

# ARTICLES

## Individual Negotiation of Warranty Disclaimers: An Economic Analysis of an Assumedly Market Enhancing Rule

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### I. INTRODUCTION

Few concepts in law have been attacked with the ferocity and tenacity that the judiciary has reserved for disclaimers of warranty. Even though U.C.C. section 2-316 provides the manner by which parties to a transaction for the sale of goods may disclaim implied warranties of merchantability and fitness for a particular purpose, courts have held many disclaimers meeting the section's requirements to be unenforceable.<sup>1</sup> In Washington State, a combination of judicial and legislative actions has added to the requirements of the U.C.C., and to warranty disclaimers not governed by the Code, the additional requirements that a disclaimer of implied warranties be explicitly negotiated and that the attributes being disclaimed be specifi-

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1. See, e.g., *Hartwig Farms Inc. v. Pacific Gamble Robinson*, 28 Wash. App. 539, 625 P.2d 171 (1981); *Dobias v. Western Farmers Ass'n*, 6 Wash. App. 194, 491 P.2d 1346 (1971). *But cf.* *Travis v. Washington Horse Breeders Ass'n*, 111 Wash. 2d 396, 759 P.2d 418 (1988) (disclaimer contained in auction catalog held valid irrespective of buyer's ignorance of the clause); *Frickel v. Sunnyside Enters.*, 106 Wash. 2d 714, 725 P.2d 422 (1986) (disclaimer of warranty of habitability contained in contract for sale of commercial property upheld when there had been no express negotiation but the contract was reviewed by the buyers' lawyer). In jurisdictions other than Washington, courts have invalidated warranty disclaimers as being unconscionable, despite their compliance with the disclaimer requirements of U.C.C. § 2-316. See, e.g., *Martin v. Joseph Harris Co.*, 767 F.2d 296 (6th Cir. 1985) (seller failed to inform buyer of disclaimer and its effects); *A. & M. Produce v. F.M.C. Corp.*, 135 Cal. App. 3d 473, 186 Cal. Rptr. 114 (1982) (seller did not negotiate disclaimer nor inform buyer that it would).

cally described.<sup>2</sup>

The genesis of these requirements was *Berg v. Stromme*, a case in which the Washington Supreme Court sustained the claim that a disclaimer of the implied warranty of merchantability did not bar a new car buyer from recovering for a breach because the term had not been "explicitly negotiated" between him and the dealer.<sup>3</sup> In *Berg*, the plaintiff, a nonmerchant, purchased a new car from the defendant. After the plaintiff experienced problems with the car, he sued, claiming a breach of express and implied warranties. The court found that the plaintiff negotiated with the defendant the purchase of more than forty pieces of optional equipment, the cost of which nearly doubled the price of the car. The court also found, however, that the plaintiff did not negotiate with the defendant over various terms appearing in condensed type on the reverse side of the purchase order. One of those terms was a disclaimer by the defendant of all warranties, express or implied.<sup>4</sup> The court stated that "[w]aivers of such warranties, being disfavored in law, are ineffectual unless *explicitly negotiated* between buyer and seller and set forth with particularity showing the particular qualities and characteristics of fitness which are being waived."<sup>5</sup> Although the *Berg* decision may

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2. *Berg v. Stromme*, 79 Wash. 2d 184, 196, 484 P.2d 380, 386 (1971); WASH. REV. CODE § 62A.2-316(4) (1989) (WASH. REV. CODE § 62A.2-316 requires only that disclaimed attributes be set forth with particularity and does not apply to sales by nonmerchants or to sales to commercial parties).

3. *Berg*, 79 Wash. 2d at 196, 484 P.2d at 386.

4. The transaction contained two warranty disclaimers: one on the back side of the purchase order, in type of even size and style, as item three of eleven items, the second occupying one line of 26 lines that covered half of an entire page in the conditional sales contract. *Id.* at 193, 484 P.2d at 385.

The transaction in *Berg* was governed by the Uniform Sales Act. If it had instead been governed by the stricter terms of the Uniform Commercial Code, the relevant provision of which is codified in Washington as WASH. REV. CODE § 62A.2-316 (1989), the disclaimer probably would have been invalidated for failing to use the word "merchantability" and for not being conspicuous. As discussed *infra* text accompanying notes 28-101, if marginal buyers would notice such disclaimers so that the disclaimers' existence would affect their purchasing decisions, the size and placement of the disclaimers would not result in suboptimal terms and should not affect the disclaimers' enforceability. On the other hand, if the terms were so obscure or incomprehensible that marginal buyers would not evaluate such terms in making their purchase decisions, the terms ought not be deemed to have been part of the transaction on the basis of fraud. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 103 (3rd ed. 1986). Despite the fact that the disclaimers met the disclosure requirement of U.C.C. § 2-316(2) by being conspicuous and mentioning merchantability, some courts have held such disclaimers unconscionable under U.C.C. § 2-302. See, e.g., *Martin v. Joseph Harris Co.*, 767 F.2d 296 (6th Cir. 1985).

5. *Berg*, 79 Wash. 2d at 196, 484 P.2d at 386 (emphasis added).

have provided relief to the bedeviled owner of a 1965 Pontiac, it also created rules that increase the transaction costs of the bargaining process to the extent those rules are adhered to by contracting parties.

To the Washington Supreme Court, the *Berg* case involved a paradigmatic unfair transaction in which the contract term was provided on a standard form without negotiation.<sup>6</sup> The court assumed that the buyer was unaware of the onerous disclaimer clause and that he would never have agreed to it if he had known of its existence.<sup>7</sup> Thus, in the eyes of the court, the buyer received what economists would classify as a suboptimal term. The facts that the court recited were apparently intended to suggest that the seller was unconcerned with the buyer's preferences and completely unwilling to take those preferences into account when drafting his form contract.<sup>8</sup>

The court's dire view of contracts using standardized terms, if correct, might be perceived by some to justify the explicit negotiation and particularized disclaimer requirements of *Berg*. But if, instead, the terms of those contracts are the product of determined efforts by merchants to offer the terms that buyers desire, explicit negotiation and particularized disclaimer would simply be unnecessary, unwanted, and costly protections forced upon buyers by the courts.

In this Article, we will examine the economic forces that shape the typical contract for the sale of goods to determine whether *Berg's* requirements of explicit negotiation and specific disclosure are justified, and if not, whether the *Berg* rules should be modified or abolished. In particular, we will examine how buyers and sellers determine the terms of the contracts they enter. Most importantly, we will consider the common assertion that consumers have no ability to bargain and therefore have no influence on what terms merchants and manufacturers include in their standard contracts. We will also consider whether merchants systematically frustrate consumers' preferences regarding contract terms, or whether, instead, merchants are driven by market forces to satisfy those preferences at either competitive or monopolistic prices. We will conclude by suggesting that the *Berg* rules are ineffective,

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6. 79 Wash. 2d 184, 484 P.2d 380.

7. *Id.*

8. *Id.*

or at best unnecessary, in furthering the consumer protection goals announced by the court itself.

## II. THE RULES OF *BERG* AND ITS PROGENY

Courts quickly extended the *Berg* rules, described above, to situations other than disclaimers of warranty in consumer purchases of durable goods.<sup>9</sup> In *Dobias v. Western Farmers Association*,<sup>10</sup> the Court of Appeals invalidated a disclaimer of warranties because it was not explicitly negotiated, even though both parties to the contract were merchants, and even though the party seeking to defeat the disclaimer actually knew of its presence by virtue of its inclusion in previous contracts between the parties.<sup>11</sup> Apparently unconcerned that the *Berg* court's desire to protect against unknowing assent to disclaimers had been completely satisfied by the buyer's actual knowledge of the disclaimer, the *Dobias* court instead focused on explicit negotiation, as if the court considered negotiation to be an indispensable ritual indicating actual assent.<sup>12</sup>

The approach in *Dobias* appears to have been modified somewhat by *Hartwig Farms, Inc. v. Pacific Gamble Robinson*,<sup>13</sup> in which the same court recognized in dicta that disclaimers could be effective between merchants if sufficient evidence were introduced to show that either a course of dealing between the parties or trade usage provided for such disclaimers.<sup>14</sup> Finding insufficient evidence of such a course of dealing or trade usage, the court went on to invalidate the dis-

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9. Although the *Berg* decision was not explicitly predicated upon the fact that the party attempting to avoid the disclaimer was a nonmerchant buyer, the Washington Supreme Court later appeared to so characterize the decision. In *Schroeder v. Fageol Motors*, 86 Wash. 2d 256, 544 P.2d 20 (1975), the court rejected the defendant's attempt to distinguish *Berg* on the basis of the plaintiff's status as a merchant. The *Schroeder* court stated:

We are fully aware that the rule enunciated in *Berg v. Stromme, supra*, was premised predominately on policy grounds. However, this does not support Fageol's contention that the *Berg* rule is limited to disclaimer cases involving innocent consumers as contrasted with purely commercial transactions involving businessmen . . . . We now find no persuasive reason why this same public policy should not extend to cases . . . in which the litigants are both businessmen.

*Id.* at 261, 544 P.2d at 24.

10. 6 Wash. App. 194, 491 P.2d 1346 (1971).

11. *Id.* at 200, 491 P.2d at 1350.

12. *See id.*

13. 28 Wash. App. 539, 625 P.2d 171 (1981).

14. *Id.* at 547, 625 P.2d at 175-76.

claimer at issue because it had not been explicitly negotiated.<sup>15</sup>

Despite the rapid and enthusiastic expansion of the *Berg* doctrine,<sup>16</sup> the Washington Supreme Court has recently limited the doctrine in important ways in cases involving nonconsumer transactions. In *Frickel v. Sunnyside Enterprises*,<sup>17</sup> the court considered the case of an inexperienced buyer who purchased apartment buildings that later proved to have faulty foundations. The buyer sued the developer/seller, claiming that the seller had breached an implied warranty that the apartments would be habitable. The seller defended on the ground that, among other things, the contract of sale signed by the buyer included a disclaimer of warranties.

After holding that an implied warranty of habitability did not attach to the transaction, the court went on to state in dicta that the seller's disclaimer of warranties was valid even though the parties did not explicitly negotiate over it.<sup>18</sup> The court found the *Berg* case distinguishable from the case at bar in several important ways: first, the buyers, though inexperienced, were entering into the purchase of commercial property as an investment;<sup>19</sup> second, the transaction was at arm's length, with no hint that it involved what is commonly characterized as a contract of adhesion;<sup>20</sup> and third, the buyers were represented by counsel and had ample opportunity to inspect the premises or obtain an expert inspection if they had desired to do so.<sup>21</sup> Thus, the court concluded, the buyers did not require

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15. *Id.* at 545, 625 P.2d at 174-75.

16. The Washington courts extended a modified version of the explicit negotiation rules to provisions dealing with limitations of remedy. In *Schroeder v. Fageol Motors*, 86 Wash. 2d 256, 544 P.2d 20 (1975), the Washington Supreme Court considered a limitation on consequential damages that was contained in a sales contract between two merchants. The court rejected a per se requirement of explicit negotiation to validate such limitations of remedy, instead requiring the limitation to be proven unconscionable under WASH. REV. CODE § 62A2-302 (1989). *Schroeder* 86 Wash. 2d at 259, 544 P.2d at 23. The court stated that considerations of specific negotiation and conspicuousness of the limitation of remedy would be relevant to a determination of unconscionability, although not conclusive. *Id.* at 260, 544 P.2d at 23. The court also stated that the course of dealing between the parties and relevant trade practices would be pertinent as well. *Id.* The court further noted that, because determinations of unconscionability can be made only after a full hearing, lack of explicit negotiation could not be grounds for summary judgment on the issue of the conscionability of a limitation of remedy. *Id.* at 262-63, 544 P.2d at 24-25.

17. 106 Wash. 2d 714, 725 P.2d 422 (1986).

18. *Id.* at 720, 725 P.2d at 426.

19. *Id.* at 720, 725 P.2d at 425.

20. *Id.* at 720, 725 P.2d at 426.

21. *Id.* at 720, 725 P.2d at 425.

the protection afforded less capable buyers under *Berg*.<sup>22</sup>

The next contraction of the explicit negotiation requirement came in *Travis v. Washington Horse Breeders Association*.<sup>23</sup> In *Travis*, the court dealt with a buyer purchasing a racehorse at auction on behalf of a partnership of which he was a member. After purchasing the horse, the buyer discovered that the horse was physically unfit for use as a racehorse. The former owner of the horse and the auctioneer refused to refund the purchase price, and the buyer sued both, claiming, among other things, breach of an implied warranty.<sup>24</sup> In their defense, the seller and auctioneer relied on a disclaimer of warranties contained in a catalog issued to the buyer. The buyer responded by asserting that the disclaimer was invalid under *Berg* because it was not explicitly negotiated between the parties. The court sided with the seller and auctioneer and refused to extend the explicit negotiation doctrine to sales at auction.<sup>25</sup>

To support its decision, the *Travis* court explicitly relied on some of the same economic rationales explored later in this Article. The court pointed out that the auction catalog conspicuously displayed the disclaimer at issue and that such disclaimers, at least in the context of an auction, were effective even if the buyer did not have actual knowledge of them.<sup>26</sup> This rule was necessary, the court explained, to preserve the fundamental justification for auctions: "[P]art of the economic rationale of an auction is to avoid face-to-face negotiations. It is a cost-saving device in which face-to-face negotiations, except as to price, are not engaged in by the parties."<sup>27</sup>

The explicit negotiation doctrine thus appears to be developing away from the rigid and overinclusive rules of *Berg* and its progeny, moving instead toward the more refined form suggested by *Frickel* and *Travis*. In the section that follows, we analyze the economic considerations alluded to in these latter two cases.

22. *Id.* at 721, 725 P.2d at 426.

23. 111 Wash. 2d 396, 759 P.2d 418 (1988).

24. The court's conclusion, albeit apparently in dictum, was that the auctioneer, as "seller" of the horse, was a merchant and thereby made the implied warranty of merchantability under U.C.C. § 2-314. This conclusion is highly questionable since the auctioneer did not have title to the horse but acted only as agent for the owner. See *Survey: Uniform Commercial Code*, 44 BUS. LAW. 1439, 1457-58 (1989).

25. *Travis*, 111 Wash. 2d at 403, 759 P.2d at 422.

26. *Id.* at 403, 759 P.2d at 421.

27. *Id.* at 403-04, 759 P.2d at 422.

## III. THE ECONOMIC ISSUES

## A. Introduction

Intervention into a market in the form of statutes or common law rules mandating<sup>28</sup> or prohibiting<sup>29</sup> contract terms must rest on at least an implicit conclusion that the market in which the term appears is not functioning properly.<sup>30</sup> This proposition seems self-evident, since the terms generated by the market should be corrected only if the market is malfunctioning.

Market failure caused by imperfect information is clearly the policy basis for the decision in *Berg*. The court argued that the typography of the form contract presented to the buyer was so difficult to read that buyers were unable to discover from reading it that they were agreeing to a disclaimer of warranties.<sup>31</sup> The court also argued that a disclaimer of implied warranties was so far contrary to the typical expectations of a buyer who had, in the same transaction, negotiated several express warranties, that assent to such a disclaimer must be presumed to be unknowing.<sup>32</sup>

But the issue of market failure is as difficult to resolve as it is easy to raise, and the court made no effort to overcome that difficulty through rigorous analysis of the economic prin-

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28. See, e.g., Magnuson-Moss Warranty—Federal Trade Commission Improvement Act, 15 U.S.C. §§ 2301-2312 (1988) [hereinafter Magnuson-Moss Act].

29. See, e.g., Magnuson-Moss Act, *supra* note 28, at § 2308(a) (limiting disclaimers of implied warranties with respect to consumer goods for which a written warranty is provided); KAN. STAT. ANN. § 50-639(a) (1983) (disclaimers of implied warranty are void *ab initio*; statute imposes civil penalties and attorney's fees for including a disclaimer of implied warranties in a contract); ME. REV. STAT. ANN. tit. 11, § 2-316 (5) (Supp. 1988) (disclaimers of implied warranties and limitations of remedy for breach thereof are void and a violation of the state's consumer protection act); MD. COM. LAW CODE ANN. § 2-316.1 (Supp. 1988) (oral or written disclaimers of implied warranties are unenforceable); W. VA. CODE § 46A-1-107 (1986) (a consumer may not waive or agree to forego warranty rights or benefits).

30. For the purposes of this Article, a "properly functioning" market is one that achieves the Kaldor-Hicks definition of efficiency. Under the Kaldor-Hicks definition, a particular redistribution of resources is deemed efficient if that redistribution results in an increase in the wealth of those who receive the resources that is equal to or greater than the decrease in wealth of those from whom the resources are transferred. R. POSNER, *supra* note 4, at 12-13. Factors that inhibit the attainment of such efficiency include imperfect information, high transaction costs, and externalities. *Id.* at 15-17.

31. *Berg v. Stromme*, 79 Wash. 2d 184, 190-94, 484 P.2d 380, 383-85 (1971); see R. POSNER, *supra* note 4 (indicating that contract language may be so obscure or incomprehensible that it should be unenforceable on the ground of fraud).

32. *Berg*, 79 Wash. 2d at 193-95, 484 P.2d at 385-86.

ciples implicated by its decision. Moreover, once it becomes reasonably clear that a market has failed, a remedy for that failure must be fashioned that is at once effective and yet minimally intrusive; otherwise, overregulation and inefficiency will result.<sup>33</sup> In the section that follows, we examine some current theories about how markets function and fail. We then examine the rules of *Berg* and its progeny, as well as the rules' probable applications, to determine whether the markets *Berg* is intended to regulate really malfunction and, if so, whether the remedies provided by the *Berg* rules are sufficiently effective and precise to avoid suboptimal regulation.

### B. *How Markets Function*

Unfortunately, empirical research regarding the actual functioning and malfunctioning of the market for warranties and other contract terms is scarce.<sup>34</sup> Nevertheless, basic economic theory provides an analytical framework that, except for a minor extension that will be explained later, is sufficient to indicate whether a given market has failed and therefore needs judicial regulation.

Basic economic theory is founded on the postulate that markets consist of buyers, who demand and pay for products, and sellers, who produce and sell those products to buyers, with individuals in each group striving to maximize their net personal wealth. According to this postulate, and according to commonly observed reality, sellers are in the business of selling in order to make as much net income as possible, and will pursue any strategy that will increase their net income. The seller's challenge is to discover what products buyers want to purchase and to provide them at a price that will not only cover the seller's costs of producing and selling the goods, but will also afford him the highest possible return on his investment.<sup>35</sup> If any seller fails to estimate the desires of buyers correctly, an incentive will immediately be created for other sellers to enter the market and capture the additional sales

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33. R. POSNER, *supra* note 4, at 343-46. Often, the causes and cures of market failure present such intractable problems that the market itself, though malfunctioning, provides a better solution than that which could be devised by the judiciary or the legislature.

34. Schwartz & Wilde, *Imperfect Information and the Market for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1393 (1983).

35. See generally Jenner, *An Information Version of Pure Competition*, 1966 ECON. J. 786, 791.



that the first seller could have made had his estimate of buyers' preferences been more accurate. Observation again shows that such seller misestimation does in fact take place, probably inevitably so.<sup>36</sup> Although sellers can and do gather information regarding consumer preferences through surveys and other methods, it is highly unlikely that such information is complete, and trial and error appear necessary to supplement such information.<sup>37</sup> Consumers reliably reveal their preferences only after they are actually offered new goods, and many times only after they have purchased them.<sup>38</sup> In this area, the seller proposes and the consumer disposes.<sup>39</sup>

The seller's task of determining consumer preferences correctly, providing a product to satisfy those preferences, and establishing an appropriate price is complex. As a group, buyers place differing subjective values on any given good. These values tend to range from high above the seller's cost of production to far below that cost. In essence, the seller's task is to offer one price<sup>40</sup> that will induce as many of these buyers as possible to buy, despite their differing values, while at the same time leaving the seller with the highest possible return on invested capital and compensation for taking an entrepreneurial risk.

With competition among sellers, the seller can accomplish these objectives only by offering a price equal to his total cost of selling the good, including a normal profit.<sup>41</sup> By offering

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36. *Id.* at 797.

37. *Id.* at 794.

38. A. ALCHIAN & W. ALLEN, EXCHANGE AND PRODUCTION 246 (3rd ed. 1983). See Smith & Swinyard, *Information Response Models: An Integrated Approach*, 82 J. MARKETING 81 (Winter 1982) (suggesting that consumers purchase many goods for trial purposes and make committed decisions to such goods only after trial).

39. A. ALCHIAN & W. ALLEN, *supra* note 38, at 246.

40. The seller need not offer only one price. Instead, the seller could offer a different price to every nonshopping buyer by individually bargaining over price. By pricing goods through individual negotiation, the seller would be able to charge all nonshopping buyers an amount somewhere between the competitive price and the buyers' reservation price. The seller would thereby capture some "consumer surplus," which is the amount of value the nonmarginal buyer places on the good over and above the value placed on the good by the marginal buyer. So long as the seller does not charge buyers more than their respective reservation prices, the seller will lose no sales, even though he is charging a higher price. Thus, the seller's return on investment increases. However, individual negotiation over price is usually too expensive a method of pricesetting to justify the increase in net return it would generate.

41. Again, in a competitive market, the seller's price must be high enough to compensate the seller for his investment of capital and for taking an entrepreneurial risk.

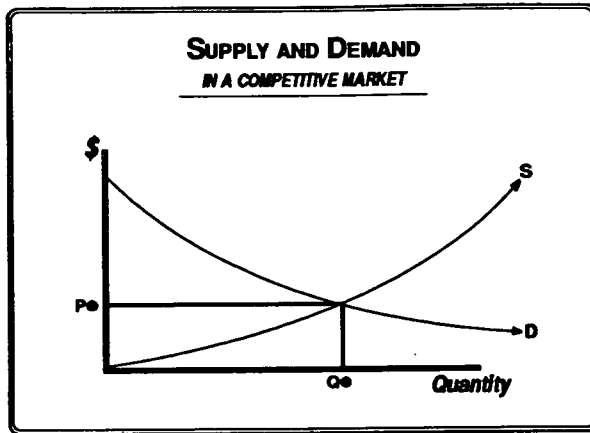


FIGURE 1

such a price, the seller induces purchases by all buyers to the left of the intersection of the supply and demand curves ( $Q_0$ ).<sup>42</sup> Figure 1 illustrates the supply and demand curves in a competitive market. Although the seller will make no sales to those buyers to the right of  $Q_0$ , he loses no profit, since to sell to buyers to the right of  $Q_0$  would require him to sell his goods for less than they cost to produce, resulting in reduced net income. The seller need not concentrate his efforts on those buyers far to the left of  $Q_0$ , since they will buy at any price less than their reservation price, which is represented by the demand curve. Rather, the seller must focus on those buyers who will not buy unless he offers his goods at a price relatively close to the seller's marginal cost of production. The people in this latter group, on the margin of the market, are called marginal buyers.

To attract these marginal buyers, a seller must ascertain what attributes his product must possess before marginal buyers will purchase them. Product attributes in a given market

42. The intersection of the supply and demand curves represents the market equilibrium. However, in reality, markets are rarely at equilibrium for long, if at all. See Jenner, *supra* note 35, at 797 (noting that once equilibrium is reached, sellers search for new products to exploit); see also Whitford, *Law and the Consumer Transaction: A Case Study of the Automobile Warranty*, 1968 WIS. L. REV. 1006, 1013-14 n.15 (describing rapid fluctuations in the scope of automobile warranties offered by General Motors, Ford, and Chrysler). Changing economic conditions, buyer preferences, improved seller and buyer information, and technological innovation can each distort markets. The fact that markets are constantly changing implies that assessment of how well a particular market is functioning must be an ongoing process. Thus, judicial conclusions regarding market function based on casual observation at any given point in time are particularly suspect.

may be numerous and varied. For example, in the new car market, some dealers may offer cars with big engines; other dealers will offer cars with small engines. In addition, the terms under which the goods are sold, including the price, must all be considered as part of the bundle of goods conveyed to the buyer. Thus, the presence or absence of a warranty, the length of time required for delivery, the quality of post-sale repairs, and every other imaginable attribute of the sales transaction must be considered an integral part of the goods offered for sale and become criteria for attracting marginal buyers and for competition among sellers.<sup>43</sup>

A product's total cost to the buyer includes, among other items, both the amount of money he pays to the seller and the amount of utility the buyer sacrifices if he buys a good having attributes that he regards as suboptimal. The existence of this latter cost provides an incentive for marginal buyers to compare the attributes of various sellers to reduce the risk of making a suboptimal purchase. If enough marginal buyers compare the attributes of goods offered by different sellers in the market, all sellers must conform the attributes of their goods, including price, to those demanded by marginal buyers. Sellers who refuse to compete across all attributes risk losing sales to competing sellers.

### *C. Market Failure*

From the foregoing material, it can be seen that in a perfectly competitive and perfectly informed market, competition among sellers will cause them to conform their goods as closely as is cost-justified to the preferences of the greatest possible number of buyers. But this conclusion will not, in itself, resolve the issue of whether the market will function in the same way once the assumptions of perfect competition and perfect information are relaxed to reflect some, or perhaps most, markets as they actually exist.

#### 1. Monopoly

To relax the first assumption, that of perfect competition, we will analyze how contract terms are generated in less than perfectly competitive markets. Because most courts and legal

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43. For ease of reference, we will refer to all of these attributes of the transaction, whether they relate to the good itself or to any of the literally hundreds of other aspects of the sales transaction, as simply "attributes."

commentators tend to equate imperfect competition with monopoly, we restrict our analysis to that phenomenon. It should be noted, however, that an attack on the premise that markets will generate optimal contract terms can just as easily be based on a number of other potentially anticompetitive phenomena.<sup>44</sup> First, we show that sellers probably will continue to offer optimal contract terms even when a monopoly exists. Then, we explain why markets dominated by monopolists will probably continue to generate optimal terms even if most buyers in that market are less than perfectly informed about the goods they are buying and about the terms upon which they are buying them.

A monopoly exists when a single producer controls the supply and price of a given commodity, so that buyers have no alternative source of the good and therefore must pay the price demanded by the monopolist or forego having the commodity that is so controlled.<sup>45</sup>

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44. Such anticompetitive phenomena include oligopolies, cartels, and markets manipulated by dominant firms. Although monopolies and oligopolies differ in many ways, these differences do not affect our analysis to any significant degree. Unless otherwise indicated, our analysis of imperfect competition under monopolistic conditions applies with equal force to situations involving oligopolistic conditions.

45. Oligopolists who explicitly collude with one another are called a "cartel." EXCHANGE AND PRODUCTION, *supra* note 38, at 263. For the purposes of our discussion, the distinction between oligopolies and cartels is irrelevant, and both will be referred to as "oligopolies."

It should be noted that the likelihood of establishing a stable oligopoly is decreased substantially by the costs of negotiating and policing an agreement to not compete openly. These costs are increased by the nature of the oligopoly itself. Each member of the oligopoly will have an incentive to cheat, thus requiring all members to take steps to monitor the production of all other members. The easiest form of cheating, and the most difficult to control, is for producers to decrease elements of the buyer's total cost other than monetary price by, for example, improving the quality of their products, their delivery or warranty services, or other product attributes not normally regulated by an anticompetitive agreement.

It is important at this point to distinguish between markets that are dominated by a few producers because of collusive behavior and markets that have reached that stage through normal processes of market competition and specialization. The cause of market domination is important in the context of *Berg*, since market domination by monopolists is popularly believed to foster abuse by sellers in various ways.

Market domination, as the end result of successful competition, is most likely to occur if economies of scale and high initial capital costs discourage producers from entering the market while rewarding large companies that produce efficiently on a large scale by allowing them to grow even larger. These firms then tend to dominate the market and squeeze out smaller, less competitive firms. Thus, domination of an industry by a few firms need not necessarily be the result of oligopolistic collusion. A good example of failing to make this distinction appears in *Henningsen v. Bloomfield Motors*, 32 N.J. 358, 161 A.2d 69 (1960), in which the court assumed that, simply because the American car market was at one time dominated by three large

Monopolies generally are perceived as undesirable for various reasons, some of which are more well-founded than others. One negative effect of monopolies, usually raised by economists, is that a monopoly will result in sellers producing less of the good and buyers having to pay more than they would have to pay if the market were competitive. Furthermore, although monopolists are better off charging monopoly prices, their welfare gains do not offset the losses suffered by buyers. This situation results in a net societal loss.<sup>46</sup> Monopolies also create, as illustrated in Figure 2, what has been called a "deadweight loss." By artificially raising the cost of goods sold by charging monopoly prices, monopoly sellers induce buyers to substitute goods that are more costly to produce than the monopoly goods, but that sell for a price below the monopoly price.<sup>47</sup> The increased cost resulting from the substitution of more costly goods is the deadweight loss, that is, a cost with no offsetting benefit.

A more frequent, but less supportable theory, is that a monopolist will take advantage of his dominance of the market by degrading the quality of terms offered in the contracts under which he sells.<sup>48</sup> This theory of attribute degradation through the exploitation of monopoly power by sellers in a concentrated market does not, however, appear to be correct. A monopolist, or a seller in a concentrated market, will gain

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companies, an oligopoly must have existed. *Id.* at 358, 161 A.2d at 87. The *Henningsen* court, after citing the high degree of centralization in the American car market in the late 1950s, stated: "There is no competition [i.e., there is an oligopoly] among the car makers in the area of express warranty." Rather than being the result of collusion, it is likely that the similarity of warranty terms observed by the court was the result of a temporary convergence of market-driven terms. The high degree of centralization of the new car market at that time was quite possibly the result of normal market forces driving smaller producers, such as Kaiser and Studebaker, out of the market while sustaining big producers such as Ford and General Motors. These big American producers have since encountered serious competition by major foreign automobile producers who have marketed their cars worldwide in order to take advantage of international demand. These foreign producers were then able to accomplish some of the same economies of scale as had the large American companies, and thus are able to effectively compete in the American market.

Interestingly, although market domination by a few firms may not be a reliable indicator of oligopoly control of a market, such domination nevertheless makes oligopolistic collusion more likely by lowering the cost of policing a collusive agreement. R. POSNER, *supra* note 4, at 267.

46. A. ALCHIAN & W. ALLEN, *supra* note 38, at 155.

47. R. POSNER, *supra* note 4, at 254-55.

48. See Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1299-1300 (1981) (describing the "exploitation theory" in relation to the content of consumer product warranties).

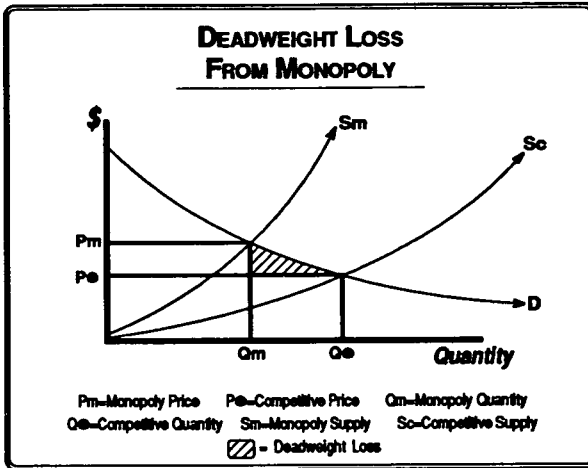


FIGURE 2

more by providing preferred terms to the greatest extent possible—while charging supracompetitive prices for those terms—than he would by selling on terms that are less desirable to buyers.<sup>49</sup> The seller's goal is, after all, to sell the most product he can at any given price, and he can achieve maximum sales only by offering the best product at the price, be it a monopoly price or a competitive price.<sup>50</sup> Not only is it theoretically unlikely that monopolists or sellers in a highly concentrated market will offer inferior terms, other than price, but what little empirical evidence exists also suggests that monopolists do not engage in such behavior.<sup>51</sup>

Moreover, to the extent that a monopolist fails to supply the attributes desired by buyers, and to the extent that those attributes can be provided by suppliers other than the monopolist at prices lower than those demanded by the monopolist, an incentive will be created for new producers to enter the market and profit by filling any unsatisfied purchaser demand. Market entry by other producers will force the monopolist to lower his price, improve his product, or both. Common examples of competition from aftermarket producers include independent insurance companies that offer warranties on new and used cars, as well as merchants of automobile accessories such as radios, fog lights, tinted windows, and custom paint

49. Coase, *The Choice of the Institutional Framework*, 17 J.L. & ECON. 493, 494 (1974).

50. R. POSNER, *supra* note 4, at 102.

51. See Priest, *supra* note 48, at 1324-25.

jobs. Competition from aftermarket sellers such as these will cause even monopolists to offer products with attributes desired by the marginal buyers, and will tend to limit the extent to which monopolists can charge supracompetitive prices for those attributes.<sup>52</sup>

Even when a monopoly exists, however, judicial intervention is unlikely to improve the buyer's position. Trebilcock<sup>53</sup> has argued that when a particular contract term is banned on the ground that one of the parties to the agreement is a monopolist who has overpowered the other party through superior bargaining power, the cost to the monopolist of foregoing the banned term will be passed on by the monopolist to the buyer by an adjustment of other terms not directly regulated. Thus, Trebilcock argues, a monopolist who is constrained as to one particular term in his contract will simply degrade other contract terms in order to achieve the same marginal cost of production and, therefore, the same net return.<sup>54</sup> Trebilcock concludes that any attempt to regulate monopoly power in a market must be comprehensive, since to attempt regulation of any lesser scope is "like squeezing putty."<sup>55</sup> Thus, according to Trebilcock's analysis, a monopolist under rules like those of *Berg* will obey a judicial requirement of explicit negotiation and particular disclosure, but will degrade other product attributes such as warranty service, product quality in excess of that necessary to make the product merely merchantable, or delivery. Unless a court that imposes such mandatory terms can demonstrate that it can effectively control all attributes of the sale transaction, there can be no assurance that sellers will not simply recover the cost of complying with the mandated term by degrading other terms, leaving consumers no better off.

## 2. Imperfect Information

Up to this point, we have assumed that buyers are perfectly informed about all aspects and attributes of the products

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52. It might be possible for a monopolist to charge somewhat higher prices if he had a comparative advantage over aftermarket sellers in producing the attribute in question. In that case, a monopolist would charge a price higher than his marginal cost of production but low enough to prevent market entry by aftermarket producers.

53. Trebilcock & Dewees, *Judicial Control of Standard Form Contracts*, in *THE ECONOMIC APPROACH TO THE LAW* 93 (P. Burrows & C. Veljanovski eds. 1981).

54. *Id.* at 104.

55. *Id.*

they purchase. This perfect knowledge allows them to choose from among the various products, sellers, and terms of sale, and ensures that their choices will attain for them the highest degree of satisfaction possible. Opponents of economic analysis have rightly attacked this assumption as being unrealistic.<sup>56</sup> Even though the assumption may be unrealistic, it does not follow that the theory that the market will provide optimal terms will be incorrect.<sup>57</sup>

*a. Marginal Buyers and Market Discipline by Competition*

Many opponents of the theory that markets will generate optimal product attributes and contract terms implicitly assume that all buyers in a given market must be perfectly informed in order for them to realize maximum satisfaction, or "utility," from their purchases. Such an assumption is mistaken, however, because it ignores the crucial function served by marginal buyers.

Because most sellers sell standard goods at prices determined without individual negotiation, sellers must make sure that the goods they sell have the attributes and prices desired by buyers at the margin, as already explained. Since these goods and prices will be standard, all buyers, whether well informed or not, will benefit from the information that marginal buyers have used when evaluating the products offered by different sellers. Thus, although only marginal buyers may be well informed, the attributes and prices offered by sellers will be the same as if all buyers were well informed.

An important qualification of the power of marginal buyers to discipline markets and to obtain optimal terms is that such buyers be sufficiently numerous to exert enough influence on the seller to induce the seller to modify the terms on which goods are offered. Schwartz and Wilde indicate that if too few marginal buyers comparison shop, sellers will be able to maximize profit without actively trying to sell to marginal

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56. For example, the assertion that consumers are inadequately informed about the products they buy is a cornerstone of the theory of strict products liability. See *Henningsen v. Bloomfield Motors*, 32 N.J. 358, 384, 161 A.2d 69, 83 (1960) (car buyers were alleged to be unable to evaluate risk of serious injury caused by defective automobiles).

57. See generally M. FRIEDMAN, *The Methodology of Positive Economics*, in 3 *ESSAYS IN POSITIVE ECONOMICS* (1953). Friedman points out that disproving the assumption underlying a theory does not negate the predictive value of the theory. Predictive value can be determined by testing the theory.



buyers.<sup>58</sup>

According to Schwartz and Wilde, there are two types of buyers: shoppers and nonshoppers.<sup>59</sup> A shopper is defined as a buyer who visits more than one seller and who will buy from the seller who offers the product attributes that the buyer most prefers at the lowest price, so long as that price is below that shopper's reservation price.<sup>60</sup> A nonshopper, on the other hand, is a buyer who visits only one seller and will buy from that seller if the price that seller offers is below that buyer's reservation price for the product attributes offered.<sup>61</sup>

In order to satisfy the preferences of shoppers and nonshoppers, a seller will likely offer the product attributes that buyers prefer, charge the absolute lowest possible price, which is the price at which the seller's marginal revenue equals his marginal cost, and sell to all purchasers who visit him.<sup>62</sup> The seller will sell to all potential buyers a product with the attributes buyers prefer and at the lowest possible price.<sup>63</sup> The seller will do this because, if he does not, other sellers will have an incentive to offer the goods with attributes buyers prefer or at a slightly lower price in order to attract shoppers away from the seller with the less preferable attributes or higher price.<sup>64</sup> Thus, for products that lack attributes buyers prefer or that sell at any price above the minimum competitive price, a seller will make no sales to shoppers, and therefore will be able to sell only to nonshoppers.<sup>65</sup> A seller who sells only to nonshoppers will then raise his price to some point between the competitive price and the nonshoppers' reservation prices and might provide attributes different from those that buyers prefer, since the seller will lose no further customers by doing so.<sup>66</sup> Sellers will pursue this strategy, however, only if they will make more profit selling only to nonshoppers at their reservation prices and with attributes different from those that buyers prefer than they would if they sold to both shoppers and nonshoppers with the attributes preferred by

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58. Schwartz and Wilde, *supra* note 34, at 1449-52.

59. *Id.* at 1403-09.

60. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

buyers at the competitive minimum price.<sup>67</sup> Sellers will usually be better off selling solely to nonshoppers only if very few consumers comparison shop.<sup>68</sup>

Several commentators, including Trebilcock and Dewees,<sup>69</sup> and Farber<sup>70</sup> have objected to the theory that the marginal buyer obtains optimal terms for all buyers. They object on the ground that the terms and prices designed to appeal to the marginal buyer are not necessarily optimal for the typical buyer.<sup>71</sup> For example, Farber contends that marginal buyers who expend resources to seek out sellers offering good warranties may be less cautious in preventing product failure than would the typical buyer (for example, by failing to provide routine maintenance), or may be less inclined to seek insurance against product-caused losses from other sources.<sup>72</sup> This assertion, however, appears ill-founded.

It is true that some nonmarginal buyers—and, it should be noted, some *marginal* buyers—may not prefer some of the attributes of the entire bundle of attributes offered by the seller. The buyer's *dislike* of some attributes of the bundle offered by a seller does not, however, mean the bundle as a whole is *suboptimal* for him. The buyer's decision to buy the goods offered by the market, in spite of the fact that he does not prefer some of the particular attributes of the goods, manifests that he values this imperfect bundle, as measured by his willingness to pay for it, as much or more than the price he must pay to obtain it. In essence, the buyer has demonstrated by his purchase that he considers himself to be better off with the goods, imperfect though they may be, than he would have been without them.

The buyer's purchase, however, does not necessarily indicate that the market could not provide him with the attributes he prefers more. Any disharmony between the attributes preferred by a given segment of buyers in a market and the attributes actually offered in the market creates an incentive for a

67. *Id.*

68. *Id.* Schwartz and Wilde extend their analysis to include the comparative advantage of sellers in selling with and without warranties. *Id.* at 1409-12. The impact of the seller's comparative advantage appears to be sufficiently limited so as not to affect the basic analysis of this Article.

69. See Trebilcock & Dewees, *supra* note 53, at 93, 108.

70. Farber, *Contract Law and Modern Economic Theory*, 78 NW. U. L. REV. 303, 333 (1983).

71. *Id.*

72. *Id.* (citing Trebilcock & Dewees, *supra* note 53, at 93, 110, 117).

seller to adapt the attributes of the goods sold to please those buyers currently not satisfied by the attributes offered in the market. If any seller can increase his net return or gain by adapting the attributes of the goods to please nonmarginal buyers, he will do so, and market segmentation will occur.

If no seller can increase his net return or gain by changing the attributes of the goods, he will offer only that bundle of attributes that attracts the marginal buyers. This result indicates nothing more remarkable than that the ability of any given market to satisfy every buyer is constrained by external factors, such as technology, scarcity of inputs, or high transaction costs, that make it inefficient to satisfy each buyer's individual preferences. In the end, although some buyers are unable to obtain exactly the package of attributes they desire, the utility of all buyers, including the somewhat disgruntled buyer, is maximized. Thus, there can be no objection to the fact that the preferences of the nonmarginal buyers may diverge somewhat from those of marginal buyers.

A question does exist regarding whether or not adverse selection or moral hazard will inhibit or prevent sellers from offering warranties of merchantability or fitness so that a competitive market cannot be expected to generate optimal warranty terms. In the context of the extension of warranties, adverse selection occurs when a person knows he can obtain greater gains from warranty protection than the average buyer and has information superior to that of the seller concerning his increased consumption of warranty protection. For example, if a seller warrants a washing machine motor for one year, expecting that the machine will be used by buyers once or twice a week to do household laundry, the owner of a laundromat where the machine will be used twenty-four hours a day, seven days a week has an incentive to purchase the machine to obtain greater benefits than the average purchaser from the warranty protection.<sup>73</sup> Sellers have, however, means to protect themselves against adverse selection while still offering the warranty protection demanded by the market. In the example above, they can include provisions that exclude coverage for commercial or other extraordinary uses.<sup>74</sup>

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73. Priest, *supra* note 48, at 1317; see Bishop, *The Contract Tort Boundary and the Economics of Insurance*, 12 J. LEGAL STUD. 241, 246 (1983); R. RUFFIN & P. GREGORY, PRINCIPLES OF MICROECONOMICS 271 (2d ed. 1985).

74. Priest, *supra* note 48, at 1317.

With respect to the warranty of merchantability, some of the risk of adverse selection is mitigated by the character of the warranty itself. In contracts for the sale of goods, U.C.C. section 2-314(2)(c) provides that the goods must be fit for the "ordinary purposes for which such goods are used." In the washing machine example posed above, in which the machine was designed for household use, one might maintain that commercial use is outside the ordinary purpose of the machine and is, therefore, not covered by the warranty. The indeterminate character of warranties of merchantability,<sup>75</sup> however, presents a substantial risk that a person engaging in adverse selection will be able to convince a trier of fact that his use of the product, although somewhat extraordinary in character, still falls within the scope of the product's somewhat nebulous ordinary use.

With respect to the implied warranty of fitness for a particular purpose, the risk of adverse selection is very low since the warranty will only arise if the seller has reason to know of the particular purpose for which the buyer is procuring the item. Thus, the rules establishing the conditions under which the warranty will exist provide for the communication of information that will minimize or eliminate the risk of adverse selection.<sup>76</sup>

As Priest indicates, a seller facing an adverse selection risk, such as that hypothesized with respect to the washing machine, may modify the product's attributes to force the person with the extraordinary use to purchase a machine more suitable to his use.<sup>77</sup> Moreover, the seller may modify the terms of the implied warranty to exclude extraordinary uses, such as commercial ones, to shorten the terms of the warranty, or to offer more than one set of warranty terms.<sup>78</sup> Thus, adverse selection does not appear to be a substantial impediment to the offering of implied warranties if buyers demand them.

Moral hazard may occur in a warranty context when a

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75. See *infra* text accompanying notes 114-16.

76. Cf. Bishop, *supra* note 73, at 254-60 (maintaining that the rule of *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854), requiring a promisee to divulge information about any extraordinary loss he might suffer as a result of breach in order to recover for such loss, mitigates the adverse selection problem by promisees who would suffer extraordinary loss).

77. Priest, *supra* note 48, at 1318.

78. *Id.* at 1347.

person fails to take cost-effective measures to assure that a loss does not occur because the warranty fully insures him against the loss. The person's behavior will result in greater consumption of the warranty's insurance than is optimal. When a seller warrants that a product will be merchantable or fit for its ordinary purpose for a certain period of time, a buyer may have an incentive not to make socially optimal investments of his own to assure that the good does not become unfit because the warranty protects against the cost of that risk. To eliminate moral hazard problems, sellers may require buyers to make appropriate investments in care, such as performance of routine maintenance as a precondition of warranty coverage. Additionally, sellers may exclude from coverage instances in which there has been product misuse<sup>79</sup> or sellers may even force the buyer to bear some of the cost of warranty service, for example, by requiring a buyer to return the product to the seller for warranty work. Moreover, any uncompensated loss the buyer may suffer if the product fails gives the buyer an incentive to avoid such failure.<sup>80</sup> Moral hazard does not appear, therefore, to be a significant barrier to the provision of implied warranties.

Before we can conclude that the buying behavior of marginal buyers will generate optimal warranty terms, several questions pertaining to the competency and impact of such behavior remain to be addressed. In particular, it must be established that it is probable that marginal buyers are sufficiently well-informed about the effects of warranty disclaimers and the probability and cost of product failure to provide appropriate incentives for sellers to offer optimal warranty terms.

If marginal buyers do not understand the legal effect of warranty disclaimers, they may demand suboptimal warranty terms.<sup>81</sup> An underestimation of a disclaimer's effect will result in an excessive demand for such a term, while an overestimation will produce insufficient demand for a disclaimer.

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79. See Bishop, *supra* note 73, at 264.

80. See Schwartz & Wilde, *supra* note 34, at 1445-46.

81. The question of whether it is reasonable to assume that marginal buyers whose decision to purchase is affected by the content of warranty terms know of the existence of warranty disclaimers is not addressed in the text. If marginal buyers are unaware of such disclaimers, they cannot be assumed to be able to demand optimal disclaimer terms. Since these buyers will not purchase a product unless they receive the warranty terms they prefer, it is reasonable to believe that they are familiar with the content of warranty provisions in contracts, including disclaimer provisions.

How such buyers know of the existence of disclaimers is less important than

The proposition that marginal buyers probably either understand or overestimate the effect of warranty disclaimers is supported by several factors. Some disclaimers contain language such as "as is" that is commonly perceived as meaning that the seller makes no commitment as to the quality of the product sold.<sup>82</sup> Since language of this sort is frequently used in connection with the sale of used products for which no warranty is given, it is reasonable to believe that many buyers, and certainly marginal buyers, will comprehend the significance of such language.

For other disclaimer terms, such as, "merchantability," it is commonly assumed that buyers do not comprehend the concept of such terms. However, marginal buyers whose purchasing behavior is affected by the content of warranty terms

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*whether* they know, but the manners in which such information is obtained can be explained.

First, with the exception of transactions in consumer goods as to which § 2308(a) of the Magnuson-Moss Act precludes modifications or disclaimers of implied warranties, warranty disclaimers are ubiquitous in contract documents. Moreover, in sales of goods governed by U.C.C. § 2-316, written disclaimers of implied warranties must be conspicuous, that is, they must be noticeable to a reasonable person. U.C.C. § 1-201(10).

Second, at least marginal buyers are likely to become aware of contract terms, such as warranty disclaimers, because these terms will likely affect the buyer's welfare during the performance of the contract in which the term appears or in similar contracts with which the buyer has had previous experience. From common experience, it is plausible to assume that most people pay little attention at the time of purchase to the terms of a disclaimer of liability appearing on the back of a form contract. Nevertheless, it is still likely that they enter into transactions subject to such terms with relative frequency. It is credible to assume that such buyers occasionally examine the terms of at least one of these contracts over the course of numerous transactions. For instance, a buyer may encounter a problem with a product and examine the product's warranty to determine the character and extent of the coverage. If the buyer is unable or unwilling to examine the warranty, he may simply demand that the seller repair the product. The seller's subsequent acceptance or rejection of the buyer's request will then inform the buyer of the *de facto* warranty terms. Thus, a buyer entering into form contracts should be able to get a good idea of the typical terms appearing in such contracts and can use his knowledge of those terms as a basis for decisions regarding subsequent similar purchases. Although the buyer may be ignorant of the terms of a particular contract, his knowledge of the typical terms appearing in similar contracts into which he has previously entered should be adequate to allow him to infer the terms of the contract into which he is presently entering.

82. The notion that "as is" has this common connotation is supported by the Federal Trade Commission Used Motor Vehicle Trade Regulation Rule, 16 C.F.R. § 455.2(a)(1) and (2) (1989), which requires a used car dealer to display a sticker on an automobile indicating whether it is a no warranty or warranty transaction. To indicate that it is a no warranty transaction, the form must provide a box followed by the terms "as is—no warranty." Although the additional qualification "no warranty" is added to the term "as is," the use of the latter clearly indicates its significance to members of the purchasing public accustomed to buying used goods.

probably do comprehend the concept since its effect may significantly affect the value of a warranty to them. Therefore, they have an incentive to engage in a cost-effective search to ascertain the effect of a disclaimer containing that term. Moreover, even if it is assumed that insufficient incentives exist to investigate the precise effects of such a disclaimer, marginal buyers would probably assume the worst possible warranty coverage consistent with the information provided, that is, that there is no warranty whatsoever.<sup>83</sup> If, in fact, the disclaimer had a less drastic effect, the buyer would assume the seller would say so, since doing so would increase the value of the transaction to the buyer and result in increased sales and revenue to the seller.<sup>84</sup>

If a buyer decides to purchase a product despite his incorrect assumption that a disclaimer is broader than it really is, he will have obtained the good he desires on terms that are at least minimally acceptable to him. He simply will have erred on the side of purchasing more protection than he otherwise would have if he were better informed. The incorrect assumption is certainly inefficient in the sense that it will cause buyers to overestimate the total cost of goods they buy, thereby causing them to consume a suboptimal amount of goods. However, buyers will have purchased more warranty protection than they would have preferred, not less, and can hardly be said to have been victimized by their ignorance in any exploitive sense.<sup>85</sup>

Finally, at least some marginal buyers will become familiar with the effects of warranty disclaimers because such disclaimers will affect the buyers' welfare in some of the transactions in which disclaimers are used. Over time, buyers enter into numerous transactions where warranty disclaimers are involved. During the performance of some of these transactions, problems with the items sold are likely to occur. If a buyer is unaware of the effect of a disclaimer when entering into a transaction, he will probably learn its effect when he seeks relief from the seller. From this and similar experiences,

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83. Cf. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461, 465-466 (1981) (explaining that consumers rationally expect a seller's quality to be the poorest possible consistent with his disclosure).

84. *Id.*

85. See Priest, *supra* note 48, at 1304 (research of numerous warranty disclaimers indicates similarities in the kinds of attributes found in such disclaimers).

the buyer will obtain information about the legal effect of disclaimers and will store this information for use in future transactions since it will assist in assessing the value of those transactions and in minimizing the risk of making a purchase with suboptimal terms.

If marginal buyers inaccurately estimate the probabilities that products will fail, they will demand and sellers will provide suboptimal warranty terms. If such buyers overestimate the probability of product failure, they will demand excessive warranty protection; if they underestimate such probability, they will demand insufficient warranty coverage.

Although equally serious from an efficiency perspective, overestimating the probability of product failure is probably considered less serious with respect to warranty protection than underestimation. As previously noted with respect to a purchaser's "worst case" assumption about the meaning of "merchantability,"<sup>86</sup> the consumer will have purchased more warranty protection than he would have if accurately informed. Purchasing more warranty protection will raise the price of the good more than is optimal, and the buyer will consume less of the good than if he were accurately informed.<sup>87</sup> The prospect of this underconsumption provides an incentive for sellers to provide more accurate information about product failure to cure excessive pessimism. Sellers may also engage in activities such as advertising to signal buyers about the quality of their products.<sup>88</sup> Moreover, an incentive exists for third-party sources of information, such as *Consumer Reports* and specialty journals and magazines, to provide accurate information to protect buyers from excessive expenditure on warranty protection.<sup>89</sup>

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86. See *supra* text accompanying notes 83 and 84.

87. To some extent purchasing more warranty protection than is optimal will increase problems of moral hazard and adverse selection. A purchaser of a washing machine, for example, may exercise less care in maintaining the appliance if she now perceives that the product's failure will be covered by the warranty. See Priest, *supra* note 48, at 1349.

88. See Kein and Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615, 630 (1981) (indicating that sufficient investment in advertising by a firm implies that the firm will not engage in short-term quality deception since the cost of advertising is a sunk cost that can only be recouped through future quasi-rents, the existence of which depend on current product quality).

89. See *Auto Service Contracts: Don't Buy One When Your Car Is Brand New. And Think Twice About Buying One At All*, CONSUMER REP. 663 (Oct. 1986) (advising new car buyers to purchase an extended warranty or service contract only for cars having a high frequency of repair as indicated in the organization's survey of car



To some, the more serious potential error in estimating product failure is the underestimation of such failure that results in consumers demanding too little warranty protection. Some evidence supports the proposition that buyers lack the information processing ability in some instances to assess the need for appropriate product attributes or contract terms. For example, some analysts contend that people, in this instance buyers, ignore or underestimate the likelihood of the occurrence of low-probability events.<sup>90</sup> A buyer may, for example, underestimate the probability of a beverage bottle exploding. As indicated above, if the buyer underestimates or ignores such a risk, he will demand, and sellers will provide, less product safety than the buyer needs and would demand if the buyer's perception of the risk of injury were accurate.

Assuming as accurate the proposition that people are incapable of evaluating accurately or do not perceive the risk of low-probability events, we believe there are limiting circumstances that preclude that phenomenon from being a serious issue with respect to product deficiencies ordinarily encompassed by the warranties of merchantability and fitness.<sup>91</sup> First, as Schwartz and Wilde point out, people's tendency to underestimate or ignore low-probability events may be a function of the "availability heuristic."<sup>92</sup> Although people underestimate the occurrence of some low-probability events, they either assess accurately or overestimate the occurrence of

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purchasers); 1987 *Buying Guide Issue*, CONSUMER REP. 55 (Dec. 1986) (recommendation against purchasing extra rust-proofing given the extent of manufacturer rust-proofing of new cars and warranties against rust perforation).

90. Kahneman & Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979).

91. Liability for personal injury resulting from defective products is dealt with under products liability law in torts and is no longer subject to contract and sales law except in cases in which the injured person may find greater protection under a warranty. See WASH. REV. CODE §§ 7.72.010-.060 (1989) (providing for liability of manufacturers and sellers of injury-producing products including manufacturer liability for products that are not reasonably safe because they fail to conform to implied warranties).

92. Schwartz & Wilde, *supra* note 34, at 1441. The availability heuristic is a rule of thumb used to gauge the frequency or probability of an event's occurrence. The heuristic is based on the ease with which instances of the occurrence are brought to mind. Tversky & Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 *SCIENCE* 1124, 1127-28 (1974). Availability is affected by several biases that may lead to erroneous judgments. For example, when determining the size of a class, a person may judge a class whose members are more easily remembered as more numerous than a class whose members are more difficult to remember although the size of the two classes is the same.

others.<sup>93</sup> To the extent Schwartz and Wilde's contention is correct, buyers may overestimate the likelihood of some product defects occurring, such as automobiles undergoing sudden acceleration, because such events receive significant publicity. Moreover, empirical evidence indicates that some, perhaps most, problems with goods and services are not infrequent, low-probability events. In one survey of consumers who had purchased various goods and services, the consumers voiced non-price problems with 32% of automobile purchases, with 26% of vacuum cleaner purchases, and with 28% of clothing purchases.<sup>94</sup> The authors of this study concluded that their data supported "the conventional belief that consumers suffer frequent problems with purchases."<sup>95</sup> Finally, if product defects ordinarily were low-probability events, underestimated by buyers, one would not expect to see the existing level of seller activity in providing and fulfilling express warranties with respect to such defects.<sup>96</sup>

In addition to the failure to recognize or to correctly estimate the occurrence of low-probability events, marginal buyers may also underestimate the probability of product failure because of insufficient information about such failure or because they gather such information from inadequate sources. Evidence indicates that people tend to use information that is readily available and understandable when making a decision and that such information may inaccurately represent the

93. Schwartz & Wilde, *supra* note 34, at 1441.

94. Best & Andreasen, *Consumer Response to Unsatisfactory Purchases: A Survey of Perceiving Defects, Voicing Complaints, and Obtaining Redress*, 11 LAW & SOC'Y REV. 701, 705 (1977). For a similar study, see Ross & Littlefield, *Complaint as a Problem-Solving Mechanism*, 12 LAW & SOC'Y REV. 199 (1978) (dissatisfaction cited in 19% of television and washing machine purchases).

95. Best & Andreasen, *supra* note 94, at 706. The occurrence of problems is not necessarily indicative of sellers' attempts to provide products of appropriate quality but of their attempts, perhaps somewhat imperfectly, to do so cost effectively.

96. We are thankful to Bruce Mann for this observation. The above discussion does not mean that there are not low-probability product defects the existence of which buyers may ignore or underestimate. Rather, it indicates that the range of such defects may be quite limited based both on the frequency with which buyers do perceive product defects and the interrelationship of the availability heuristic with the underestimation phenomenon. It cautions against an overgeneralization that a market probably has failed because the problem manifested had a low probability of occurrence. Such a generalization would probably cause courts to invalidate warranty disclaimers too frequently, causing excessive and suboptimal warranty protection.

Judicial or other legal intervention to preclude disclaimers dictated by the market ought only be undertaken when the decisionmaker is assured that the risk was not only one of low probability but also that the market failed to provide the correct warranty. See Schwartz & Wilde, *supra* note 34, at 1441-42.

whole of available information.<sup>97</sup> For example, a buyer may talk to two product owners who have not experienced product failure and come to the conclusion that the probability of failure is quite low, whereas a more accurate and larger sample would indicate a higher probability. The dependence on available information is unlikely to result in marginal buyers as a *whole* underestimating product failure probabilities since there are likely to be buyers who obtain excessively negative information, so that the information in the market is likely to be accurate concerning the probabilities of product failure. Moreover, buyers should be able to make somewhat accurate estimations of probable product failure from prior use with a prior or comparable model of the same product or experience with other similar products.

Although such experience may not provide entirely accurate information about failure probabilities for the particular product, it should apprise the buyer of the potential existence of such problems that will, to the extent it is perceived to be cost-effective, stimulate the buyer to seek accurate information about potential problems with the good from other sources. Even without such prior experience, buyers of expensive, infrequently purchased products that present high potential for loss if defective have an incentive to reduce the risk of loss by seeking information from unbiased sources such as *Consumer Reports* and other highly specialized sources of information.<sup>98</sup>

With respect to moderately priced, infrequently purchased items that do not present the risk of substantial loss if defective, such as an iron or toaster, the value of such a search may not be sufficiently high, and the potential for underestimating product risk is more likely. But even with respect to these products, those which have significant defects will cause their purchasers to enter the market more frequently to acquire replacements. From their prior experience, these buyers will have better information concerning the probability of product failure. Moreover, if the benefit to individual buyers is too small to justify an information search, and yet, to purchasers of the product as a whole the benefit is sufficiently significant

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97. See Tversky & Kahneman, *supra* note 92, at 1127-28.

98. For a formal proof of the search activity of these buyers, see Schwartz & Wilde, *supra* note 34, at 1432. See Kiel and Layton, *Dimensions of Consumer Information Seeking Behavior*, 18 J. MARK RES. 233, 237 (1981) (positive correlation between product price and amount of search).

to justify a search, an incentive will exist for a third party to acquire and sell the information.

Finally, although an expected diminution in sales gives a seller little incentive<sup>99</sup> to give correct information about the probability of a defect if consumers underestimate its existence, a seller does have an incentive to inform buyers, at least by implication, of deficiencies in competitors' products. For example, an appliance manufacturer who sells a washing machine with greater reliability, durability, or longevity has an incentive either to compare his product directly with that of other manufacturers or to state or imply that competitor products are inferior with respect to these attributes. Such behavior may not give entirely accurate information about product attributes of competitors but at least provides some information from which consumers can proceed to acquire more accurate information.

In addition to knowing the probability of product failure, a buyer must have an accurate perception of the cost that will be incurred if such a failure does occur. The reason such knowledge must exist is that it affects the value any warranty may provide. Such value is important because warranties are costly to provide, service, and enforce. It is unreasonable to assume that buyers would be willing to pay for a warranty that protects against the occurrence of a relatively high-probability defect, the cost of which is less than the cost of making and enforcing the warranty. The consumer would prefer to buy the product without warranty protection at a lower price. Here again, buyers may obtain substantially accurate estimations of the potential cost of product defects from the use of the same or similar products. Even if a buyer has purchased a newer model of a product, he may extrapolate fairly well the cost of repair from his use of a prior model. Thus, an automobile buyer who previously has incurred the cost of repairing a failed transmission may, with information about current labor costs, form a fairly good idea of the cost of repairing a new transmission in a similar automobile. Indeed, knowledge of the increasingly more costly and complex nature of many products may lead buyers to overestimate rather than underestimate

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99. Schwartz & Wilde, *supra* note 34, at 1429-30, point out that there is an incentive to provide accurate information to avoid disgruntled customers and the loss of good will. As they indicate, however, it probably is better for the seller to provide the same warranty coverage but bury its cost in the product's overall price.

defect costs. Some buyers may underestimate the cost while others overestimate it. As long as the estimation as a whole is accurate, however, any individual misestimation would be irrelevant to providing an optimal term. Moreover, sellers who offer extended warranties or service contracts may be expected to provide information protecting buyers against the risk of underestimating repair costs.<sup>100</sup> Finally, as in the situations mentioned above, at least with respect to defects in expensive, infrequently purchased products, one would expect information about at least the magnitude of defect costs to be available from third-party sources.<sup>101</sup>

#### D. Summary of Economic Principles

Thus far, we have described the fundamental economic concepts that we will later use to analyze the rationales relied upon by the *Berg* court to justify its ruling. By examining the interrelationship of those concepts, we have come to some basic conclusions: First, competitive markets will provide consumers with products that have optimal attributes, under contractual terms that allocate risks in an optimal manner, and at a price that will attract as many buyers as possible while still allowing the seller a reasonable return on his investment.

Second, perfect competition is not necessary to assure that products and contractual terms offered by sellers will be optimal. Even under conditions of imperfect competition, such as monopoly, sellers will have an incentive to conform their products and terms to those desired by the greatest number of buyers, except that the incentive to keep prices at the competitive equilibrium will be weaker, and, therefore, prices will be higher than they would be under conditions of perfect competi-

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100. See R.C.A. extended service contract information warning that the labor portion of unwarranted repairs can be expensive (on file with the University of Puget Sound Law Review).

101. See *1989 Buying Guide Issue*, CONSUMER REP., which includes estimated repair costs for used automobiles based on surveys of its readers. The report presents the survey results with respect to frequency of repairs for 1982-87 model cars. It also indicates the average repair costs for 1982-86 models and the extent to which a particular model deviates from the average. Although this information pertains to used cars, it provides a basis for estimating the repair costs of new models. There would appear to be little risk that a buyer reading the survey would underestimate the frequency or cost of repair for a new car, the previous models of which were much worse than average in these categories. It is more probable the buyer would assume a "worst case" scenario with respect to such costs absent strong, credible evidence to the contrary.

tion. The amount of goods produced under monopoly conditions will also be lower than under competitive conditions.

Third, only a relatively small percentage of buyers need to comparison shop to motivate sellers to offer goods preferred by the greatest number of buyers on terms those buyers find optimal. Although reliance on the decisions of such buyers requires that they be reasonably well informed as discussed above, buyers are likely to be able to obtain the necessary information by reading the contract, by inspecting and using the goods, by obtaining information from third parties such as friends and consumer magazines, and through repeat purchases of similar goods. This information is likely to be enhanced further by sellers of above average quality goods, who will have an incentive to indicate that the quality of their goods is above that of their competitors, and by the negative inferences drawn by buyers from the failure of some sellers to make such claims.

With these conclusions, it is appropriate at this point to examine the economic validity of the rationales used by the courts applying *Berg* to justify the requirement that disclaimers of warranty be specifically negotiated and that those disclaimers set forth with particularity the attributes being disclaimed.

#### IV. ANALYSIS OF THE BERG RULES

##### A. *Perceived Market Failures*

##### 1. Buyers' Imperfect Information

Among the rationales used to support the requirements in *Berg* that disclaimers of implied warranties be individually negotiated, and that the attributes being disclaimed be described with particularity, is the claim that such rules are needed to ensure that buyers are aware of the terms of the contracts they sign and have assented to those terms.<sup>102</sup>The

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102. *Berg v. Stromme*, 79 Wash. 2d 184, 193-95, 484 P.2d 380, 385-86 (1971). The court implied that a disclaimer of warranties in a contract for the purchase of a new car is strong evidence that the buyer never intended to agree to the terms of the contract. The facts of *Berg* itself tend to negate this assertion. The plaintiff in *Berg* was a psychiatrist of presumably higher than average intelligence who had previously purchased cars from the same dealer. It is, therefore, reasonable to assume that the plaintiff had notice or actual knowledge of the terms appearing in contracts covering later purchases from the same seller. Signing the contract under these circumstances can be seen only as an act of assent.

principal error of this justification is that it overestimates the importance of any given buyer reading a contract. As pointed out earlier,<sup>103</sup> only a relatively small number of buyers need to read form contracts in order to influence sellers to provide contract terms appealing to the greatest number of buyers. Thus, buyers who do not invest resources to negotiate disclaimers specifically or to discover every particular attribute being disclaimed can rely on buyers who do take such steps to choose the most optimal products and terms possible. Complete information on the part of all buyers, or even most buyers, is therefore not a necessary condition of a properly functioning market. Thus, the *Berg* court's rationalization of specific negotiation on that ground must fail.

Furthermore, requiring every buyer to explicitly negotiate over disclaimers contained in contracts fails to recognize that buyers will refuse to read contract terms or negotiate over them only when they have concluded that the marginal benefit of doing so does not justify the marginal cost.<sup>104</sup> Most buyers probably recognize that they could improve their understanding of the terms of the contracts they enter by reading the contract themselves or by consulting persons better able to evaluate the contract, such as better-informed friends or an attorney. The fact that many buyers see fit to sign contracts without obtaining help from others, or many times without even reading the contract, most likely is explained by their conclusion that the cost of such measures is greater than the expected benefits of undertaking them. Thus, those buyers who would otherwise refuse to negotiate over disclaimers because of their conclusion that they would be no better off by doing so are forced by the *Berg* rule to undertake those procedures anyway. Because these buyers are forced to spend

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103. See *supra* text accompanying notes 57-62.

104. In *Frickel v. Sunnyside Enters.*, 106 Wash. 2d 714, 725 P.2d 422 (1986), the court held that buyers of commercial property were bound by a disclaimer appearing in the contract, partly because they were represented by an attorney and partly because they failed to protect themselves by hiring an expert to inspect the property for defects. *Id.* at 721-22, 725 P.2d at 426. It seems highly unlikely that the court would have required the plaintiffs to hire such experts if the transaction had involved a less expensive item, such as a used automobile. Such a difference in treatment can be explained only by a recognition that buyers are responsible for investing resources to determine contract terms and product attributes up to the point at which it is no longer cost effective to do so. The same rationale would permit disclaimers to be effective even if the buyer has determined that it is not cost effective for him to investigate the terms of the contract or the precise nature of the particular attributes being disclaimed.

resources negotiating when they would rather not, they are unable to spend those resources in other ways that they must value more highly. To force them to engage in such negotiation is inefficient and makes both buyers and society as a whole worse off than they would be if buyers were able to choose whether to negotiate over disclaimers.

Moreover, although it is possible that some buyers may have *no* idea that disclaimers of warranty exist, such ignorance is both unlikely and irrelevant from a conventional contracts perspective. *Complete* ignorance of disclaimers is unlikely because disclaimers are used pervasively except in transactions governed by the Magnuson-Moss Warranty Act and in jurisdictions that prohibit disclaimers at least in some transactions.<sup>105</sup> Thus it is unlikely that a buyer would not expect to find a disclaimer in a contract he was about to sign. Furthermore, as pointed out above, only a relatively small minority of buyers needs to be informed about the terms of a contract to ensure that sellers have adequate incentives to offer those terms that are desired by the greatest number of buyers.

Ignorance of the terms of a contract is also irrelevant in determining whether a party has assented to a contract, so long as the buyer has reason to know that he is entering into a contract and the seller is not engaged in an attempt to defraud the buyer.<sup>106</sup> Several years after *Berg* was decided, the Washington Supreme Court stated that "the whole panoply of contract law rests on the principle that one is bound by the contract which he voluntarily and knowingly signs."<sup>107</sup> Indeed, were this not the rule, it would be difficult to see how a person who could

105. The number of contracts in which disclaimers appear is undoubtedly lessened by § 2308 of the Magnuson-Moss Act, *supra* note 28, which prohibits a seller of consumer goods from disclaiming implied warranties when the seller makes an express warranty of the kind defined by the Act. To the extent that § 2308(a) of the Act reduces the number of disclaimers of implied warranties, buyers are deprived of an opportunity to learn about them through experience, contributing to consumer ignorance of disclaimers—a result contrary to the purposes of the Act as stated in § 2302(a).

106. See RESTATEMENT (SECOND) OF CONTRACTS § 211 (1980). Subsection 3 provides that a term in a writing does not become part of the agreement if one party has reason to believe that the other party would not manifest assent to the agreement if he knew the writing contained the particular term. This provision ordinarily ought not apply to disclaimers of implied warranties since the historical existence of disclaimers in markets over an extended period of time would lead sellers to believe that buyers would assent to transactions even if the buyers knew of the existence of such terms in the particular writings involved.

107. National Bank of Wash. v. Equity Investors, 81 Wash. 2d 886, 912-13, 506 P.2d 20, 36 (1973) (dictum).



not read or understand the language in which a contract was written could ever be bound by it.<sup>108</sup>

Although the *Berg* individual negotiation rule succeeds at increasing buyers' awareness of disclaimers, albeit to an inefficient level, the rule does little, if anything, to accomplish another of its implied purposes, which is to ensure that the buyer has an opportunity to negotiate with the seller over the terms that the buyer might consider suboptimal. Individual buyers, like individual sellers, are very unlikely to be able to negotiate terms other than those regarded as optimal by most buyers and sellers. Instead, sellers will offer to contract only on the terms contained in their standard contract—terms that they have previously determined to be most nearly optimal. Any buyer attempting to vary the terms of these standard contracts will most likely be rebuffed by the seller, who will prefer to deal with another buyer.<sup>109</sup> Thus, even if a buyer were to gain knowledge of a disclaimer by virtue of specific negotiation, it is highly unlikely, especially in cases of goods sold under standard form contracts, that the buyer will be able to negotiate a different term. The buyer will simply be left with a "take-it-or-leave-it" offer.<sup>110</sup>

Second, even if mandatory negotiation over terms were optimal, it is probable that the parties to a transaction would not negotiate concerning the disclaimer of part or all of the implied warranties, since the marginal costs of simply negotiating a lower price while leaving the standard form disclaimer intact would be cheaper than negotiating and drafting limita-

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108. For a case indicating that contracts are binding without regard to whether the signer is able to read, see *Cohen v. Santoianni*, 330 Mass. 187, 192, 112 N.E.2d 267, 271 (1953) (dictum). The signer need not even be able to read the language in which the contract is written. *Secoulsky v. Oceanic Steam Navigation*, 223 Mass. 465, 112 N.E. 151 (1916); cf. Comment, *Plain English Contracts: The Demise of Legalese?*, 30 BAYLOR L. REV. 765, 777-79 (1978) (advocating adoption of a law to require Spanish copies of English contracts to be given to buyers upon request); see also Calamari, *Duty to Read—A Changing Concept*, 43 FORDHAM L. REV. 341, 341-49 (1974).

109. The inability of the individual buyer to affect the terms offered by sellers in the market is analogous to the economic phenomenon of sellers who are "price takers." Price takers are sellers who offer their goods in markets in which there are a large number of sellers offering identical goods. If any of the sellers attempts to raise his price above the price set by the market, that seller will lose all sales to any other sellers offering their goods at the market price. See A. ALCHIAN & W. ALLEN, *supra* note 38, at 205.

110. Of course, the buyer faced with a suboptimal contract term will consider the extent to which the presence of that term in the contract reduces the value of the good to him when deciding at what price he will buy.

tions on the warranty disclaimer.<sup>111</sup> Even if the buyer believed it to be optimal to obtain greater warranty coverage than provided with the standard form disclaimer, it would probably be cheaper for the seller to provide an express warranty for the desired coverage than to carve exceptions from the standard form document with the costs of employing persons competent to draft such exceptions or the attendant risks of allowing unqualified persons to do so.

Even if we were to accept the premise that buyers in uncompetitive markets are forced to accept terms that they consider suboptimal, it is difficult to see how explicit negotiation or particular disclosure of the attributes disclaimed would help buyers. According to the premise just stated, buyers in monopoly-controlled markets are unable to negotiate successfully with the seller. Thus, requiring explicit negotiation would lead only to the monopolist offering his terms and the buyer either taking them or leaving them.

The *Berg* court also supported its requirement of explicit negotiation by emphasizing the irony of a seller's contract that contains both express warranties *and* disclaimers of any responsibility for assuring that the subject goods will be fit for their ordinary purpose.<sup>112</sup> Although this argument has some appeal, upon careful scrutiny it appears to have several problems.

First, the argument confuses two separate issues. The *Berg* court, for example, assumed that no buyer would contract for the purchase of a car with express warranties while at the same time implicitly negating his deal by agreeing to a disclaimer of the warranty of merchantability.<sup>113</sup> This argument fails to consider that accepting a disclaimer of merchantability is perfectly consistent with a transaction in which an express warranty is given, and in which the buyer, although expecting to receive a car of merchantable quality, nevertheless is willing to forego a legal remedy against the seller if the car in fact turns out to be unmerchantable. A seller may, for example, be willing to warrant that a product possesses a particular attribute without warranting that the product will attain a certain level of performance.

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111. See *infra* text accompanying notes 125-27 (discussing further the costs of disclaiming individual attributes of the merchantability warranty).

112. *Berg v. Stromme*, 79 Wash. 2d 184, 193, 484 P.2d 380, 385 (1971).

113. *Id.*

Moreover, as Priest points out,<sup>114</sup> the legal standard for determining whether an implied warranty of merchantability has been breached is inherently indeterminate. It is therefore costly to establish whether the warranty has in fact been breached. Furthermore, since determinations of what "merchantable" means in a given situation are usually made by juries, there is a significant possibility of error costs.<sup>115</sup> Different juries will reach different conclusions about the scope of the warranty of merchantability under similar facts, thereby making it difficult for sellers to estimate correctly their likelihood of success in any given suit for breach of the warranty. These factors combine to make performing, policing, and enforcing an implied warranty of merchantability relatively expensive, and thus present a legitimate explanation for disclaimers of the implied warranty of merchantability.<sup>116</sup>

Second, the argument that no buyer would voluntarily disclaim a warranty of merchantability mistakenly assumes that such legal sanctions are the only means buyers have of insuring that they receive a merchantable product. Sellers are subject to competition from other sellers, not only for current purchases, but also for purchases to take place in the future. Thus, sellers have an inherent incentive to provide good products to buyers, despite the lack of any legally enforceable remedy on behalf of the buyer if they fail to do so.<sup>117</sup> The disciplining effects of these competitive forces are extremely well illustrated by the facts of the *Berg* case itself. In *Berg*, the defendant car dealer attempted to repair the plaintiff's car several times,<sup>118</sup> although the dealer was under no obligation to do so according to the explicit terms of its contract with the buyer. Such activity can be explained logically only by the seller's desire to retain the goodwill of the buyer and of those persons whose future purchases the buyer may be able to influence.

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114. Priest, *supra* note 48, at 1344-45.

115. *Id.*

116. See Calfree & Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 965-67 (1984).

117. See Darby & Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 73 (1973); see also Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 448, 499-500 (detailing customer retaliation against brand-name goods when those goods have proven faulty before).

118. *Berg v. Stromme*, 1 Wash. App. at 917, 465 P.2d at 182 (1970) (the appellate court indicated that the dealer worked on the car for a total of over 45 days).

*B. Berg as Applied to Parties with Knowledge of a Disclaimer*

Although the Washington Supreme Court may be unwilling to follow them,<sup>119</sup> the courts of appeal have held in a disturbing number of cases that disclaimers are ineffective against commercial parties who had actual knowledge of the existence of those disclaimers on the ground that they were not explicitly negotiated. Such decisions are obviously unnecessary to further *Berg's* goals of assuring that buyers have notice of disclaimers and truly assent to them, since the buyers in those cases were merchants who knew of the disclaimers, who had bargaining power apparently equal to that of the seller, and who clearly assented to the disclaimers by signing the contracts containing the clauses.

The Washington Supreme Court has recently indicated that it may be unwilling to allow the expansion of *Berg* to include cases in which a party invoking *Berg* to resist the disclaimer had knowledge or notice of the term. In *Travis v. Washington Horsebreeders Association*,<sup>120</sup> the court refused to strike down a disclaimer even though it had not been specifically negotiated. The court pointed out that the disclaimer was contained in an auction catalog, was clear and conspicuous, and, in a radical departure from *Berg*, stated that the disclaimer was binding upon the buyer regardless of whether the buyer had even seen it, let alone negotiated with the seller over it. Central to the court's reasoning was its recognition that buyers and sellers would voluntarily choose to adopt such a rule over one requiring specific negotiation of terms in order to reduce their transaction costs.<sup>121</sup> Although the court distinguished the *Travis* case from *Berg* on the ground that *Travis* involved an auction, the transaction costs reducing rationale used by the court to support *Travis* applies with equal force to any transaction in which the parties desire to reduce the costs of entering contracts by using nonnegotiable standard terms.

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119. See *Travis v. Washington Horse Breeders Ass'n*, 111 Wash. 2d 396, 759 P.2d 418 (1988) (refusing to strike disclaimer contained in auction catalog); *Frickel v. Sunnyside Enters.*, 106 Wash. 2d 714, 725 P.2d 422 (1986) (refusing to strike disclaimer contained in contract for sale of commercial property even though not explicitly negotiated).

120. 111 Wash. 2d 396, 759 P.2d 418 (1988).

121. *Id.* at 403-04, 759 P.2d at 422.

### C. Other Economic Ramifications of Berg

Although the economic principles laid out above indicate that the rationales relied upon by the *Berg* court to support its ruling are of questionable merit, there are other economic ramifications of the *Berg* rules with which the courts have not dealt. In this section, we examine some of those ramifications.

One effect of the *Berg* rules that has not been discussed by the courts is the rules' tendency to limit buyers' choices. Different buyers have different preferences regarding the total package of product attributes that they receive when they purchase a good. These attributes include such factors as the quality of the good itself, the warranty and return privileges offered in the seller's contract, and the pleasantness of the surroundings in which the transaction takes place. To the extent that sellers can increase their net return by adjusting the attributes of the sale of a given good to satisfy the peculiar wants of various subgroups within a market, they will do so. This adjustment by sellers will cause market segmentation, ranging in degree from subtle to radical. Thus, some sellers offer relatively poor quality goods with no warranty out of the back of a truck, while other sellers offer high quality goods with a guarantee of complete satisfaction in stores with plush decor.

The *Berg* rules artificially narrow buyers' choices by restricting the variety of conditions under which sales of goods can be made. Under *Berg*, no buyer desiring to forego tedious negotiations of disclaimers or a discussion of each attribute disclaimed can find a seller who is able to *legally* include a disclaimer in the contract without those rituals. *Berg* imposes mandatory bargaining and disclosure upon buyers who would rather not pay for the privilege. To the extent that buyers' demand for a product is elastic and sensitive to the added cost of forced negotiation,<sup>122</sup> demand for the seller's product will drop, causing the resources he otherwise would have used to produce more of his product to be used less efficiently in other endeavors.<sup>123</sup> Even if the buyers' demand is not sensitive to

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122. Those readers who might scoff at the idea that buyers' demand for a product would be sensitive to the added costs of specific negotiation and particular disclosure should ask themselves whether they would not be less willing to buy a very low-priced item if they had to specifically negotiate with the seller a disclaimer of warranty and then listen to the seller's particular disclosure of the attributes being disclaimed.

123. The desirability of buyer's choice is not absolute. For example, products that impose significant externalities upon society, such as highly polluting cars, might

the added costs of specific negotiation and particular disclosure, the *Berg* rules nevertheless impose transaction costs that the parties would rather expend in other, more productive ways, and thus impose a net welfare loss on society.<sup>124</sup>

For example, buyers and sellers are prohibited from agreeing to disclaim implied warranties of fitness and of merchantability unless the disclaimer "set[s] forth with particularity the . . . particular qualities and characteristics of fitness which are being waived."<sup>125</sup> A buyer and seller who wish to disclaim the implied warranty of fitness for a particular purpose or of merchantability cannot, therefore, rely on a simple statement that unequivocally and clearly expresses that intent, as do the phrases "as is" or "with all faults," which are allowed by statute in the case of sales of nonconsumer goods.<sup>126</sup> Instead, both the buyer and seller must expend resources to disclose and to discuss the precise attributes of the warranty of merchantability that are to be disclaimed, which in the case of a blanket disclaimer are all attributes. Since an all-encompassing, individually negotiated (as opposed to standard-form) disclaimer is highly impracticable, if not economically infeasible, the likely result is that sellers and buyers will disclaim merchantability only as to those attributes that are the most costly to warrant, and will leave the seller responsible for the merchantability of all other attributes. In the long run, the market will most likely compensate the seller for the expense of warranting these attributes by passing most of the cost on to the buyer in the form of a higher price for the good, or less quality, or similar degradation of nonwarranty attributes.<sup>127</sup> The result is that buyers are forced to consume a suboptimally high amount of warranty protection, raising the cost of the good above the price they would prefer to pay, and would be able to pay, but for *Berg's* requirement of particularity. Furthermore, this higher price will decrease demand, thereby causing buyers to consume less of the good. Given buyers' preferences, this result is suboptimal.

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present a legitimate need for regulation that would prohibit selling those goods, thus depriving buyers of some degree of choice.

124. This loss is analogous to the deadweight loss caused by monopoly. See *supra* text accompanying notes 45-47.

125. *Berg v. Stromme*, 79 Wash. 2d 184, 196, 484 P.2d 380, 386 (1971); WASH. REV. CODE § 62A.2-316(2) (1989).

126. WASH. REV. CODE § 62A.2-316(3)(a) (1989).

127. Trebilcock & Dewees, *supra* note 53, at 102-04.

Parties contracting under the *Berg* rules have another option: they can simply ignore the rules' requirements of specific negotiation and particular disclosure if they can do so cost effectively.<sup>128</sup> If buyers and sellers chose to disregard the requirements of *Berg*, sellers would be vulnerable to claims based upon the implied warranties of fitness and merchantability, since the disclaimers they would include in their form contracts would be invalid under the *Berg* rules, and therefore unenforceable.<sup>129</sup> Sellers would simply take the cost of such claims into account when determining their price, and to the extent possible, would pass that cost along to buyers.<sup>130</sup>

Cross-subsidization is another problem created by the *Berg* rules that has gone unnoticed by the courts. In the context of sales transactions, cross-subsidization occurs when a seller

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128. It is likely that sellers and buyers do, in fact, tend to ignore the *Berg* rules. Although both authors have lived in Washington for substantial periods of time and have entered into contracts containing disclaimers of the implied warranties of fitness and merchantability, neither has ever dealt with a seller who has attempted to comply with the requirements of *Berg*. However, one of the authors, Ferrell, successfully invoked the *Berg* rules to defeat the disclaimer defense of a merchant with whom he was involved in a dispute.

129. The implied warranty might be successfully disclaimed, however, if a seller could establish a course of performance, course of dealing, or usage of trade that evidenced the parties' intent that no implied warranties attach. WASH. REV. CODE § 62A.2-316(3)(c) (1989). Applying the *Berg* rules to invalidate an otherwise effective disclaimer under § 62A.2-316(3)(c) appears to be directly contrary to that statute and, therefore, would be unconstitutional as a violation of the separation of powers doctrine. If buyers and sellers were allowed to disclaim implied warranties through a course of dealing or performance, the cross-subsidization created by the *Berg* rules would be reduced or eliminated.

130. The seller's cost (and therefore the price he must charge to buyers) is also increased by the expected cost of claims based on breaches of the warranties of merchantability and fitness connected with attributes that either the seller forgot to include in his particular disclosure or whose particular disclosure he cannot later prove.

*Thomas v. Ruddell Lease-Sales*, 43 Wash. App. 208, 716 P.2d 911 (1986), presents a good example of the difficulties created by the particularity requirement of *Berg*. In *Thomas*, the buyer of a car initialed a disclaimer that stated, "I understand that you don't provide any warranties whatsoever, and the auto is sold as is and with all defects." *Id.* at 210, 716 P.2d at 913. The buyer was told by the seller's salesman that the provision would protect the seller from warranty claims for engine problems caused by abusive driving. *Id.* The buyer brought an action for rescission of the contract and, in preparation for trial, discovered that the car had been wrecked and that the frame of the car had been inadequately repaired. *Id.* at 211, 716 P.2d at 913. The buyer pleaded breach of the warranty of merchantability, contending that the disclaimer contained in the contract was invalid because it had not been explicitly negotiated and did not particularly disclaim defects in the frame of the car. *Id.* at 214-15, 716 P.2d at 914-15. The court agreed on both counts. *Id.* at 214, 716 P.2d at 915. Thus, the seller was left responsible for the merchantability of an attribute that he apparently intended to disclaim by way of a blanket disclaimer.

charges a single price for an attribute of a good, even though the seller's cost of supplying buyers with the attribute varies among buyers. Thus, the seller charges some buyers more than the seller must spend to provide them with an attribute and charges other buyers less than the cost they impose on the seller. Although the seller is, in the end, correctly compensated for his total cost of providing an attribute to all buyers, cross-subsidization results in a wealth transfer from buyers imposing low costs on the seller to those imposing high costs on the seller. An automobile dealer offering a two-year unlimited mileage warranty against engine breakdowns is a good example. The seller will calculate his potential warranty liability according to the average cost of warranty claims during the warranty period and will charge a price for the warranty that equals this average cost. Some buyers, however, will drive harder or more miles than the average during the warranty period, while others will drive easier or fewer miles than the average. If all buyers pay the same price for the warranty, some will thus be charged more than their use warrants and others will be charged less. Low-intensity buyers who subject vehicles to less wear by the manner or extent of their driving will thereby subsidize high-intensity buyers.

Cross-subsidization occurs in much the same way under the *Berg* rules, particularly as it applies to limitations of liability for consequential damages. Under *Berg*, sellers will pass on to all buyers the average expected cost of warranty suits based on violations of the *Berg* rules. Buyers who have knowledge of the rules, who incur relatively low costs of enforcing a contract, or who have consequential damages high enough to warrant a lawsuit, will be able to use the *Berg* rules to avoid disclaimers and remedy limitations that are not specifically negotiated or that do not describe the attributes disclaimed with particularity. On the other hand, some buyers will be ignorant of the rules, will have high enforcement costs, or will have damages too low to warrant suit. These buyers will therefore be unable to avoid disclaimers even though they are invalid under the *Berg* rules. Both sets of buyers, however, will be charged the same amount by the seller to reimburse the seller for the cost of suits based on violations of the *Berg* rules. Therefore, cross-subsidization will result between buyers who are unable to avoid invalid disclaimers and remedy limitations and buyers who, through their relatively greater



ability to pursue a claim, are able to avoid the invalid disclaimers and remedy limitations.

The cross-subsidization resulting from the *Berg* rules can be eliminated only by eliminating the rules themselves. If all disclaimers and remedy limitations were valid regardless of whether they were explicitly negotiated or whether they set forth with particularity the attributes disclaimed, all buyers would be bound by the disclaimer, and cross-subsidization would be drastically reduced.<sup>131</sup>

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131. In his recent article, *The Unintended Revolution in Product Liability Law*, 10 CARDOZO L. REV. 2193 (1989), Professor Richard Epstein questions the extent, if not the existence, of the cross-subsidization problem with respect to personal injury recovery for product failure. As articulated by Priest, *supra* note 48, at 1351, cross-subsidization of product purchasers with high incomes or high consequential losses other than lost income by those with low incomes or low potential consequential losses will occur when insurance against lost income or other consequential losses is provided by a product manufacturer *via* strict liability for product defects. This result will occur because the manufacturer will have to calculate the premium, which is included in the product's price, on an average cost basis. The high income or high potential consequential loss purchaser, whose expected damages will be higher than those of the low income or low potential consequential loss buyer, will purchase insurance at a price lower than the cost he imposes and *vice versa*. Epstein questions one of the assumptions underlying the argument that low income purchasers will subsidize high income buyers, namely, that the probabilities of being harmed by a product are the same for both low and high income product users. Epstein, *supra*, at 2215. He argues that so long as some element of uncompensated loss rests upon product users, they will have some incentive to exercise care against product risks. Product users with higher incomes or potential consequential losses may suffer greater uncompensated losses and therefore have an incentive to take greater care in using a product. *Id.*

Although Epstein's argument is valid in some situations, it is questionable whether it applies to most situations involving defective products. With respect to any given product, higher income or potential consequential loss users will take greater care than lower income users *only* when the cost of increased care exceeds the value of such care to members of the latter group. Therefore, it is probable that they will not take such care. Since markets for a number of goods tend to segment based on purchasers' income or wealth levels (for example, the automobile market in which lower income people tend not to buy luxury cars), the spread of income or potential consequential losses within the purchasing group may be relatively narrow and the differences in uncompensated losses similarly narrow. If the cost of reducing or minimizing the risk of harm in a cost-effective manner is less than the expected value of the loss to buyers at the low end of the income or consequential loss ranges, all product buyers will expend the same amount on care, the risk of harm occurring will be minimized in the same amount for all purchasers, and lower income or consequential loss purchasers will subsidize higher income or consequential loss buyers through manufacturer provided insurance.

The existence of uncompensated loss as a factor minimizing or eliminating the problem of cross-subsidization is more problematical when that phenomenon arises from different intensities in product use. The amount of resources a high intensity user will expend to reduce the occurrence of product failure will depend upon the expected value of uncompensated losses and the gains derived from the high degree of use. For example, a salesman who has purchased a new car and is entitled to a

## V. CONCLUSION

The foregoing discussion demonstrates the economic unsoundness of the rationales underlying the *Berg* rules of specific negotiation and particular disclosure of warranty disclaimers and remedy limitations. *Berg* is unnecessary to alert buyers to the terms of the contracts they sign and is inefficiently overinclusive. It causes a deadweight societal loss so far as it requires all buyers to be so informed, subject to the caveat that sufficient marginal buyers may be able to discipline the market as to contract terms by comparing the terms offered by various sellers. This caveat, however, is not a serious qualification of our argument. For the reasons discussed above with respect to the likelihood of marginal buyers knowing of the existence of warranty disclaimers, it is highly credible to assume that those buyers know that warranty disclaimers exist. That marginal buyers are motivated to shop for such terms is strongly suggested by the fact that buyers as a whole perceive that they frequently have cause to complain about the quality of the products they buy,<sup>132</sup> and by extension, have cause to resort to the warranty covering those products. Even stronger evidence that marginal buyers consider warranty terms a criterion in comparing sellers is that sellers find it in their best interests to advertise the quality of their goods and of the warranties they offer to cover those goods. Such acts would be inefficient unless sellers could thereby attract more marginal buyers and thus increase their net income by increasing their market share.

Furthermore, specific negotiation generally<sup>133</sup> will do nothing to improve the terms of the contracts into which buyers enter, since individual buyers and sellers are economically unable to vary the terms of a contract from those demanded by the market in general. Moreover, mandatory negotiation over disclaimers of warranties covering low-probability events will

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"loaner" from a dealer whenever his car needs warranty work, may have a strong incentive to "consume" the warranty by driving the automobile as hard as possible during the warranty coverage. Even if he is not entitled to a loaner, the buyer may find it beneficial to use a car intensively if the cost of obtaining a substitute vehicle during warranty work is offset by the value of driving the car harder. Increased care in such a circumstance would not be cost effective to the buyer, his high intensity use would continue, and subsidization of his use of the vehicle by less intensive users would continue.

132. See *supra* text accompanying notes 94-95.

133. See *supra* text accompanying notes 110-11.

do little to increase buyers' welfare. Simply disclosing the fact that a disclaimer exists and stating with particularity the attributes as to which the warranty is disclaimed will do nothing to inform the buyer of the probability that the event will occur. Thus, mandatory negotiation wholly fails to address the problem of buyers underestimating the probability that a defect covered by, or excepted from, a warranty will occur. Also, to the extent that courts have extended *Berg* to allow parties with actual knowledge of the terms of contracts they have signed to avoid those terms on the ground that they were not explicitly negotiated or explained with particularity, society has been made worse off economically, without furthering any of the policy rationales used by the *Berg* court to support its decision.

The *Berg* rules narrow buyers' choice of contract terms suboptimally by disabling willing buyers from agreeing to disclaimers without incurring additional transaction costs. The *Berg* rules are also inefficient to the extent that they create cross-subsidization among buyers, with all of that phenomenon's negative economic consequences. Most ironically, the *Berg* rules, by virtue of their failure to comprehensively regulate the transactions to which they apply, allow sellers to recover the added costs of complying with the rules by passing those costs on to buyers through higher prices or attribute degradation. This result leaves buyers with a bundle of attributes that they desire less than the attribute bundle they would be provided if the rules were not in effect. This result also requires them to pay a higher price for that bundle of attributes. As well intentioned as the *Berg* court may have been, the *Berg* rules fail to help purchasers in the way the court supposed they would; indeed, these rules make purchasers worse off. Accordingly, the *Berg* rules should be eliminated. Warranty disclaimers generated by a market should be enforced to the extent they comply with other legal requirements, such as the disclosure criteria of U.C.C. Section 2-316(2), unless it is established that a market failure occurred, precluding the provision of optimal warranty terms in the manner discussed in this Article.