidable title" and the "power to transfer a good title to a good faith purchaser for value." U.C.C. § 2-403(1) (AM. LAW INST. & NAT'L CONFERENCE OF COMM'RS ON UNIF.

of land who knows the sale to him violates a previously made purchase agreement takes the land subject to an equitable claim of the aggrieved purchaser.<sup>170</sup>

In a few cases, contractual restrictions on the use of chattels have been enforced against downstream purchasers of the chattel.<sup>171</sup> These cases raise the possibility of using chattel servitudes (or the equitable doctrine of notice) to subject a purchaser or user of a chattel to a reasonable exculpatory term covering a defect in the chattel when the person knows or has reason to know of the term when he acquires or uses the chattel. For example, a volunteer organization refurbishes beat-up old bikes, paints them yellow, and then leaves the bikes in public places for anyone to use.<sup>172</sup> The organization prominently emblazons a disclaimer of liability on the bikes, informing a user of the bike that he or she bears the risk of a defect in the bike. The principles identified in Part II support enforcing the term, unless a bike was clearly unsafe to use when the organization placed the bike on the street. Riders are best situated to monitor the condition of the bikes they use. Contract law offers a possible legal basis for enforcing the exculpatory term in this case, but the contract theory requires classifying the relationship between the yellow bike organization and a bike user as contractual. The law of chattel servitudes (or the equitable doctrine of notice) offers an alternative legal theory for enforcing the term that does not depend on the classification of the relationship as contractual.

---

STATE LAWS 2014). A downstream purchaser of the chattel who has notice that it was wrongfully acquired takes the chattel subject to the victim's equitable claim. For intangible rights (e.g., "choses in action") the rule is embodied in the doctrine of latent equities. See RESTATEMENT (SECOND) OF CONTRACTS § 343 (AM. LAW. INST. 1981); JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 18-20 (2d ed. 1977). Under this doctrine, an assignee who acquires an intangible asset such as an insurance policy for value without notice of an equitable claim of a third party takes the asset free of the claim.

170. See, e.g., *Greenfield Country Estates Tenants Ass'n v. Deep*, 666 N.E.2d 988, 994 (Mass. 1996) ("A holder is entitled to injunctive protection against sale to a bona fide purchaser, and may enforce the right in an action of specific performance against a third party who purchased with notice of the option. The third-party purchaser holds legal title, subject to the equitable obligation to convey the property to the holder of the right on receipt of payment of the required purchase price."); *George v. Oakhurst Realty Inc.*, 414 A.2d 471, 474 (R.I. 1980).

171. See Glen O. Robinson, *Personal Property Servitudes*, 71 U. CHI. L. REV. 1449 (2004). Robinson highlights *Pratte v. Balatsos*, 113 A.2d 492 (N.H. 1955) (enforcing rental agreement for juke box against purchaser of business). The case elicited wry critique. See Zechariah Chafee, Jr., *The Music Goes Round and Round: Equitable Servitudes and Chattels*, 69 HARV. L. REV. 1250, 1250-53 (1956) (arguing that servitudes in chattels should not be recognized generally because they mostly are used for illegitimate ends and serve few legitimate ends); see also Robinson, *supra*, at 1455-60 (describing four other relatively recent cases enforcing a servitude in a chattel).

172. See, e.g., AUSTIN'S YELLOW BIKE PROJECT, <http://austinyellowbike.org> (last visited Feb. 27, 2016).

Possible objections to using the equitable doctrine of notice to enforce the exculpatory term in the yellow bike hypothetical include the doctrine's obscurity and the fact the doctrine has never been used for a purpose such as this. Apart from the law of servitudes, the doctrine fills an obscure niche in property law. The doctrine almost always operates to preserve an upstream owner's proprietary interest in an asset against a downstream purchaser, who acquires the asset with notice of the upstream owner's proprietary interest.<sup>173</sup>

But there is no obvious reason why the application of the doctrine should be limited to the preservation of proprietary interests in assets. Indeed, there is no longer any obvious reason to limit the doctrine to asset-based legal claims.<sup>174</sup> Previously, the old form of the privity doctrine limited the potential use of the doctrine to claims of proprietary interests in assets. To see the connection, consider the case of an asset that is passed down through a stream of hands. Handlers include successive owners of the asset, non-owners who handle the asset in servicing it, and non-owners who handle the asset in using it. Under the privity doctrine, a downstream handler could never have a claim against an upstream handler for carelessness in handling the asset, even if the carelessness predictably harmed the downstream party. Non-contractual claims only went one way—downstream. And the only possible non-contractual claim was a proprietary claim by an upstream owner against a downstream party in possession of the asset, asserting an interest in the asset superior to

---

173. Technically, an equitable interest in an asset is a non-possessory, proprietary interest that does not involve legal title. Traditionally, the doctrine operated negatively and was not a basis for imposing an affirmative obligation on a party. Thus, traditionally, only negative servitudes (land use restrictions) were recognized, and these were enforceable only by injunction. Damages were not available for violation of an equitable servitude. In addition, an owner of an asset subject to an equitable interest does not commit a wrong against the interest holder by selling the asset to a bona fide purchaser, even though the sale destroys the equitable interest. This feature distinguishes the doctrine from the tort of interference with contract.

174. The doctrine has been applied to vindicate interests that are not associated with a particular thing. In a pair of 1994 English cases, the Law Lords used the doctrine to prevent a creditor from enforcing a guarantee of a debt, when the guarantee was obtained by the debtor from a loved one using undue influence, misrepresentation, or some other equitable wrong, if the creditor had reason to suspect the wrong-doing. *Barclays Bank PLC v. O'Brien* [1994] 1 AC 180 (HL) (appeal taken from Eng.); *C.I.B.C. Mortgs. PLC v. Pitt* [1994] 1 AC 200 (HL) (appeal taken from Eng.). James Edelman explains this application of the doctrine is "an anomaly largely prompted by public policy considerations." *SNELL'S EQUITY* para. 8-028, at 237 (John McGhee ed., 32d ed. 2010).

Going back some time, it seems the doctrine may have been used in the law of merchant shipping in the nineteenth century to hold a shipper who consigns goods to a vessel for shipping to the terms of a charter agreement even though the shipper had nothing to do with the agreement. See JAMES T. FOARD, *A TREATISE ON THE LAW OF MERCHANT SHIPPING AND FREIGHT* 294-95 (1880). I have not pursued this lead because proof of the point would add little to the case for using the doctrine today.

the downstream party, or a right to control use of the asset. The law generally cuts off an upstream owner's proprietary claim to protect a bona fide purchaser and successors in interest. The equitable doctrine of notice prevents the claim from being cut off when the downstream purchaser had notice of the claim. The doctrine applied in the only situation where, because of the privity doctrine, a downstream handler's notice of an upstream handler's legal position in relation to the asset could matter.

The fall of the old form of the privity doctrine exposes an upstream handler of an asset, who is responsible for a defect in the asset, to a liability claim by a downstream handler of the asset, who is harmed by the defect. Sometimes the law will allow the upstream handler to absolve himself from liability for the defect to a purchaser of the asset by including an exculpatory term in the sales contract. There is no a priori reason why this exculpatory term should not also exclude a claim by a downstream handler, who has actual or constructive notice of the term. Further, there is no a priori reason why the doctrine should be limited to exculpatory terms covering defects in tangible assets. Returning to *Ossining Union Free School District*, if the District knew or had reason to know that the contract between the Architect and the Engineers had a waiver of consequential damages, and in the circumstances the District reasonably should have understood this term applied to any claim it might bring against the Engineers, then the court could hold the District is subject to the term based on the equitable doctrine of notice. That said, it is unlikely that lawyers and judges will think of using the equitable doctrine of notice to give effect to an exculpatory term, other than in cases in which the term is in the form of a real servitude. Lawyers and judges are likely to look to tort law, to which I now turn.

## VII. TORT LAW

This Part concerns approaches in tort law that courts may use to implement the principles identified in Part II.<sup>175</sup> Tort law generally

---

175. The doctrine of assumption of risk is not considered. In the U.S., the doctrine of implied assumption of risk has been pared back so that an unreasonable decision by a plaintiff to engage in an unreasonable activity is treated as contributory negligence. What remains of the doctrine of implied assumption of risk covers cases in which a plaintiff makes a reasonable decision to engage in an activity with others that involves a risk of physical harm, such as playing a sport. The doctrine shields other participants in the activity from negligence liability for conduct that is commonly associated with the activity. The application of the doctrine by a court to find no duty can involve question-begging determinations of the reasonableness of an activity, the reasonableness of the plaintiff's decision to engage in the activity, and whether the defendant's conduct was appropriate to the activity. All of these issues are near the surface in the leading California case. See *Knight v. Jewett*, 834 P.2d 696, 711 (Cal. 1992) (holding that a woman of slight build assumed the risk of rough bodily contact by a much larger male participant in an impromptu



will determine the effect of an exculpatory term in cases where the victim is not a party to the contract with the exculpatory term. The way tort law handles these cases depends in part on whether the relevant harm is physical or purely economic. Section VII.A concerns cases involving physical harm, typically in the nature of bodily harm to the plaintiff. Usually in these cases the victim cannot be expected to protect herself from the risk by contract, often because the victim is not connected to the harm-doer through a chain of contracts. Section VII.A considers the limited ways in which tort law still makes the terms of an actor's contract relevant to the actor's duty to a nonparty.

Section VII.B concerns cases involving pure economic loss. In these cases, it is widely agreed that tort law sometimes should give way when the victim and the harm-doer are connected through a chain of contracts, and it is possible for the victim to protect herself from the risk by contract. There is no agreement on when precisely tort law should give way, or on what is it precisely about a claim's contractual context that might justify dismissing a claim when there are strong reasons for liability under the usual negligence factors. Section VII.B.1 shows the problem is best approached as one of contract interpretation or contract construction. A court should try to predict whether the parties would have disavowed the possibility of a negligence claim if the issue had been brought to their attention before the problem arose. This approach makes duty a matter of predicted intent. Section VII.B.2 concerns rules in the law of economic negligence that give parties to a contract the power to disclaim a duty to a nonparty victim, without regard to the nonparty victim's assent, either actual or predicted. Section VII.C considers the tort action for negligent misrepresentation separately. It returns to the concern for information costs and argues this concern does not justify the New York rule requiring "near privity" or the California rule requiring "intended reliance."

### A. *Negligence Involving Physical Harm*

Under modern rules of tort law, an actor is likely to have a duty of care when the actor's conduct creates a risk of physical harm to another. As a consequence, when the performance of a contract involves a risk of physical harm to a nonparty, one or both of the contracting

---

tu co-ed touch football game because the contact was appropriate to the game). The consensus among U.S. scholars is that we would be better off without the doctrine because any useful work done with it can be better done using other doctrines. *See, e.g.*, Stephen D. Sugarman, *Assumption of Risk*, 31 VAL. U. L. REV. 833 (1997). For a contrary view, see Avihay Dorfman, *Assumption of Risk, After All*, 15 THEORETICAL INQUIRIES L. 293 (2014).

parties is likely to have a duty of care to the nonparty. But tort law gives the parties some power to determine who among them has this duty of care. The first Section concerns these rules. The second Section concerns the power that the parties to a contract may have to disclaim any duty to a nonparty by including an exculpatory term in a contract. An absence of duty under both sets of rules does not generally depend on contractual considerations involving the plaintiff's assent to an exculpatory term, either actual or predicted.

1. *The Power to Determine Who Has a Duty to a Nonparty*

Under the *Restatement (Third) of Torts*, "An actor ordinarily has a duty to exercise reasonable care when the actor's conduct creates a risk of physical harm."<sup>176</sup> Under this general duty rule, when the performance of a contract involves a risk of physical harm to a nonparty, one or both of the parties to the contract is likely to have a duty to the nonparty. However, the parties have some power to determine who among them bears the duty: they have flexibility in defining the legal relationship between themselves, and they can use their contract to allocate performance obligations. This power is a product of interaction between negligence law and rules outside of negligence law. These other rules come from areas such as contract law, the law of business organizations, agency law, and the law of vicarious liability. The rules on independent contractors illustrate how this works.

Owner wants to cut down a tree on his property, which involves a risk of physical harm to Neighbor. If Owner cuts down the tree himself, then he will have a duty of care to Neighbor. But Owner can limit his duty to Neighbor, and partly shield himself from possible negligence liability, by hiring Tree Service to do the work as an independent contractor. Hiring an independent contractor is not a perfect shield against a negligence claim by Neighbor against Owner, should Neighbor be injured when the tree is cut down. The shield is not available if the task is considered a non-delegable duty.<sup>177</sup> Further, a hirer has a duty of care in selecting an independent contractor and in giving instructions to an independent contractor.<sup>178</sup> But these caveats aside, Owner will be shielded from liability for the independent contractor's carelessness in performing the contract. A hirer generally has no duty to monitor an independent contractor's performance. And

---

176. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 7 (AM. LAW INST. 2010).

177. 2 DAN B. DOBBS ET AL., THE LAW OF TORTS § 432 (2d ed. 2011).

178. *Id.* at 815 (first citing RESTATEMENT (SECOND) OF TORTS § 411 (AM. LAW INST. 1965) (negligent selection); then citing RESTATEMENT (SECOND) OF TORTS § 413 (negligent instructions); and then citing RESTATEMENT (SECOND) OF TORTS § 414 (negligent exercise of retained control)).

in most states a hirer does not have a duty to investigate an independent contractor's finances or insurance coverage to ensure the contractor can satisfy any claims that arise from negligence in doing the work.<sup>179</sup>

Under the old privity rule, Tree Service would not have been liable to neighbor.<sup>180</sup> Today tort law starts from the opposite premise: a contract cannot absolve an actor from a duty of care the actor would owe to a nonparty in the absence of a contract. Instead, a contract can only be an additional source of a duty. This is expressed by two rules in the *Restatement (Third) of Torts: Liability for Physical Harm* section 43. The rule in section 43(a) applies if an action of Tree Service in performing the contract creates a risk of harm to Neighbor. The rule in section 43(b) applies if Tree Service undertakes to perform a duty owed by Owner to Neighbor. The contract is the source of Tree Service's duty under the rule in section 43(b), and so the terms of contract between Tree Service and Owner may be relevant to the existence of a duty. The terms of the contract are generally irrelevant to the existence of a duty under the rule in section 43(a).

Under the rule in section 43(a), an actor ordinarily has a duty of care to a nonparty in performing a contract, or in performing any other undertaking, if an action increases the risk of physical harm to the nonparty "beyond that which existed without the undertaking."<sup>181</sup> The action can be in the performance of the undertaking, or it can be the engagement in the undertaking. Duty arises under this rule because an action creates a risk of harm. The terms of the actor's contract generally have no bearing on his duty.<sup>182</sup> For example, Electrician is hired by Shopkeeper to repair an electrical line, and he carelessly loosens a light fixture, which falls on Customer.<sup>183</sup> It is irrele-

179. *Id.* at 817-18.

180. As discussed in Part IV, *infra*, the old rule shielded an actor from liability to a nonparty—both in contract and in tort—for harm he caused in carelessly performing a contract.

181. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 43(a) (AM. LAW. INST. 2010). This rule does not reach cases of culpable nonfeasance, so section 43(b) and (c) provide two other bases for a duty: "the actor has undertaken to perform a duty owed by the other to the third person" or reliance by a relevant person, which includes at least the plaintiff and the other party to the contract. *Id.* § 43(b)-(c).

182. An exception to this general rule is the rule that a contractor building in accordance with plans and relying on valid business permits is not liable to a third party even though the contractor creates an unreasonably dangerous condition by following the plans. The contractor is liable only if no competent contractor would follow the plans. *Soave v. Nat'l Velour Corp.*, 863 A.2d 186, 191 (R.I. 2004). This is similar to the "contract specification defense" in the law of products liability. See OWEN, *supra* note 72, at 879-81 (reporting this is the majority position and gaining adherents).

183. The example is from the Restatement. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 43 cmt. d (AM. LAW INST. 2010).

vant to Electrician's duty under section 43(a) that he was not hired to ensure the fixture was secure. Electrician has a duty of care to Customer because his conduct created the risk of harm.

The terms of the actor's contract do have a bearing on duty under the rule in section 43(b). This rule provides that a duty of care to a nonparty can arise by contract (or other undertaking) when "the actor has undertaken to perform a duty owed by [a party] to the [nonparty]."<sup>184</sup> In Electrician's case, this rule comes into play if the loose light fixture is a pre-existing condition not of Electrician's making. Electrician has a duty of care under the rule in section 43(b) if, in addition to repairing the electrical line, he actually undertakes to check the safety of the fixture. On the other hand, if checking the safety of the fixture is not part of Electrician's undertaking—i.e., it is outside the scope of his contract—then Electrician has no duty with respect to the loose fixture when it is a pre-existing condition, which is not of his making.<sup>185</sup> Of course, Shopkeeper will have a duty to correct the loose fixture as part of his general duty to Customer to maintain safe premises.

The distinction between the case in which Electrician loosens a light fixture, and the case in which Electrician fails to correct an already loose light fixture, is often expressed as the distinction between misfeasance and nonfeasance. The Restatement Third properly shifts the focus to the source of the risk of the harm the plaintiff suffers. If the risk is partly of an actor's making, then the action that created or increased the risk can be the source of a duty, and there is no need to justify the actor's duty by reference to his contract.<sup>186</sup> On the other

---

184. *Id.* § 43(b).

185. *See, e.g., Doe v. Grosvenor Props. (Haw.) Ltd.*, 829 P.2d 512, 518-19 (Haw. 1992) (holding an elevator maintenance company was not liable for failing to connect the elevator stop button to the alarm bell when this was not within the scope of the company's maintenance obligation); *Cassell v. Collins*, 472 S.E.2d 770, 772-73 (N.C. 1996) (holding a security service was not liable when a guard failed to intervene to protect a guest on the property from a violent assault when the contract provided for unarmed surveillance).

186. The misfeasance/nonfeasance dichotomy suggests a plaintiff must establish either an affirmative action by the defendant that was unreasonable (misfeasance) or a failure to fulfill a contractual undertaking (culpable nonfeasance). This is not required. It is enough for duty that the defendant's action created or increased the risk of the harm that occurred. The action that created the risk need not be unreasonable in itself for a duty to arise, and the duty that arises because of the action may go beyond the scope of the contract. *Anderson v. PPCT Mgmt. Sys., Inc.*, 145 P.3d 503 (Alaska 2006), illustrates the possibility. The plaintiff, an employee of the state Department of Corrections ("DOC"), was injured while being trained in "use-of-force techniques." The defendant designed the training program, which involved techniques approved by the defendant. The defendant did not run the training sessions. These were run by DOC employees, who were trained and certified by the defendant. The plaintiff was injured in a session by a trainer who did not follow the defendant's protocol in a live simulation. The conduct of the trainer could not be imputed to the defendant, for the trainer was not the defendant's employee and was not in the defendant's control. *Id.* at 507-11. The only theory left to the plaintiff was negligent

hand, if an actor had no hand in creating the risk, he is unlikely to have a duty of care unless his contract provides a basis for one. In such a case, the actor generally will be subject to negligence liability only if he had a contractual obligation to take the untaken precaution.

## 2. *The Power to Disclaim a Duty to a Nonparty (Physical Harm)*

We have seen parties to a contract have some power to decide who among them owes a duty to a nonparty. This Section considers the limited situations in which parties to a contract are able to completely disclaim a duty to a nonparty when performance of a contract involves a risk of physical harm to the nonparty. To begin, the parties may have this power if neither party to a contract has performed an act that creates or adds to the risk of the harm suffered by the plaintiff. To see how performance of a contract may involve a risk of physical harm to a nonparty though neither party had a hand in creating or adding to the risk, consider the facts of two cases, *Stanley v. McCarver*<sup>187</sup> and *Butler v. Advanced Drainage Systems, Inc.*<sup>188</sup>

In *Stanley v. McCarver*, a hospital hired a radiologist to screen a prospective employee's x-rays for tuberculosis. McCarver, the radiologist, told people at the hospital that shadows on the x-rays should be looked into. But McCarver did not follow up with Stanley, the prospective employee, and no one at the hospital passed the information to her. The shadows were an early sign of lung cancer. By the time the cancer was detected, it was untreatable. Stanley did not claim she skipped a checkup, relying on the screening as a bill of health. *Butler v. Advanced Drainage Systems, Inc.* raises the same basic issue in less tragic circumstances. A city hired contractors to design and build a drainage system for a lake to mitigate flooding. As a result of design and construction errors, the system worked poorly, and owners of lakeside property suffered flooding that would have been avoided if the contractors had done their jobs competently. But the

---

training. The trial court ruled this required the plaintiff to show the maneuver involved in her injury, that the defendant taught this maneuver to instructors, and that it was negligent for the defendant to train instructors to teach this maneuver to others. *Id.* at 511. The trial court granted summary judgment for the defendant when the plaintiff failed to produce such evidence. The Alaska Supreme Court reversed, holding that the defendant might be found negligent if the jury found the defendant "developed a program that, as a whole, produced instructor trainers and instructors who lacked the training they reasonably needed to protect their future students from harm." *Id.* at 512.

187. 92 P.3d 849 (Ariz. 2004).

188. 717 N.W.2d 760 (Wis. 2006).

flooding was no worse than it would have been without the drainage system. The owners of lakeside property did not claim that they relied on the system in any way.

In both cases, the defendant was hired to perform a task that, if done competently, would have diminished a pre-existing risk of harm to the plaintiff. The defendant did nothing to increase this risk, and so had no duty to the plaintiff. The person who hired the defendant (“the hirer”) also had no duty with respect to the risk. The hirer did not create or add to the risk and was not otherwise under a duty with respect to it. (In a moment we will look at the more common case in which the hirer has a duty of care with regards to a pre-existing condition because of the hirer’s own contract with the plaintiff). Further, there is no claim by the plaintiff that she detrimentally relied on competent performance of the undertaking.

One might wonder whether there is any basis in tort law for imposing a duty on the defendants in these cases. The answer is no under the rules in Restatement section 43,<sup>189</sup> but the two cases are authority that a duty may exist in these circumstances. In *Stanley v. McCarver*, the court held there was a duty but suggested its content may be affected by the terms of the physician’s contract, among other factors.<sup>190</sup> A leading torts treatise applauds the decision and reports it reflects the trend in recent cases.<sup>191</sup> In *Butler v. Advanced Drainage Systems, Inc.*, the court did not allow the claim, but the majority skipped over the duty issue and instead found no liability under an unusual Wisconsin rule. This rule allows a court to make a no-liability determination based on public policy.<sup>192</sup> (A concurring opinion applied the rules in the Restatement and held there was no duty.)<sup>193</sup>

As for the source of the defendant’s duty in each of these cases, the obvious source is the relevant contract between the defendant and the hirer. Abundant precedent shows that, even where Restatement

---

189. There is no duty under the rule in section 43(a) because the defendant’s actions did not create or increase the risk of the harm that occurred. See RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 43(a) (AM. LAW. INST. 2009). There is no duty under the rule in section 43(b) because the hirer was under no duty to the plaintiff with respect to the risk. See *id.* § 43(b).

190. *Stanley*, 92 P.3d at 853-55. The court did not define the content of the duty, saying this “may depend upon factors such as whether there is a treating or referring physician involved in the transaction, whether the radiologist has means to identify and locate the patient, the scope of—including any contractual limitations on—the radiologist’s undertaking, and other factors that may be present in a particular case.” *Id.* at 854-55.

191. See DAN B. DOBBS ET AL., THE LAW OF TORTS § 286, at 143-45 (2d ed. 2011). The authors directly challenge the rules in the Restatement. See *id.* § 412, at 687-88.

192. *Butler*, 717 N.W.2d at 767-69.

193. *Id.* at 774-75.

section 43 provides no basis for duty, a contract may still create a duty in tort to a nonparty. A familiar example comes from the law of economic negligence: when a lawyer botches a bequest, many states allow the disappointed beneficiary to recover in tort on a malpractice claim. Some states treat this as a third-party beneficiary claim on the lawyer's contract with the testator. I will refer to the tort form of the claim as a third party duty claim.

How does third party duty analysis differ from third-party beneficiary analysis? An obvious but mostly superficial difference is that the "intent to benefit" test is used in third-party beneficiary analysis, whereas *Stanley v. McCarver* makes no mention of the parties' intent to benefit the plaintiff. This is mostly a superficial difference: when the contract does not expressly identify the plaintiff as a third-party beneficiary, and a court must therefore predict the parties' intent, the 'intent to benefit' test does little work in the analysis. A more substantive difference is whose interests are considered. In third-party beneficiary analysis, only the interests of the contracting parties count. A court asks whether allowing a nonparty plaintiff to sue for breach of contract advances the interests of the parties in making the contract. The interests of the nonparty plaintiff are irrelevant. In third party duty analysis, some weight is given to the interests of the nonparty plaintiff, and to society's interests. It is difficult to justify the result in *Stanley v. McCarver* if only the interests of the radiologist and the hospital count in the analysis.

One way to think about the difference between the two analyses is that, when reasonable care in performing a contract protects a nonparty from a risk of physical harm, a court will more readily imply a duty to use such care using tort law. This seems right to me. However, it also seems right that the contracting parties' interests remain paramount in duty analysis in tort law when neither party owes a duty of care to the plaintiff, independent of the contract, with respect to the risk of the harm suffered, because neither party had a hand in creating the risk. *Stanley v. McCarver* and *Butler v. Advanced Drainage Systems, Inc.* seem to recognize this point. In *Stanley v. McCarver*, the court justified the duty by arguing the law required the physician to do only what most physicians would do in the same situation.<sup>194</sup> If this is correct, then the burden imposed by the duty was slight, and the "threatened flood of litigation might instead be a trickle."<sup>195</sup> The court also suggested the duty could be avoided by con-

---

194. See *Stanley*, 92 P.3d at 855 ("We suspect, based upon the ethical standards governing radiologists, that most radiologists do in fact communicate with some responsible party when a serious abnormality is discovered.").

195. *Id.*

tract.<sup>196</sup> In justifying the absence of liability in *Butler v. Advanced Drainage Systems, Inc.*, the court emphasized the chilling effect liability might have on contractors bidding on municipal abatement projects.<sup>197</sup> I expect that if the city and the contractors had specified in their contract that they did not intend to create any duty to the owners of lakeside property, then that would have been the end of the matter, and the court would not have thought it necessary to give policy reasons to explain the absence of liability.

The argument I have made up to this point is fairly modest. Two parties who enter a contract to advance their own interests can disclaim a duty with respect to some risk of physical harm to a nonparty, even if reasonable care in performing the contract would decrease that risk. But the parties have this power only where the initial risk is not of either party's making, and only if neither party otherwise owes a duty with respect to that risk to the nonparty. When I say the parties have the power to disclaim a duty, I mean that a court should give effect to the disclaimer even though the court thinks the disclaimer is unreasonable and not likely to be in the interest of the parties, or society. The parties have the final say on the matter. Thus, if an employer hires a radiologist to screen the x-rays of a prospective employee, and the contract between the hospital and the radiologist disclaims any duty on the part of the radiologist to the employee, then the court should give effect to the disclaimer, even if the court thinks this arrangement is unreasonable. If you had to explain this in terms of the parties' interests, then you might say the employer and the radiologist are assumed to have a benevolent interest in aiding the employee, so long as benevolence does not impose much of a burden on them, and so long as they do not disclaim any benevolent interest in aiding the employee.

Cases in which this claim is put to the test hopefully will be rare. It would be depressing to learn that radiologists responded to *Stanley v. McCarver* by adding a term in their standard contracts disclaiming the duty. *Hampton v. Federal Express* raises a related issue, which is of much greater practical significance.<sup>198</sup> In one respect, the case is similar to *Stanley v. McCarver*. The boy died as a result of a pre-existing condition. Nothing the hospital or Fed Ex did created or in-

---

196. *Id.* ("Finally, we note that doctors may deal with this issue as a matter of contract. They may, for example, require x-ray subjects to consent to having the results reported only to the employers."). The court did not explain how radiologists are to obtain a subject's consent when they do not deal directly with the subject.

197. *Butler*, 717 N.W.2d at 769. The court also reasoned liability was unnecessary, because the city had sued the contractors for breach of contract, and the suit was settled to the city's satisfaction. *See id.* at 769 n.8.

198. 917 F.2d 1119, 1119 (8th Cir. 1990).



creased the boy's risk of dying of cancer. In another respect, *Hampton* is unlike *Stanley*: the hospital undertook a duty to treat the boy's condition. This may make a great deal of difference legally, for Fed Ex might owe a duty of care to the boy under the rule in Restatement section 43(b).<sup>199</sup> The carrier's duty to the boy would be derivative of the hospital's duty.

The major difference between the two cases is in the strength of the reasons for negligence liability. While the legal basis for finding a duty is quite weak in *Stanley*, there are strong reasons for imposing negligence liability. McCarver, the radiologist, knew he had information that should be passed on to Stanley. The court thought the burden it was imposing on future radiologists was slight, and that any unfairness to McCarver in holding him liable for a risk that was not of his making was mitigated by the fact that he was being held liable only for failing to do what the court assumed most radiologists would have done as a matter of course. Conversely, in *Hampton*, the reasons for negligence liability are incredibly weak, despite the stronger legal basis for finding a duty. The court emphasized the factor of foreseeability—Fed Ex could not know the importance of the package it lost. Other factors support the result. The liability Fed Ex was asked to bear was disproportionate to its degree of fault. And the hospital bears primary responsibility—someone at the hospital should have followed up to ensure delivery of the package.

There are also strong policy reasons for the result in *Hampton*. *Edwards v. Honeywell, Inc.*, a case that raises issues similar to *Hampton*, speaks to these policy reasons.<sup>200</sup> In *Edwards*, the widow of a firefighter sued the company that provided a fire alarm service for the house in which her husband died while fighting a fire. She alleged her husband died as a result of the company's negligent delay in communicating the alarm. The court found the alarm service had no duty to the firefighter. The opinion is by Judge Posner, who focuses on the policy issue.<sup>201</sup> The alarm service can do only so much to reduce the incidence of errors by its employees. Some errors are inevitable. Meanwhile, tragic losses from these inevitable errors, like the death of the fireman, are rare. Imposing liability for such unusual losses is unlikely "to evoke greater efforts at preventing accidents; it

---

199. See RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR PHYSICAL AND EMOTIONAL HARM § 43(b) (AM. LAW. INST. 2010).

200. *Edwards v. Honeywell, Inc.*, 50 F.3d 484 (7th Cir. 1995).

201. Judge Posner also argues the alarm service is not the best loss avoider. See *id.* at 491. People on the scene (the owner of the premises and people on the premises, like the fireman) can better assess fire risk and take precaution against it. See *id.* "The alarm service constitutes . . . not a first or second line of defense against fire but a third line of defense—and in this case possibly a fourth, fifth or . . . nth." *Id.*

is likely merely to constitute the employer an insurer.”<sup>202</sup> Judge Posner concludes: “All things considered, however, the creation of a duty of care running from the alarm service to Edwards is likely to make at best a marginal contribution to fire safety and one outweighed by the cost of administering such a duty.”<sup>203</sup> These reasons apply with equal or greater force in *Hampton v. Federal Express*.

*Hampton* and *Edwards* have another fact in common: there was an exculpatory term in both contracts in the form of a liability cap.<sup>204</sup> The contract between the homeowner and the alarm service in *Edwards* limited the company’s liability to \$250. The presence of the exculpatory term is utterly unsurprising in both cases for many of the reasons Judge Posner identifies. In both cases, the defendants provide a standardized service. In both cases, the service does not in itself create a risk of harm, but an error in providing the service can interact with background risks that are not of the defendant’s making. The congruence of an error by the defendant and background risk occasionally yields a large loss, including bodily harm. In both cases, the service provider cannot observe the level of background risk, nor can the service provider alter the error rate or the price based on the level of background risk. Not surprisingly, in both cases, firms in the defendants’ lines of business routinely cap their liability in the event of error. Not surprisingly, liability caps are routine in business-to-business contracts as well as in consumer form contracts. And not surprisingly, these caps are routinely upheld in the first party context (i.e., when the plaintiff is a party to the contract with the term).<sup>205</sup>

There is a modest take away point: the presence of an exculpatory term in a contract is relevant to duty analysis, even when the plaintiff is not a party to the contract with the term. An exculpatory term is at least some evidence of what one or both of the parties to a con-

---

202. *Id.* at 490.

203. *Id.* at 491.

204. *Id.* at 485; *Hampton*, 917 F.2d at 1121.

205. For a collection of relevant cases, see Shields, *supra* note 6, §§ 4-5. For example, it reported nineteen decisions holding a clause valid in a case involving fire, heat, or air quality damage, and one case holding a clause invalid. The pattern is the same in cases involving burglary and theft. See *id.* §§ 9-12.

Alarm services have won a majority of the reported cases in which the plaintiff is not a party to the contract with the term, though nonparty plaintiffs have prevailed in a substantial number of cases. See *id.* §§ 21-22 (reporting seven cases involving third-party claims in which the clause was applied and five cases in which it was not). Typically, when the service prevails, it is because the court characterizes the plaintiff’s claim as a third-party beneficiary claim. See, e.g., *Fretwell v. Prot. Alarm Co.*, 764 P.2d 149, 151 (Okla. 1988). This begs the nettlesome issue why a negligence claim is not available. *Edwards v. Honeywell* grasps the nettlesome issue and finds no duty under negligence law. 50 F.3d at 492.

tract considered to be an appropriate allocation of risk. When a term is customary in a trade, it is evidence of what people in the trade consider to be an appropriate allocation of risk. The relevance to duty analysis of contract terms that allocate the risk in question is rarely acknowledged, but this modest point should be uncontroversial.<sup>206</sup> I want to make a stronger claim. There is a category of cases in which an exculpatory term in the harm-doer's contract should presumptively absolve the harm-doer of a duty to a nonparty. *Hampton* and *Edwards* are specific instances of this larger category of cases. In cases in this category, the contractual allocation of risk is likely to be in the interest of the affected parties as well as society. The burden should be on the plaintiff to persuade the court otherwise. The presumption is a shortcut to the result the court should reach if the court engages in unfettered duty analysis.

How precisely to define this category of cases is a difficult question, for we immediately run into the boundary-drawing problem. *Hampton* and *Edwards* are easy cases because of the combination of factors identified above: the defendant supplies a service that does not generally create a risk of bodily harm to users of the service; some level of error is inevitable in providing the service; the impact of an error depends on the user's background risk; the defendant cannot readily observe the background risk, or readily adjust its error rate or price in response to changes in the background risk; exculpatory terms (liability caps) are common in the defendant's trade; these terms are common in business-to-business contracts as well as in consumer form contracts; and the terms are upheld in the first party context (i.e., liability caps are held to not violate public policy).

In addition, imposing liability on the defendant cannot be justified in *Hampton* or *Edwards* as an indirect mechanism to deter the other party to the defendant's contract from creating an unreasonable risk of harm to people like the plaintiff. *Eaves Brooks Costume Co. v. Y.B.H. Realty Corp.* raises this concern.<sup>207</sup> A fire sprinkler system in a commercial building malfunctioned over the weekend and flooded a tenant's premises, causing over \$1 million in property damage. The sprinkler system was quite old. The malfunction was due to the failure of a sprinkler head that was manufactured in 1915 and that should have been replaced years earlier. It appears the tenant could not recover this loss from the building owners because the owners defaulted.<sup>208</sup> The tenant sued a company hired to inspect the sprin-

---

206. See *Eaves Brooks Costume Co. v. Y.B.H. Realty Corp.*, 556 N.E.2d 1093, 1096-97 (N.Y. 1990) (acknowledging the relevance of an exculpatory term to duty analysis).

207. *Id.* at 1094.

208. *Id.* at 1094 n.\*.

kler system and the fire alarm service, which should have detected the sprinkler system was activated. The building owners hired both defendants, and there was a low liability cap in both contracts.

The claim against the inspection company raises the new concern. The company was hired to inspect the system and report specific service needs. It was not hired to maintain the system, or to inform the owners the entire system needed upgrading. This might seem to make it an easy no-duty case under the rules discussed in the previous Section even without the liability cap. The inspection company did not create the risk of the harm that occurred, and the untaken precaution was clearly outside the scope of the company's obligations under the contract. But the narrow scope of the company's undertaking facilitated the owners' breach of their duty of care to the tenants, because it enabled the owners to put off a needed upgrade. If you do not see the concern yet, then imagine the inspection company repeatedly reports a specific service need, the owners take no action, and there is a catastrophic fire that could have been avoided had action been taken. In this situation, we might impose liability on an inspection company for a dangerous condition that is not of the company's making, but of which the company is aware, as an indirect mechanism to pressure the building owner to correct the dangerous condition.

In *Eaves Brooks*, the court held the inspection company and the alarm service had no duty of care to the tenant. This seems right to me. The only reason for imposing a duty on the inspection company is the reason just identified, and it is not a strong reason. The duty would raise the cost of inspection. Inspection companies would pressure owners to correct some dangerous conditions that would otherwise not be corrected, but the increased price of inspection would also cause some owners to forgo inspections, leaving some dangerous conditions undetected (and uncorrected). Even if the net result were positive, the good would have to be offset against the additional costs of processing claims against inspection companies.<sup>209</sup> The calculus might be otherwise if the law required building owners to have safety systems regularly inspected. The calculus probably should be otherwise if an inspector is required to visibly certify the system, and the public is invited to rely upon the visible certification. Then the inspection company would be in a position similar to an auditor who is hired to certify a company's public financial statements.

---

209. Important to this calculus is the fact that inspection does not in itself create a risk of bodily harm. No direct benefit in risk reduction comes from reducing the level of inspection.

This Section identified a category of cases in which a rule giving presumptive effect to an exculpatory term in a defendant's contract is a justified shortcut to the result that should be reached through unfettered duty analysis. There is useful work to be done in fleshing out the boundaries of this category. I will not do this work here, for it is best done case-by-case, using the common law method to identify and weigh relevant factors and values. *Hampton*, *Edwards*, and *Eaves Brooks* are good starting points. It is no coincidence that in all of these cases the defendant did nothing to create the risk of harm that occurred. For cases within this category, the parties have the presumptive power to disclaim a duty of care to a nonparty who is bodily harmed as a result of carelessness in performing a contract. Moreover, the absence of a duty does not depend on the plaintiff's acquiescence to the term. If the quality of assent justifies the absence of a duty in these cases, it is social or aggregated assent reflected in the pervasiveness of the exculpatory term.

### B. Negligence Involving Pure Economic Loss

This Section considers negligence claims involving pure economic loss.<sup>210</sup> Section VII.B.1 considers one of the more intractable problems

---

210. This Section focuses on business-to-business claims where both the victim and the harm-doer are fairly sophisticated. The principles identified in Part II support tailored, categorical no-duty rules involving other types of claims. An example is the rule immunizing an employee for claims involving pure economic loss for torts committed in the scope of employment. This immunity rule mirrors the liability rule of respondeat superior, which holds an employer strictly liable for torts committed by an employee while working within the scope of his or her employment. Under the immunity rule, if an employee carelessly harms a victim while working within the scope of his or her employment, and causes a pure economic loss, then the victim has no claim against the employee and must look solely to the employer for compensation. *Greg Allen Constr. Co. v. Estelle*, 798 N.E.2d 171, 173 (Ind. 2003); *Kennett v. Marquis*, 798 A.2d 416, 418 (R.I. 2002) (holding seller's broker as seller's agent was not liable to buyer for negligent misstatement regarding property); *Krawczyk v. Bank of Sun Prairie*, 553 N.W.2d 299, 302 (Wis. Ct. App. 1996) (holding a bank trust officer was not individually liable for negligence resulting in solely pecuniary harm). This is also the position of Canadian and English law. See *Edgeworth Constr. Ltd. v. N. D. Lea & Assocs. Ltd.*, [1993] 3 S.C.R. 206 (Can.); *Williams v. Nat. Life Health Foods Ltd.* [1998] UKHL 17, [1998] 1 WLR 830 (HL) (appeal taken from Eng.). *But see Hart v. Bayer Corp.*, 199 F.3d 239, 247 (5th Cir. 2000) (applying Mississippi law and holding employee officer is individually liable if he was involved in negligent misstatement). For a review of California law on the point, see Richard Malamud, *Employee Liability for Economic Losses of the Employer's Customers: A California-Based Examination of the Question of Duty*, 30 TORT & INS. L.J. 195 (1994). Unless an employer is a shell company, or an employer is shielded from liability by its contract with the victim, the employer liability provides compensation and deterrence, diminishing the reasons for employee liability. If an employer is shielded from liability by its contract with a victim, then the immunity rule preserves the agreed allocation of risks.

The rule appears to be otherwise when the harm is physical. See RESTATEMENT (SECOND) OF AGENCY §§ 348-357 (AM. LAW INST. 1958). An agent is individually liable if the agent is complicit in fraud and duress, *id.* § 348, trespass, *id.* § 348A, conversion, *id.* § 349, but that an agent is not individually liable for solely pecuniary harm if the agent neglects

in the law of economic negligence. The issue involves determining when contract should displace negligence law as a mechanism for dealing with the problem of carelessly caused harm. The draft of the Restatement (Third) of Torts: Liability for Economic Harm speaks to this issue when the plaintiff and defendant are in privity of contract or when the negligence occurs in the negotiation of a contract. It adopts a rule that generally precludes a negligence claim for pure economic loss.<sup>211</sup> But the draft says little about cases in which the plaintiff and defendant are not in privity yet are connected through a chain of contracts.<sup>212</sup> Section VII.B.1 addresses these cases. It proposes that, if there would be a negligence claim under general principles of tort law were it not for the contractual context, then courts should initially approach the duty issue as a problem of contract interpretation or contract construction.<sup>213</sup> A court should try to predict whether the parties would have disavowed the possibility of a negligence claim, had the question of the claim's availability been brought to the parties' attention before the problem arose. Section VII.B.2 considers cases in which the parties to a contract have the power to disclaim a duty to a nonparty without regard to the assent of the nonparty, either actual or predicted. These cases involve considerations similar to the cases discussed in Section VII.A.2.

### 1. *Duty and Predicted Intent*

Often negligence claims involving pure economic loss arise in settings in which the plaintiff and defendant are connected through a

---

to perform its duties to its principal, *see, e.g., id.* §§ 352, 357. The rule also appears to be otherwise when the employee is a professional, such as a lawyer. *See, e.g., Moransais v. Heathman*, 744 So.2d 973 (Fla. 1999). These rules can be explained by the general policies against liability shields for carelessly caused physical harm and professional malpractice.

211. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM § 3 (AM. LAW INST. Tentative Draft No. 1, 2012). The claim for professional malpractice is recognized as an exception. *Id.* § 4. The claim for negligent misrepresentation is not recognized as an exception. *See id.* § 5(5) cmt. m.

212. *See id.* § 3 cmt. f (explaining that the rule in section 3 does not apply when parties are “indirectly linked by contract”). Comment f goes on to state that “missed opportunities” to seek protection by contract in such cases explain the absence of a duty “outside the well-recognized categories stated in this Chapter.” *Id.* at cmt. f, illus. 8. Section 6 (“Negligent Performance of Services”) Comments b and c address some of the problems discussed in Section VII.B.1, *infra*. *See id.* § 6 cmt. b-c.

213. This will generally be true when it is fairly clear the defendant acted unreasonably; the plaintiff suffered a loss that almost certainly would have been avoided had the defendant used reasonable care; the risk of the loss suffered by the plaintiff is among the risks that made the defendant's conduct unreasonable; the loss did not involve the plaintiff's own unreasonable conduct, or the wrongful conduct of another person; the loss can be measured in dollars with a reasonable degree of certainty; and liability for the loss does not expose the defendant to indeterminate liability, or to liability that is disproportionate to the degree of fault.

chain of contracts that might address the risk in question. *J'Aire Corp. v. Gregory* is a notorious example.<sup>214</sup> The plaintiff was a tenant who operated a restaurant at a county airport. The defendant was a contractor who was hired by the county to renovate the heating and air conditioning system in the tenant's restaurant. There were egregious construction delays, shutting down the restaurant and causing a substantial loss of income to the tenant. The tenant brought both a negligence claim and a third-party beneficiary claim against the contractor. It dropped the third-party beneficiary claim on appeal. The case is notorious because of the principles invoked by the California Supreme Court to justify allowing the claim. The court applied the *Biakanja* balancing test and established "foreseeability as the key component necessary to establish liability."<sup>215</sup> The court also rejected "overly rigid common law formulations of duty" and the view that "economic interests" are less deserving of the law's protection than physical.<sup>216</sup> Meanwhile the court said nothing about the contractual context of the claim, suggesting its irrelevance to the negligence issue.

There is widespread agreement that *J'Aire Corp.* was a mistake. Most states have rejected foreseeability as the relevant criterion of negligence in cases involving pure economic loss.<sup>217</sup> Drafts of the Restatement (Third) of Torts explicitly reject the result in the case.<sup>218</sup> If the case arose in California today, the result would almost certainly be different under later decisions of the California Supreme Court, which continue to apply the *Biakanja* balancing test but in a very different spirit.<sup>219</sup> However, while there is widespread agreement

---

214. 598 P.2d 60, 60 (Cal. 1979) (holding Contractor was obligated to complete its work in a manner which did not cause injury to Tenant's business, where such injury is foreseeable).

215. *Id.* at 64.

216. *Id.*

217. Anita Bernstein, *Keep It Simple: An Explanation of the Rule of No Recovery for Pure Economic Loss*, 48 ARIZ. L. REV. 773, 791 (2006) ("The bulk of economic-loss case law repudiates *People Express* and *J'Aire*."). The claim is clearly precluded in states like Florida, Illinois, and Texas, which have rules that generally preclude negligence claims involving pure economic loss, unless the claim is within one of the established pockets of liability, such as for professional malpractice and negligent misrepresentation. The claim would also be precluded in states that have adopted a categorical no-duty rule for third-party claims in the construction context. The claim would also be precluded in states, like Oregon, that predicate a duty on a special relationship.

218. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM § 1 cmt. e, illus. 3 (AM. LAW INST., Tentative Draft No. 1, 2012).

219. *Bily v. Arthur Young & Co.* holds that an auditor is subject to liability only to persons with whom the auditor is in privity plus intended beneficiaries of the audit and only on the specific ground of negligent misrepresentation, not the general ground of negligence. 834 P.2d 745, 747 (Cal. 1992) (in bank). The court reasoned negligence liability should not be imposed when parties are able to determine their rights and obligations by

*J'Aire Corp.* was a mistake, there is no agreement on when negligence law should give way because of the contractual context of a claim.

*J'Aire Corp.* has many of the factors that make the problem difficult. The contractor clearly owes a duty of care to the tenant if general principles of negligence law apply. The contractor knew construction would harm the tenant. Indeed the delay harmed only the tenant, for the project was fully contained within the restaurant. There was little or nothing the tenant could do to protect himself from the harm, unless the tenant had the foresight to secure protection from the loss in its contract with the county. Further, no other actor's wrongful conduct was involved; there was no difficulty in determining causation or damages; and the claim did not raise the concern for imposing indeterminate liability, or for imposing liability that is disproportionate to the degree of fault. Viewed solely as a negligence problem, the claim should be allowed.

Part of the difficulty of the problem is that many of these factors are also reasons to think the tenant, county, and contractor might have used their contracts to address the issue of the contractor's liability to the tenant in the event of a construction delay.<sup>220</sup> But here we run into the privity rule in contract law. The tenant and the contractor are not in privity of contract, and so it would seem that the terms of the parties' contracts, and contract law, have no bearing on the availability of a negligence claim. But this point is not as self-evident as it may seem. In principle, if a claim might be available under general principles of negligence law, and the argument is that the claim should give way because of the contractual context, then it seems natural to look to general principles of contract law for a reason why the claim should be denied. Once one looks to general principles of contract law, the initial question is: what did the parties in-

---

contract, because of a preference for "private ordering." *Id.* at 761. *J'Aire* would not stand under this view. *Aas v. Superior Court* rejects negligence and other tort claims brought by homebuyers against developers and contractors for defective construction seeking as damages repair cost or the diminution in market value of the property. 12 P.3d 1125, 1128 (Cal. 2000). The majority opinion, which had five votes, postulates the centrality of physical harm to the negligence action. *See id.* at 1138-39. *Biakanja* and *J'Aire* elide this distinction. A three-justice concurrence disagreed but only at the margin of the new position, arguing that a negligence claim should be allowed for defects that if uncorrected would pose a risk of physical harm. *Id.* at 1143. The court has used the balancing test to reject negligence claims for pure economic loss in other cases. *Summit Fin. Holdings, Ltd. v. Cont'l Lawyers Title Co.*, 41 P.3d 548, 554 (Cal. 2002); *Quelimane Co. v. Stewart Title Guar. Co.*, 960 P.2d 513, 532 (Cal. 1998).

220. The Dobbs treatise puts the point gently, speaking of *J'Aire Corp.*: "This result is out of line with the settled principle that greater protection, not lesser, is to be afforded to contracts than to uncontracted-for opportunities." DOBBS ET AL., *supra* note 191, § 655, at 611 n.3.



tend? Intent usually determines the legal effect of a contract. Thus, if general principles of contract law justify denying the negligence claim in *J'Aire Corp.*, then it probably is because to allow the claim would violate the parties' intent. Perhaps courts have been slow to grasp that the parties' intent has to be the linchpin when arguing why principles of negligence law should give way to principles of contract law, as in *J'Aire Corp.*, because courts are not used to asking about intent when the relevant intent is that of three or more parties, who are connected through two or more contracts.

Once we ask "What did the parties intend?" we run into another difficulty. The contracts in *J'Aire Corp.* did not speak directly to the issue of the contractor's liability to the tenant.<sup>221</sup> But in contract law courts do not give up on trying to determine intent simply because the contract does not clearly reveal intent. Courts do their best to ascertain or to predict the parties' likely intent. I propose courts do just this to determine whether a claim's contractual context justifies denying the claim, even if the rules of negligence law would otherwise allow it. The court should try to predict what the parties would say regarding the availability of the negligence claim, if the issue had been brought to the parties' attention before the problem arose.

Once the issue is put in these terms, some cases turn out to be quite easy. Sometimes we can predict with a fair degree of confidence that the parties would disavow a possible negligence claim, had they been asked before the problem arose. For example, in *J'Aire Corp.*, it is likely that the tenant, county, and contractor would have agreed they did not want the restaurant to have a possible negligence claim against the contractor, had they been asked about the availability of the claim before the problem arose. Gary Schwartz fills in the contractual context, as reported to him by the plaintiff's lawyer in a phone conversation. He was told the restaurant could have recovered its losses through a contract claim against the county, and the county could have passed this loss on to the contractor through a contract claim against the contractor. The restaurant chose not to pursue its

---

221. This is often the case when the plaintiff and defendant are not in privity of contract. People typically do not focus on liability issues in a contract until a problem arises. People are especially unlikely to focus on liability issues involving a nonparty, including their liability to a nonparty and a nonparty's liability to them. Such inattention is not just a matter of nonparty liability issues' not being salient. There is no clear and immediate payoff to addressing nonparty liability issues in a contract, unless the desired result is to make the nonparty a third-party beneficiary (i.e., either to create a duty to a nonparty or to disclaim a duty owed by a nonparty). The privity rule in contract law makes it impossible to disclaim a duty to a nonparty or to impose a duty on a nonparty by contract. There is another reason the parties may not have addressed the nonparty liability issue in *J'Aire Corp.*: the negligence claim was novel. The parties had no reason to address a negligence claim for which there was no precedent.

contract claim because “the tenant did not wish to upset its friendly relations with the building owner and thereby jeopardize the continuation of the lease arrangement.”<sup>222</sup>

The contract claims protected the tenant from the risk of construction delays and passed the loss on to the contractor, providing both compensation and deterrence. The tenant could have minimized the threat and cost of litigation to the county by offering to suspend its claim against the county in return for an assignment of the county’s claim against the contractor, and agreeing to release the county once a judgment was obtained against the contractor.<sup>223</sup> Allowing the tenant to “short circuit[]” the contracts<sup>224</sup> by bringing a negligence claim directly against the contractor adds little in the way of compensation and deterrence, but it complicates resolution of a dispute, if a dispute arises. Contracts tend to have clear performance metrics to determine when compensation is due, whereas negligence has a vague standard. A negligence claim may involve issues of contributory negligence, so the negligence of the county may become an issue. A negligence claim short circuits contractual terms included in the contract to simplify dispute resolution, such as a liquidated damage clause or a mandatory arbitration term. Settlement becomes more complicated if a negligence claim is available because the contractor has to get the assent of both the county and the tenant. The tenant could play the county and the contractor against each other, because the tenant can settle with one while proceeding against the other.<sup>225</sup> I could go on, but you get the point. If reasonably sophisticated parties have gone through the trouble to establish contractual mechanisms to provide for compensation and deterrence, then they would also likely disavow an additional negligence claim if presented with it as a possibility before a problem arises.

It is important to be clear about the character of this inquiry into intent, for intent has several meanings in contract law. In *J’Aire Corp.*, the parties did not intend to disavow the negligence claim in the sense that this is among the “terms that the parties . . . probably had in mind but did not trouble to express.”<sup>226</sup> We can be confident no

---

222. Gary T. Schwartz, *Economic Loss in American Tort Law: The Examples of J’Aire and of Products Liability*, 23 SAN DIEGO L. REV. 37, 41 (1986). Schwartz also reports that the repair work was done entirely inside the plaintiff’s restaurant. *Id.* at 40 & n.19.

223. This is a good deal for the county, for it is off the hook if the contractor cannot satisfy the judgment.

224. *Henderson v. Merrett Syndicates Ltd.*, [1995] 2 AC 145 (HL) 195 (appeal taken from Eng.).

225. *Chambo v. Urban Masonry Corp.*, 647 A.2d 1284 (Md. Ct. Spec. App. 1994) (holding that a subcontractor harmed by another sub’s mistakes who settled its claim against the general for the loss has no claim against the other sub).

226. Glanville L. Williams, *Language and the Law—IV*, 61 L.Q. REV. 384, 401 (1945).

one considered the possibility of a negligence claim until the problem arose. The claim was unprecedented. The parties may have intended to disavow the negligence claim in the sense that this is among the “terms that the parties, whether or not they actually had them in mind, would probably have expressed if the question had been brought to their attention.”<sup>227</sup> Given the novelty of the negligence claim, we can imagine the tenant, county, and contractor would have agreed to disavow a possible negligence claim, if the issue had been brought to their attention before the problem arose. This would be particularly likely if they had consulted a lawyer, who would have told them there was no legal precedent for the claim.

Of course, we cannot be certain the tenant would have agreed to disavow the negligence claim, had the issue been brought to the parties’ attention before the problem arose, because having the additional claim is generally to the tenant’s advantage. But it is still possible to say the parties intended to disavow the claim, for intent can be defined objectively. The concept of objective intent in contract law is capacious enough to encompass terms that “are implied by the Court because of the Court’s views of fairness or policy.”<sup>228</sup> In this scenario, we predict the parties would have disagreed about the availability of a negligence claim, had the issue been brought to their attention before the problem arose. Presumably the parties are predicted to disagree because we think they have different views on what is fair, or on what is in their interest. This is a case of latent misunderstanding: the misunderstanding is not revealed until the problem arises. In *J’Aire Corp.*, the contractor’s view prevails in this scenario because it is the more reasonable view, for the reasons just explained. A term is “intended” even though only one party intended the term, if the other party’s intent is unreasonable. The absence of a negligence claim is objectively intended.

If intent regarding the availability of a negligence claim turns out to depend on what the court considers reasonable, then it may seem we are back to where we started, for a standard of reasonableness is also at the heart of negligence law. But the contract and negligence inquiries are different. An important difference is the focal point in time. Under the contract inquiry, the court generally focuses on a point in time before the problem arose—typically this is the point in time when the contracts were made. Under the negligence inquiry, the court generally focuses on the point in time the harm was carelessly caused. Another important difference is in whose interests and values count. The contract inquiry takes only the interests and

---

227. *Id.*

228. *Id.*

values of the parties as relevant. The negligence inquiry considers social interests and values more generally. The contract inquiry also places greater weight on the interest in self-governance and on the value of planning.

There is some overlap between the contract and negligence inquiries. In particular, the plaintiff's vulnerability to the relevant risk is an important factor under both inquiries, as is the strength of the reasons for negligence liability more generally. *J'Aire Corp.* is an easy case because the contract claims provided compensation and deterrence. But sometimes we can predict the parties would disavow a negligence claim with a fair degree of confidence in the prediction, even though the absence of the negligence claim leaves the plaintiff vulnerable to carelessly caused harm.<sup>229</sup> *Lutz Engineering Co. v. Industrial Lowers, Inc.* illustrates.<sup>230</sup> A subcontractor incurred a

---

229. The discussion of *Ossining Union Free School District v. Anderson*, 539 N.E.2d 91 (N.Y. 1989), makes the related point that parties may rely on the exculpatory terms when the term is ubiquitous in a trade. See *supra* notes 122-27 and accompanying text. More generally, when participants in a multi-party project legitimately choose to eliminate first-party claims, then generally it makes little sense to allow third-party claims. The defendant is unlikely to expect a third-party claim, and so little or nothing is achieved in the way of deterrence. Whatever compensation is achieved is capricious. Recovery depends on the plaintiff being able to assign responsibility for the harm to a participant in the project with whom the plaintiff is not in privity, and who has the resources to satisfy the claim. Claims-resolution costs are also likely to be high because of the need to establish negligence, causation, and the absence of responsibility on the part of other participants in the project.

The handling of exculpatory terms when there is a first-party claim in the construction context reinforces this conclusion. Exculpatory terms in construction contracts are enforced when a claim involves pure economic loss. See, e.g., *Valhal Corp. v. Sullivan Assocs., Inc.* 44 F.3d 195, 201-04 (3rd Cir. 1995) (applying Pennsylvania law and enforcing term limiting engineer's liability to \$50,000 or total fee for services). This deference is warranted. The AIA standard construction documents have been described as a classic example of "private legislation." Justin Sweet, *The American Institute of Architects: Dominant Actor in the Construction Documents Market*, 1991 WIS. L. REV. 317, 317 (1991); Thomas J. Stipanowich, *Reconstructing Construction Law: Reality and Reform in a Transactional System*, 1998 WIS. L. REV. 463, 485 (1998) ("For the construction industry the standard form contract—particularly the AIA Standard Document set—has in several respects served as a surrogate for a commercial code."). Admittedly, the AIA's process for creating these documents is imperfect. Standard waivers of consequential damages have been criticized as favoring architects over other participants in the industry. See Mark R. Patterson, *Standardization of Standard-Form Contracts: Competition and Contract Implications*, 52 WM. & MARY L. REV. 327, 353 (2010). Other criticisms include the underrepresentation of some participants in the industry (particularly owners and lenders), and sometimes failing to strike the right balance between achieving simplicity, clarity, completeness, and flexibility. But there are plausible reasons to think the AIA got it right. See Carl J. Circo, *Contract Theory and Contract Practice: Allocating Design Responsibility in the Construction Industry*, 58 FLA. L. REV. 561, 619-22 (2006) (arguing private risk allocation through business contracts is sensible because it is much cheaper and as effective to handle unforeseen problems within a project informally by negotiation rather than through high stakes litigation).

230. 585 A.2d 631 (R.I. 1991).

large loss on a manufacturing project as a result of an engineer's failure to catch nonconformities between shop drawings submitted by the subcontractor and contract specifications. The general contractor hired the engineer. We can be reasonably certain that the parties would have disavowed the negligence claim had they been asked before a problem arose. Explicit terms in both contracts made it clear that the subcontractor was intended to bear the risk in question. A term in the subcontract provided the subcontractor bore sole responsibility to ensure its drawings complied with the specifications, and a term in the engineer's contract provided its review of drawings was solely to protect the general contractor.<sup>231</sup> In the case, the Rhode Island Supreme Court held the engineer had no duty to the subcontractor. Unfortunately, the court did not explain the result by reference to the parties' actual or predicted intent. The stated reason for the result is incoherent.<sup>232</sup>

---

231. *Woolcock St Invs Pty Ltd v CDG Pty Ltd*, a leading Australian case, might be explained on the same basis. (2004) 216 CLR 515 (Austl.).

232. The Rhode Island Supreme Court said this in *Lutz* to distinguish its earlier case, *Forte*:

Forte was in a position wherein it had to rely on the architect's record keeping regarding the removal of rock and boulders because Forte would be compensated for rock removal only in the amounts the architect-engineer reported had been removed. The architect-engineer therefore had a *direct* responsibility [sic] to Forte, the contractor, whose payment was dependent on the architect-engineer's records. Our holding in *Forte*, therefore, has no application to this case.

585 A.2d at 636.

The word "direct" cannot bear the weight being placed on it. In *Forte*, the engineer's "direct responsibility" was to the owner, the principal he undertook to serve as an agent. Perhaps the court was getting at something else. The word "direct" often has a causal connotation: a harm is considered to be "indirect" when other human conduct is involved in the pathway between the actor's conduct and the harm. In tort law, when the involvement of other human conduct justifies absolving a harm-doer from liability for carelessly caused harm, the other conduct is often labeled a "superseding cause." What is or is not a superseding cause is a normative determination, which requires explanation. In *Forte*, for example, the loss would not have occurred if the owner had waived the contract term to rectify the engineer's mistake. Why is this not a superseding cause, changing the result in the case? A likely candidate for a superseding cause in *Lutz* is the subcontractor's mistake in submitting shop diagrams that did not match contract specifications. But, what justifies treating this as a superseding cause, justifying the result in the case?

A later Rhode Island case, *Volpe v. Fleet National Bank*, further confuses matters. 710 A.2d 661 (R.I. 1998). The case holds that a bank owes no duty of care to a noncustomer when the bank is presented with a check made out to the noncustomer as payee. *Id.* at 655. The bank cashed the check on a forged endorsement. *Id.* at 661. The result is clearly correct under the principles identified in Part II. A negligence claim is unnecessary to protect the payee because the law of conversion provides a remedy. Also, on the facts of the specific case, the plaintiff was compensated for the loss by the state bar. *Id.* at 662 n.3. Her lawyer negotiated a settlement without her knowledge, and then cashed the settlement check, forging her signature. *Id.* at 662. What is troublesome about the case is the rationale, which is the privacy doctrine: "This rule is based on the legal principle that there is no priv-

Sometimes the parties' intent regarding the availability of a negligence claim will be unpredictable, particularly when the absence of a negligence claim leaves the plaintiff vulnerable to the harm in question. An earlier Rhode Island case, *Forte Brothers, Inc. v. National Amusements, Inc.* illustrates.<sup>233</sup> A contractor (Forte) was hired to remove rocks and boulders. Forte was paid based on the volume of material he removed, as reported by a supervising engineer, who was hired by the owner. Forte claimed he was underpaid as a result of the engineer's negligence, but he apparently could not recover the underpayment from the owner. The Rhode Island Supreme Court allowed the contractor to bring a negligence claim against the engineer to recover the underpayment.

A classic torts case, *Glanzer v. Shepard*, may raise a similar issue.<sup>234</sup> A buyer overpaid the seller for beans, allegedly as a result of a careless error by a bean weigher hired by the seller. A mystery in the case is why the buyer did not seek to recover the overpayment by bringing a restitution claim against the seller. Victor Goldberg infers there was a term in the contract between the buyer and seller making the certified weight "final and binding."<sup>235</sup> The New York Court of Appeals allowed the negligence claim. Goldberg argues this may have been a mistake.<sup>236</sup>

An inquiry into the parties' likely intent is inconclusive in *Glanzer* without more information. The purpose of a "final and binding" term is to eliminate potential litigation between the buyer and the seller.<sup>237</sup> Allowing a negligence claim against the bean weigher defeats this purpose. Goldberg concludes "[s]hifting the losses around in this way looks like a reasonably expensive proposition with little to show for it in the way of deterrence."<sup>238</sup> If the parties' goal is efficiency and minimizing transaction costs, then I expect they would agree with Goldberg. But the parties may also care about fairness. Goldberg speaks to the fairness issue, noting that gains and losses from mistakes in weighing beans are likely to even out.<sup>239</sup> But the buyer may not be consoled by this prospect. The buyer may also worry about potential bias on the part of the bean weigher, who is hired by the seller, and

---

ity between the parties and that therefore the bank owes a stranger no duty of vigilance." *Id.* at 664.

233. 525 A.2d 1301 (R.I. 1987).

234. 135 N.E. 275 (1922).

235. GOLDBERG, *supra* note 52, at 249-50. For the original publication of this chapter, see Goldberg, *supra* note 3.

236. See GOLDBERG, *supra* note 52, at 270-71.

237. See *id.* at 253-54.

238. *Id.* at 271.

239. *Id.* at 270.

who may be subject to liability to the seller on a contract claim when an error results in an under-payment, which harms the seller. The buyer may think fairness in the particular case more important than efficiency in the long run.<sup>240</sup>

When intent is uncertain, courts fall back on rules of contract construction. These are basically presumptions. One way of understanding the Rhode Island cases is that principles of negligence law control, unless the court can be reasonably certain the parties would have disavowed the negligence claim had they been aware of the issue before a problem arose. Some states come at the problem from the opposite direction, using the opposite presumption. These states adopt a categorical no-duty rule for cases in which a victim and a harm-doer are connected by a chain of contracts, and people in the victim's position generally are sophisticated enough to be expected to protect themselves—through these contracts—from the risk of carelessly caused harm, when it is in their interest to do so. These categorical no-duty rules rely on private ordering to do the work of negligence law in cases that are within the rules' scope. In the parlance of contract law, these are rules of presumed intent or rules of contract construction, like the employment-at-will rule.

*Berschauer/Phillips v. Seattle School District* is a leading case that establishes such a general no-duty rule.<sup>241</sup> A general contractor sued an architect and inspector seeking to recover cost overruns resulting from the defendants' alleged carelessness. The general contractor, architect, and inspector all worked under separate contracts with the school district. The contractual context is similar to *JAire Corp.*: apparently, the general contractor was entitled to compensa-

---

240. Often the outcome in these close cases will depend on how the court weighs fairness in the particular case against efficiency in the long run.

241. *Berschauer/Phillips Constr. Co. v. Seattle Sch. Dist. No. 1*, 881 P.2d 986, 992-93 (Wash. 1994) (en banc). The rule actually stated in the case is narrower and bars only a claim by a contractor against a design professional with whom the contractor is not in privity. *Id.* For a similar categorical rule and often the same rationale, see *BRW, Inc. v. Dufficy & Sons, Inc.*, 99 P.3d 66, 68 (Colo. 2004). See also *City Express, Inc. v. Express Partners*, 959 P.2d 836, 839-40 (Haw. 1998); *Anderson Elec., Inc. v. Ledbetter Erection Corp.*, 503 N.E.2d 246 (Ill. 1986); *Floor Craft Floor Covering, Inc. v. Parma Cmty. Gen. Hosp. Ass'n*, 560 N.E.2d 206, 208 (Ohio 1990); *Am. Towers Owners Ass'n v. CCI Mech., Inc.*, 930 P.2d 1182, 1190 (Utah 1996); *Blake Constr. Co. v. Alley*, 353 S.E.2d 724, 727 (Va. 1987); *Rissler & McMurry Co. v. Sheridan Area Water Supply Joint Powers Bd.*, 929 P.2d 1228, 1234-35 (Wyo. 1996).

*Berschauer/Phillips* names the rule "the economic loss rule." 881 P.2d at 989. Later Washington cases rename the rule "the independent duty doctrine." *Eastwood v. Horse Harbor Found., Inc.*, 241 P.3d 1256, 1268 (Wash. 2010); *Affiliated FM Ins. Co. v. LTK Consulting Servs., Inc.*, 243 P.3d 521, 526 (Wash. 2010) (en banc). *Affiliated FM Insurance Co.* allowed a negligence claim against an engineer when the alleged negligence created a dangerous condition involving a significant risk of bodily harm and physical harm to other property. *Id.* at 523.

tion for the overruns from the district under its contract with the district, and the district had a right to pass through this loss to the architect and inspector under its contracts with them.<sup>242</sup> The dismissal of the negligence claim left the general contractor with an assigned contract claim.<sup>243</sup> But importantly, the outcome was not made to depend on the facts of the case. The Washington Supreme Court established a categorical no-duty rule for claims involving pure economic loss where the plaintiff and defendant are participants in a construction project who are not in privity with each other.<sup>244</sup> The rule does not require investigation of the facts of a case, including the details of the relevant contracts. Under the rule, participants in a construction project are expected to protect themselves from the risk of inadvertently caused pure economic loss by contract, when it is in their interest to do so.<sup>245</sup> Several reasons justify this expectation: it is assumed that most participants in construction projects are sophisticated; contracts generally are routinized; and participants in a construction project generally should be aware of the risks they face from other participants to whom they are connected through a web of contracts but are not in privity with. Some courts have adopted similar categorical no-duty rules for claims involving pure economic loss that result from a defect in commercial, real, or personal property when the plaintiff and the defendant are not in privity of contract.<sup>246</sup>

The Washington rule is clearly better than some current alternatives. It is clearly better than the approach taken in *J'Aire Corp.*, which ignores the contractual context of a negligence claim entirely. And it is clearly better than the more extreme versions of the economic loss rule, which preclude negligence claims involving pure

---

242. Both facts may be inferred from the fact that the district assigned its contract claims against the architect and inspector to the contractor in satisfaction of the contractor's contract claim against it.

243. The Washington Supreme court held the claim to be assignable in another part of the decision. *Berschauer/Phillips*, 881 P.2d at 993-94.

244. *Id.* at 993.

245. *Id.* at 992-93 ("We . . . maintain the fundamental boundaries of tort and contract law by limiting the recovery of economic loss due to construction delays to the remedies provided by contract. We so hold to ensure that the allocation of risk and the determination of potential future liability is based on what the parties bargained for in the contract. . . . A bright line distinction between the remedies offered in contract and tort with respect to economic damages also encourages parties to negotiate toward the risk distribution that is desired or customary. We preserve the incentive to adequately self-protect during the bargaining process. If we held to the contrary, a party could bring a cause of action in tort to recover benefits they were unable to obtain in contractual negotiations.") (citation omitted).

246. *Bos. Inv. Prop. No. 1 State v. E.W. Burman, Inc.*, 658 A.2d 515, 518 (R.I. 1995); *Daanen & Janssen, Inc. v. Cedarapids, Inc.*, 573 N.W.2d 842, 850 (Wis. 1998).



economic loss more generally, and without regard for the plaintiff's ability to protect itself from the risk of carelessly caused harm by contract.<sup>247</sup>

The comparison between the Washington rule and what I infer to be the Rhode Island approach is a bit closer. Under the Rhode Island approach, principles of negligence law control unless a court can be reasonably certain the parties would have disavowed negligence liability, if the issue had been brought to the parties' attention before a problem arose. The Rhode Island approach involves greater claims processing costs than the Washington rule in these cases, though the two often yield the same result. The Rhode Island approach also involves greater legal uncertainty because of factual uncertainty, normative uncertainty, and random error. The Washington rule yields a certain but debatable result in a case like *Forte Brothers*. The result is uncertain under the Rhode Island approach. A judge who thought efficiency in the long run to be more important than fairness in the immediate case might reject the claim.

These are the familiar trade-offs between a rule and a standard. The advantage of a standard is that sometimes a rule will be overbroad, meaning the rule yields a result that is inconsistent with the reasons for the rule. Consider *Squish La Fish, Inc. v. Thomco Specialty Products, Inc.*<sup>248</sup> The plaintiff (Squish La Fish) invented an

---

247. An example is the rule established by the Florida Supreme Court in *AFM Corp. v. Southern Bell Telephone & Telegraph Co.* that "without some conduct resulting in personal injury or property damage, there can be no independent tort flowing from a contractual breach which would justify a tort claim solely for economic losses." 515 So. 2d 180, 182 (Fla. 1987). This reinstates the old privity rule for cases in which negligence in the performance of a contract results in a pure economic loss to a nonparty. It also eliminates the well-established first-party tort claims for legal and accounting malpractice.

The Florida Supreme Court abandoned this rule when some of these consequences became apparent. In *Moransais v. Heathman*, the court narrowed the scope of the economic loss rule "to those contexts or situations where the policy considerations are substantially identical to those underlying the product liability-type analysis." 744 So. 2d 973, 983 (Fla. 1999). Ironically, this was to allow a negligence claim that probably should have been denied. The plaintiffs hired an engineering company to inspect a home they were considering purchasing. *Id.* at 974. Their contract with the company had a liability limitation. *Moransais v. Heathman*, 702 So. 2d 601, 602 (Fla. 2d DCA 1997). The negligence claim was against two employees of the company. *Moransais*, 744 So. 2d at 975. The court relied on rules that allow direct claims by clients against lawyers and health-care professionals who render services through a professional corporation. *Id.* at 975-78. Liability waivers by lawyers and health care professionals are void as against public policy. *See id.* at 978-79, 83. These rules prevent lawyers and health care professionals from immunizing themselves from liability indirectly by providing services through a professional corporation. *Id.* Individual liability of the engineers in the case should have been conditioned on a determination that a liability waiver in a home inspection contract is void as against public policy.

248. 149 F.3d 1288 (11th Cir. 1998) (applying Georgia law). The court held Georgia's version of the economic loss rule did not preclude the claim for the technical reason that the claim was a negligent misrepresentation claim, and not a negligence claim. *Id.* at 1291.

inexpensive device to squeeze fluid from a tuna can. It contracted with ProPack to design and supply retail packaging for the device. ProPack purchased the glue from a 3M distributor, relying on the distributor's expertise in selecting the glue. The glue chosen by the distributor was not easily washed off the squeezer, which made the squeezer unmarketable and caused the plaintiff to lose a multimillion-unit contract it had in hand. The court allowed the plaintiff to bring a tort claim against the distributor. In some states, the claim would have been precluded by a categorical no-duty rule like the Washington rule, which applies in the products setting.

We can be fairly confident that, had the issue of the negligence claim's availability been brought to the parties' attention before the problem arose, the parties would have agreed the claim was available. As previously noted, this is because courts handle predicted intent as a matter of reasonableness. Even if we predict the 3M distributor would have dissented on this point, its position is unreasonable on the facts of the case. ProPack relied on the distributor to provide water-soluble glue, and this reliance was made clear to the distributor. The distributor had reason to know of the plaintiff's potential loss if the glue did not work, and it seems the distributor did not disclaim liability for consequential damages in its contract with ProPack.<sup>249</sup> The strongest argument against allowing the negligence claim is that redress may have been available under contract law. But the plaintiff's decision to pursue the tort claim against the distributor is excusable. The plaintiff's strongest contract claim was against ProPack under UCC section 2-315 for breach of the implied warranty of fitness. But recovery on the claim was uncertain because of unusual facts in the case.<sup>250</sup>

A categorical no-duty rule may also yield the wrong result when established mechanisms for dealing with a risk fail in unusual circumstances. *Plata American Trading, Inc. v. Lancashire* illustrates.<sup>251</sup> A scoundrel, Marco, devised a scheme to divert tallow that was being loaded into a carrier's vessel so that 501 tons were recorded while only 375 tons were loaded. The plaintiffs were buyers of the tallow who paid for 501 tons. The buyers had two contractual mecha-

---

249. Neither the opinion nor the appellate briefs discuss the contracts between plaintiff and ProPack and between ProPack and the distributor. *See id.*; Brief of Appellant, *Squish La Fish, Inc.*, 149 F.3d 1288 (No. 97-8595); Brief of Appellee, *Squish La Fish, Inc.*, 149 F.3d 1288 (No. 97-8595).

250. The plaintiff may have thought it did not have a claim for breach of the implied warranty of fitness against ProPack because ProPack disclosed it had no expertise in the type of packaging plaintiff wanted. While ProPack would have had a claim under the implied warranty against the distributor, this claim would cover the plaintiff's lost profits only if they were recovered by the plaintiff in a contract claim against ProPack.

251. 214 N.Y.S.2d 43 (N.Y. Sup. Ct. 1957).

nisms protecting them against the unexpected shortfall: an insurance policy covering the goods while they were in transit and a recital in the carrier's bill of lading that it had received 501 tons. The court held this risk was uninsured because the 501 tons were never loaded into the vessel. And it held the carrier was not liable under the bill of lading with regard to the shipper (the first buyer), and that on the facts of the case, the second buyer stood in the same shoes as the first buyer. The court held the buyers could recover from the cargo inspector, Martin, explaining that "Martin negligently,—grossly so,—lent himself to the scheme. He merely measured the amount of tallow that left Marco's tanks without troubling himself to find out where it actually went."<sup>252</sup> The result is clearly correct under the Rhode Island approach. Martin's carelessness left the buyers completely vulnerable to the risk of being defrauded by the seller. The buyers went to great lengths to protect themselves from the risk of a shortfall on delivery, but these mechanisms did not cover the possibility that tallow would be diverted between the seller's tank and the vessel.

It is possible to reduce the incidence of wrong results under a categorical no-duty rule by treating the rule as a strong interpretive presumption. The presumption would be that participants in a multi-person project intend to disavow possible negligence claims for pure economic loss between participants who are not in privity of contract, when it is possible to create contractual mechanisms to protect against the risk. The interpretive presumption could be overcome if the plaintiff persuaded the court that the contracts were not intended to cover the risk of the relevant harm, and that the parties would have agreed to allow a negligence claim if the issue had been brought to their attention before the problem arose. Conversely, it is possible to reduce claims processing costs, uncertainty, and error under a more flexible approach by establishing rules of thumb, such as the rule a negligence claim is not available when contract claims provide compensation and deterrence, and the rule a negligence claim is not available when the contracts preclude first-party claims for the harm in question. The important point is that courts should use contractual techniques of interpretation and construction to inform no-duty analysis by asking whether the parties would have agreed to disavow the negligence claim had they addressed the question when the contract was made.

---

252. *Id.* at 49.

2. *The Power to Disclaim a Duty to a Nonparty (Pure Economic Loss)*

Under the approach proposed in the last Section, the parties to a contract do not have the power to disclaim a duty in tort to a nonparty by including an exculpatory term in a contract. The presence of an exculpatory term is only a factor to be considered by a court in determining whether the contractual context of a claim justifies a no-duty determination. This Section briefly considers cases in which parties to a contract do have the power to disclaim a duty in tort to a nonparty.

Two examples illustrate the general circumstances in which this power should exist:

- Testator agrees to absolve Draftsman from negligence liability in return for Draftsman preparing Testator's will for a lower price. Intended Beneficiary loses a bequest as a result of Draftsman's carelessness. The contract clearly shields Draftsman from a malpractice claim by Intended Beneficiary.
- Employer hires Testing Company to drug test prospective employees. The contract provides the tests are done solely for Employer's benefit, and that Company is not subject to liability to an employee in the event of a false positive. The contract clearly shields Testing Company from a negligence claim by an employee in the event of a false positive.

The reasons why parties should have the power to disclaim a duty in these cases are similar to the reasons why parties should have the power to disclaim a duty to a nonparty in a case involving physical harm, when neither party created the risk of the physical harm that occurred or was otherwise under a duty of care with respect to the physical harm.<sup>253</sup> Testator has the right to not make a bequest to Beneficiary. Employer has the right to not hire a prospective employee. In both cases, the defendant's negligence results in the plaintiff being denied a benefit that the hiring party (Testator and Employer) had the right to withhold. The hirer should have the power to absolve the defendant from possible liability to the plaintiff if the hirer decides this arrangement to be in her interest.

To have an absence of a duty in the physical harm cases, it is important that the plaintiff did not rely on the defendant. For example, in *Stanley v. McCarver*<sup>254</sup> the radiologist would have owed a duty of care to the plaintiff under general principles of tort law if the plaintiff relied on the clean bill of health to forego a checkup that would

---

253. See *supra* Section VI.A.2.

254. 92 P.3d 849 (Ariz. 2004).

have detected the cancer. The radiologist's action in giving a clean bill of health would create a risk of harm through the plaintiff's reliance. Similarly, if Intended Beneficiary changes his position in reliance on receiving the bequest, then Draftsman may owe a duty of care to Intended Beneficiary because of the reliance.

When negligence results in physical harm through a plaintiff's reliance, the reliance need only be foreseeable for the defendant to be subject to negligence liability. More is generally necessary for a defendant to be under a duty of care when the plaintiff's reliance involves a pure economic loss. For there to be a duty, the defendant (or the person who hired the defendant) must have reasonably appeared to invite the plaintiff's reliance. So, for example, if Lender hires Engineer to inspect property to protect Lender's security on a purchase money loan, it is generally held that neither Lender nor Engineer has a duty of care to the Purchaser unless Lender (or Engineer) tells the Purchaser they intend for the Purchaser to be able to rely on the inspection. That the parties could foresee Purchaser would rely on the inspection is not sufficient to rise to a duty of care.<sup>255</sup> This raises the question whether Lender and Engineer have the power to disclaim a duty of care to Purchaser by including an exculpatory term in their contract, while inviting Purchaser's reliance. The next Section addresses this question in the context of a negligent misrepresentation claim.

### *C. Negligent Misrepresentation, Invited Reliance, and Information Costs*

The possibility that a party to a contract may be subject to liability to a nonparty for negligent misrepresentation raises the concern for nonparty search costs, which justifies the privity rules in contract law.<sup>256</sup> This Section considers whether this concern might justify related restrictions some states have placed on the tort, including a requirement that the parties be in "near privity" and a requirement that the defendant have subjectively intended to invite the plaintiff's reliance. It concludes these restrictions are too crude and that there are better ways to balance the interests of information suppliers and information recipients using an invited reliance duty rule.

A pair of illustrations in the current draft of the Restatement (Third) Torts: Liability for Economic Harm<sup>257</sup> raises the general concern. In both illustrations, Borrower hires Accountant to prepare a

---

255. See Gergen, *supra* note 16, at 754-56.

256. See *supra* Section V.B.

257. RESTATEMENT (THIRD) OF TORTS: LIABILITY FOR ECONOMIC HARM § 5 cmt. g, illus. 10, 11 (AM. LAW INST., Tentative Draft No. 1, 2012).

report Borrower intends to use to get a \$5 million line of credit from Lender. As a result of a negligent oversight by Accountant, the report erroneously states Borrower is in good financial shape. Lender declines to extend the line of credit. Borrower then gives the report to "Second Choice Bank," which relies on the report, extends the line of credit, and eventually suffers a loss. The Restatement draft takes the position Accountant has no duty to Second Choice Bank if there is an express understanding between Accountant and Borrower "that [the report] is for transmission to Lender only."<sup>258</sup> But under the Restatement draft, Accountant has a duty if "Borrower merely informs Accountant that he expects to negotiate a loan . . . and has Lender in mind."<sup>259</sup>

The illustrations assume the terms of the engagement between Accountant and Borrower are common knowledge. But what if they are not? What if Second Choice Bank believes the report was prepared for its use when it was not, because the understanding between Accountant and Borrower is not communicated to Second Choice Bank. This is a classic case of misunderstanding: Second Choice Bank thinks its reliance is invited; Accountant thinks otherwise. Generally a misunderstanding is resolved against the party who is more at fault. This is Second Choice Bank, if the report clearly indicates that it is prepared for Lender's use only. But Accountant may be more at fault if the report merely states the report is for Borrower to use in obtaining a \$5 million line of credit, with no indication the report is for Lender's use only. The comments in the Restatement adopt essentially this analysis, explaining that what matters in such a case is Accountant's objective or apparent intent, and not Accountant's actual intent.<sup>260</sup>

I have argued elsewhere that this inquiry into Accountant's objective intent is best understood as an inquiry into the presence or absence of invited reliance, which is essentially a contractual ques-

---

258. *Id.* at cmt. g, illus. 10.

259. *Id.* at cmt. g, illus. 11.

260. Comment g(2) observes that:

Courts sensibly interpret what a defendant "knew" to encompass as well what the defendant should have known—in other words, what the defendant reasonably should have expected the client's use of the information to be. Otherwise a defendant's negligent assessment of that use would serve to reduce its own duty of care.

*Id.* at cmt. g(2). The relevant point can be put a bit more precisely: Accountant's liability to Second Choice Bank does not turn on whether Accountant knows or has reason to know Borrower might give the report to Second Choice Bank. It turns on whether Accountant knows or has reason to know that Second Choice Bank might understand that one of Accountant's purposes in supplying the report was that Second Choice Bank might be able to rely on it.

tion.<sup>261</sup> The act of inviting reliance is similar to the act of making a promise. Both are speech acts. Both involve a shared understanding of the purpose of the act. For reliance on information to be invited, *A* supplies information to *B* with an intent that *B* be able to rely on the information, *B* understands this is *A*'s intent in supplying the information, *A* understands this is *B*'s understanding, and so on. A promise involves a specific type of invited reliance. When *A* promises *x* to *B*, *A* is inviting *B* to rely on *A* to perform *x* in the future (or to be responsible if *x* does not occur). As speech acts, promising and inviting reliance are largely a matter of manifested intent. Manifested intent to undertake an obligation is more important than the reasonableness of the obligation that is undertaken. Thus, if an information supplier disseminates information to the world while stating, "We invite the world to rely on this information," then there is invited reliance, and the information supplier may have a duty of care to the world to ensure the accuracy of the information, even though inviting the world to rely on information is an unreasonable thing.<sup>262</sup> Conversely, an information supplier can avoid undertaking a duty of care in supplying information to a recipient by clearly manifesting his intent not to invite the recipient's reliance, even though the likely quality of the information may make it reasonable to invite the recipient's reliance.

To be clear, the presence of invited reliance is a necessary but not a sufficient condition for duty under the tort of negligent misrepresentation. In particular, sometimes the contractual context of a claim negates duty even though reliance is invited.<sup>263</sup> *Ossining Union Free*

261. See Gergen, *supra* note 86. Reliance is invited when an actor "supplies information with an apparent purpose that the recipient be able to rely on the information." *Id.* at 959 (emphasis omitted). Reliance is explicitly invited when an information supplier effectively says to the recipient, "I want you to be able to rely on this [information]." *Id.* Both the user and the use must be invited. It is not necessary that the invitation be to a specific user and a specific use. The invitation may be to a class of users and for a category of uses.

262. See *Rozny v. Marnul*, 250 N.E.2d 656, 658 (Ill. 1969) (noting that a plat of survey had a legend stating, "This plat of survey carries our absolute guarantee for accuracy" and holding that the surveyor had a duty to the downstream purchaser of land who was given the plat by the seller).

263. See *Hedley Byrne & Co. v. Heller & Partners Ltd.* [1963] UKHL 4, [1964] AC 465 (Appeal taken from Eng.). A bank gave a positive credit reference regarding a customer with the disclaimer "without responsibility on the part of this Bank or its officials." The court established the availability of an action for negligent misstatement under English law but then went on to hold the bank was under no duty in giving a credit reference because of the disclaimer. In later English cases, courts reason the bank undertook a duty of care in answering the inquiry, but hold the exculpatory term absolved the bank from liability for breach of the duty on an essentially contractual ground. See *Smith v. Eric S. Bush* [1990] UKHL 1, [1990] 1 AC 831 (appeal taken from N. Ir.). I have argued elsewhere that the latter explanation is preferable on technical doctrinal grounds, if the information supplier simultaneously invites reliance on information and disclaims legal liability should the information turn out to be inaccurate, because there is a duty of care under the

*School District v. Anderson LaRocca Anderson* illustrates.<sup>264</sup> This is the case in which two engineers were hired to evaluate the safety of a building owned by a school district. The engineers mistakenly reported the building was unsafe, causing the district to incur a substantial, unnecessary expense. The engineers worked as subconsultants for an architect, who was hired by the district. Invited reliance exists, but because the parties likely would have disavowed the negligence claim if the issue were previously brought to their attention, the engineers probably have no duty. The parties would be likely to disavow the negligence claim if contracts claims were available to provide compensation and deterrence. And the parties would be likely to disavow the negligence claim if both contracts had liability caps or waivers that precluded a first-party claim.

In the case, the New York Court of Appeals allowed the claim for negligent misrepresentation, based on a finding that the parties were in near privity,<sup>265</sup> and without saying a word about the terms of the district's contract with the architect and the architect's contracts with the engineers. This is crazy. The fact the parties are in "near privity" cuts against finding a duty in *Ossining Union* because it increases the likelihood that the risk is addressed directly or indirectly in the parties' contracts. And this can be determined only by examining the contracts.

The mistake of the New York Court of Appeals is to assume "near privity" is sufficient to establish duty under the tort. The usual effect of the "near privity" test is to impose a heightened requirement for duty. The test requires direct communications between the plaintiff and defendant.<sup>266</sup> Other states impose various heightened standards for duty, also requiring something more than invited reliance. California law seems to require that the defendant have actually intended that the plaintiff be able to rely on the information.<sup>267</sup> Louisiana

---

relevant duty rule. Mark P. Gergen, *Contracting Out of Liability for Deceit, Inadvertent Misrepresentation and Negligent Misstatement*, in *EXPLORING CONTRACT LAW* (Jason W. Neyers et al. eds., 2009).

264. 539 N.E.2d 91 (N.Y. 1989).

265. *See id.* at 94-96.

266. *See Credit All. Corp. v. Arthur Andersen & Co.*, 483 N.E.2d 110, 120 (N.Y. 1985) (holding that repeated contact between the auditor and the lender involving discussions of the lender's interest in the borrower's financial condition is sufficient to find that the plaintiff and defendant were in near privity); *see also* Walpert, Smullian & Blumenthal, *P.A. v. Katz*, 762 A.2d 582, 608-09 (Md. 2000) (adopting the New York rule while restating the requirement of direct contact in a way that suggests the real concern is that the accountant be able to estimate the size of the user's consequential damages.).

267. *Bily v. Arthur Young & Co.*, 834 P.2d 745, 773-74 (Cal. 1992).



seems to require the defendant's actual knowledge.<sup>268</sup> These rules basically resolve a misunderstanding about whether the defendant intended to invite the plaintiff's reliance against the plaintiff.

Does the concern for information costs justify any of these heightened requirements for duty under the tort of negligent misrepresentation? As Section V.B explained, the privity rules in contract law make it possible to reduce information costs by partitioning a project that involves three or more participants into two or more contracts. Because of the privity rules, a participant who wants to ensure he does not inadvertently undertake an obligation needs to monitor closely only the contract to which he is a party, performances under that contract, and his interactions with the other party to that contract. These rules do not apply when the claim is for negligent misrepresentation.

A test of "invited reliance" provides an information supplier some protection from inadvertently undertaking an obligation to a recipient of the information, because duty requires a court to find that the information supplier reasonably appeared to intend to invite the recipient's reliance. But an information supplier may worry about his intent being misunderstood, and a court concluding he is more at fault in the misunderstanding. The risk of misunderstanding can be great when the intended users and uses of information are ambiguous. In addition, often an intermediary who transmits information has an interest in leading the recipient to believe the information supplier intended to invite the recipient's reliance. In the example in the Third Restatement draft, Borrower has an interest in having Second Choice Bank believe Accountant prepared the report for the bank's use in the transaction. Accountant may worry Borrower will miscommunicate its intent in this regard, and that a court will conclude Accountant bears more responsibility for the miscommunication than does Second Choice Bank. The risk of misunderstanding, and the risk of miscommunication by an intermediary, gives an information supplier an incentive to investigate potential users and uses of information when the information is supplied. The risk of miscommunication provides an incentive to monitor to whom the information is later transmitted, and on what terms.

A test of "near privity" and a test of "actual intent" reduce the risk of an information supplier inadvertently undertaking an obligation to a recipient as a result of a misunderstanding, or as a result of a miscommunication by an intermediary. A test of "actual intent" does this

---

268. *Bank of New Orleans & Tr. Co. v. Monco Agency Inc.*, 719 F. Supp. 1328 (E.D. La. 1989), *aff'd sub nom.* *First Nat'l Bank of Commerce v. Monco Agency, Inc.*, 911 F.2d 1053 (5th Cir. 1990) (applying Louisiana law).

by resolving a misunderstanding about an intended user and use in the favor of the information supplier. A test of "near privity" does this by limiting the universe of recipients to whom an information supplier may have a duty to persons with whom the information supplier is in direct communication. These direct communications also provide the information supplier with inexpensive opportunities to clarify its intent, or to otherwise disclaim a duty or limit its liability.

There would be nothing objectionable about these tests if people generally understood that an information supplier has no duty of care regarding the accuracy of information, even if it is predictable someone will attach substantial weight to the information, and even if the information is presented in ways that make it seem reliable. My impression is that many people do not understand this, particularly when the information comes from a source, like a certified accountant or a rating agency, that holds itself out as a reliable source of information. The "near privity" test creates bad incentives, for it allows an information supplier to aggressively invite reliance, with no fear of liability if the information is inaccurate, so long as they avoid direct communications with potential victims. The "actual intent" test is better in this regard. But the test creates similar bad incentives if the test requires an information supplier to have a specific user and use in mind. This form of the "actual intent" test allows an information supplier to aggressively invite reliance so long as the information is not targeted at a specific user and use.

There are better ways to protect an information supplier from the risk of inadvertently undertaking a duty to a recipient with whom the supplier is not in privity of contract. The simplest solution is to create a safe harbor in the form of a rule that allows an information supplier to absolve itself from a duty to a recipient by including a clear and conspicuous disclaimer with the information. The disclaimer might state: "Rely on this information at your own risk. We are under no legal responsibility to make any effort to ensure its accuracy."

## VIII. CONCLUSION

It is possible to incorporate contractual considerations in negligence analysis without upending negligence law. Sometimes the parties to a contract have the power to disclaim a duty to a nonparty. But the principles that justify this power derive from negligence law, not contract law. For example, there is a power to disclaim a duty to a nonparty when carelessness by a party in performing a contract exposes the plaintiff to a pre-existing risk, which was not of the making of either party to the contract. When a negligence claim involves pure economic loss, negligence principles do partly give way to con-

tractual considerations when the plaintiff and defendant are connected through a chain of contracts, and the parties may be expected to address the risk that occurred in these contracts. But negligence principles remain an important touchstone in these cases. Courts should take account of contractual considerations in approaching the duty question in negligence law by asking whether the parties probably would have disavowed the negligence claim, had the question of the availability of the claim been presented to them before the problem arose. Cases in which the answer to this question is clear present no real difficulty, once this is understood to be the question. The difficult cases are those in which the answer is not clear. I have suggested courts deal with these cases by adopting a presumption either allowing or disallowing a negligence claim when the inquiry into predicted intent is not decisive.

Contract law should determine the effect of an exculpatory term only when the term is in a contract to which the victim is a party. The ultimate question in these cases is whether the harm-doer is an intended third-party beneficiary of the term. When the term is ambiguous, the answer to the ultimate question is a matter of predicted intent, and the strength of the reasons for negligence liability is an important consideration in this analysis. One change in the law is warranted here. U.S. courts should not give literal effect to an exculpatory term, to deny a negligence claim against a nonparty harm-doer, when the denial of the claim does not advance the interests of the other party to the contract. Principles of contract law do not require literalism in this context because it does not serve the interests of the parties to the contract.

Property law and the equitable doctrine of notice may be used to create new channels for private ordering, to give effect to a waiver of liability, when a victim and a harm-doer are not in privity of contract. But courts should be cautious in creating these channels. A new channel should be created for waiver of liability only when there is genuine possibility that the background rules of negligence law impose liability when it is not in the interest of the parties or society. On the other hand, when a court believes the existing background rules of negligence law may not reach as far as they should, a court might create a channel for waiver of liability while expanding the reach of negligence law. In particular, courts should consider eliminating the restrictions on the scope of the tort of negligent misrepresentation that immunize rating agencies and public auditors from negligence liability to the public. Immunity might be conditioned on rating agencies and public auditors presenting information in ways that make it clear to the public that users of the information rely at their own risk.