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Norman Siebrasse*

The Choice Between Implied
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Property Market

The Supreme Court's decision in Winnipeg Condo. Corp. No. 36 v. Bird Construction expanded recovery for pure economic loss in tort by allowing a subsequent purchaser to recover the cost of repairing a dangerous defect arising out of negligence in the construction of a building. This article outlines the theoretical justifications for extended tort liability when the parties are linked by a contractual chain but are not in privity, and concludes that it is not possible to determine whether extended liability is desirable without considering the details of the market in question. A comparison between tort liability and the protection afforded by the warranties offered by the New Home Warranty Corporations across the country indicates that the private warranties offer a better trade-off between protection and cost than does tort liability. The article further argues that while the builder's liability should be extended, it should be accomplished through a contractually implied third-party beneficiary warranty of fitness for habitation rather than through expansion of tort recovery for pure economic loss. Among other factors, the article considers the view that indeterminacy of recovery militates against expanded tort recovery and argues that indeterminacy per se is not as important as increased litigation and transaction costs that accompany expanded tort recovery.

Par sa décision dans l'arrêt Winnipeg Condo Corp. No. 36 c. Bird Construction, la Cour Suprême du Canada a élargi le droit au recouvrement pour perte purement économique en matière de responsabilité civile en permettant au tiers acquéreur d'un édifice de récupérer le coût des réparations pour un vice de construction dangereux résultant de négligence. Cet article donne un aperçu

* Faculty of Law, University of New Brunswick, Fredericton. This is a revised version of a paper presented at the 26th Annual Workshop on Commercial and Consumer Law, held at the University of Toronto on October 18 and 19, 1996. Comments from the participants of the Workshop are gratefully acknowledged. Representatives of the New Home Warranty Programs/Corporations from across the country were most helpful in explaining to me the workings of the Programs. I owe a particular debt to Michael Hall, Deputy Chief Executive of the English National House Building Council for sharing with me some of his encyclopaedic knowledge of the home warranty programs in both England and North America. Our discussions of the actuarial and insurance aspects of the industry in particular were invaluable, although any shortcomings on these points in the article are of course my responsibility. I would also like to thank Vaughan Black, Bruce Feldthusen and Ed Veitch for useful comments on earlier drafts.

sur les justifications théoriques à l'appui d'un élargissement du droit au recouvrement en matière délictuelle quand les parties en cause n'ont pas de liens contractuels et affirme qu'il faut considérer les conditions du marché en question pour déterminer si un tel élargissement est souhaitable ou non. Considérant les garanties offertes par les "New Home Warranty Corporations" dans l'ensemble du pays, à la lumière d'une analyse portant sur les coûts et les avantages, l'indemnité en matière délictuelle semble offrir une protection moins avantageuse que celle offerte par ces garanties. Cet article soutient le raisonnement selon lequel la responsabilité du constructeur devrait être élargie par le biais d'une garantie contractuelle implicite en faveur du tiers acquéreur garantissant l'habitabilité de l'édifice plutôt qu'en permettant un recouvrement en matière délictuelle pour perte purement économique. Entre autres, cet article prend en considération le raisonnement selon lequel l'indétermination du coût de recouvrement milite contre l'élargissement du droit au recouvrement en matière délictuelle et affirme que les coûts du litige et de transaction militent d'avantage contre un tel élargissement que cet élément d'indétermination.

Introduction

In *C.N.R. v. Norsk Pacific Steamship Co.*¹ the Supreme Court of Canada made clear that there is no *per se* rule against recovery of pure economic loss in tort and stated that the development of the law in this area should proceed incrementally on the basis of sound policy considerations.² The unanimous decision of the Court in *Winnipeg Condo. Corp. No. 36 v. Bird Construction*³ is a further step in this cautious evolutionary process. In *Bird* the Supreme Court of Canada allowed a tort action against a building contractor by a party not in contractual privity with the contractor (namely, a subsequent purchaser of the building) for recovery of the cost of repairing defects arising out of negligence in the construction of a building which posed a real and substantial danger to inhabitants of the building or passers-by. While the holding likely extends to chattels as well as real property and to all financial loss rather than the cost of repairs to the building, it was clearly and deliberately confined to economic loss resulting from dangerous defects. But in keeping with its recognition that the law in the area is evolving, the Court also indicated a willingness to consider the possibility of extending the builder's liability to losses resulting from non-dangerous defects.⁴ Although doctrinally a short step from the holding in *Bird*, in practice such an extension of liability would be revolutionary. It seems we are a short step away from general recovery in tort of all economic loss resulting from defective goods of any kind.

1. [1992] 1 S.C.R. 1021.

2. *Ibid.* per McLachlin J. at 1139–40, per La Forest J. at 1048–49.

3. [1995] 1 S.C.R. 85; 3 W.W.R. 85; 23 C.C.L.T. (2d) 1 [hereinafter *Bird* cited to S.C.R.].

4. *Ibid.* at 119.

This article takes up the Court's implicit invitation to comment on the possible extension of tort recovery to non-dangerous defects. I argue that while a good case can be made for extending liability, it should be done in contract by means of an implied warranty of fitness for habitation in the sale of structures which will benefit third parties, in particular subsequent purchasers,⁵ rather than through expansion of tort recovery for pure economic loss. The argument applies equally to dangerous defects, but I focus on non-dangerous defects because the issue with respect to dangerous defects has been settled by the Court's decision in *Bird*.

The basic point is not a novel one: recovery of pure economic loss in tort is dangerous because it fails to recognize the role of contract in allowing the parties to allocate risks between them more appropriately than can be done by the courts and tort law. We should not be misled into a pure tort analysis by the formal fact that there was no privity of contract between the plaintiff and defendant in *Bird*. Despite the lack of a direct contractual link, the relationship between the parties was nonetheless sufficiently close that indirect contracting was possible: if a warranty from the builder is desirable, the original owner would have an incentive to purchase the warranty from the builder which would run to subsequent purchasers, and then resell the building at a higher price to reflect the warranty protection. This possibility is not an economist's fancy, but rather, as we shall see, it is the norm in residential real estate transactions. Surely the sophisticated parties to a commercial real estate transaction could do as well.

This is not to make the argument that the courts should not intervene because parties will necessarily arrive at optimal contractual arrangements if left to their own devices. On the contrary, I will argue that there are good reasons to believe that there will be failures in the bargaining process. Rather, I am arguing that we cannot assume that contracting will break down entirely simply because the parties are not directly in privity. While there will be failures in the bargaining process in this context (as in any other context), indirect contracting is at least potentially feasible. And even though contracting is imperfect, judicial imposition of tort liability is also an imperfect solution to the risk allocation problem. An analysis based on purely formal considerations will be inadequate. What is required is a specific comparative analysis of judicial and contractual risk allocation. In other words, *Bird Construction* is as much about

5. This is the dominant American approach: see W.K. Jones, "Economic Losses Caused by Construction Deficiencies: The Competing Regimes of Contract and Tort" (1991) 59 U. Cinn. L. Rev. 1051 for an excellent and comprehensive review of the American law.

concurrency of tort and contract actions as it is about recovery of pure economic loss in tort.

Unfortunately, but understandably, the development of concurrency has been driven by the use of tort law and, to a lesser extent, the law of fiduciary obligations, to remedy perceived inequities in contract law.⁶ This path of development is understandable, since cases are driven by the clients' needs rather than by a desire for conceptual coherence, and there is no incentive to frame a cause of action in novel terms unless there is some gain to be had thereby. But it is also unfortunate because concurrency is a blunt instrument. Tort-contract concurrency introduces all aspects of tort law to the contractual scene, not just those which remedy the perceived problem at hand. It is not a foregone conclusion that because the tort rule on limitations appears to be better the tort rule on damages is also to be preferred. If the law is to be rationalized the Court needs to examine each substantive difference between tort and contract individually and determine which rule is to be preferred, or the unintended consequences of concurrency may prove a cure worse than the disease.

The decision in *Bird* is a classic example of using tort law to dodge contract law. The inconvenient aspect of contract law which *Bird* attacks is the doctrine of caveat emptor in new home sales. In *Fraser-Reid v. Droumsetkas*⁷ the Court bemoaned the irrationality of the rule of caveat emptor, but affirmed it nonetheless, saying it was too firmly entrenched to be changed judicially. It appears that the Court is no longer convinced by its own argument. *Bird* has taken the first step in making an end-run via tort law, and if the result is extended to non-dangerous defects,

6. In *Central Trust Co. v. Rafuse* (1986), 31 D.L.R. (4th) 481 (S.C.C.) [hereinafter *Central Trust*] a leading case in the development of concurrent actions, the reason the plaintiff sought (and was permitted) to bring an action in tort was in order to take advantage of a more generous rule on the running of the limitations period in tort. In *Dominion Chain Co. v. Eastern Construction Co.* (1976), 68 D.L.R. (3d) 385 (C.A.), aff'g *sub nom. Giffels Associates v. Eastern Construction Co.* (1978), 84 D.L.R. (3d) 344 concurrent actions in tort and contract were allowed in order to permit contribution between parties in breach of their duty in a contractual setting. (Contribution was denied on the facts because one of the joint tortfeasors was protected from liability to the plaintiff by a waiver of liability clause in its contract.) Negligent misrepresentation serves as a means of avoiding the parole evidence rule and the rule that damages are not available for innocent misrepresentation. In *Esso Petroleum v. Mardon*, [1976] 1 Q.B. 801 at 817 Lord Denning M.R. frankly acknowledged that a pleading of negligent misrepresentation (or collateral warranty) was used as a means of avoiding the rule that innocent misrepresentation gives no right to damages. Lord Denning stated that while he would have been willing to find a collateral warranty on the facts, he based his decision on negligent misrepresentation instead of nominal deference to the trial judge's finding of fact that there was no collateral warranty. In other words, concurrency was used simply to avoid an inconvenient factual finding by the trial judge.

7. [1980] 1 S.C.R. 720 [hereinafter *Fraser-Reid*].

Fraser-Reid will be effectively overruled.⁸ The unintended, and, I will argue, undesirable consequence which the Court has wrought by overruling *Fraser-Reid* indirectly rather than directly, is to make it much more difficult for the parties to fine-tune the terms of their relationship.

It might be objected that introducing an implied third-party beneficiary contract is too much of a change in the law, requiring as it does both a reversal of *Fraser-Reid* and the acknowledgment of implied third-party beneficiary contracts. But addressing “contract torts” (where parties are sufficiently closely linked to be able to bargain indirectly yet are not in privity) through tort law also requires major legal change, as tort law has two deficiencies in this area. The first is that tort law does not yet allow for recovery of pure economic loss in all situations where that may be appropriate. The second is that it does not allow the parties (including subsequent purchasers) to fine-tune their bargain. In *Bird* the Court has gone some way towards addressing the first problem, and indicated that it is willing to go further, but it has not even recognized the second problem. In view of this it is fair to say that the changes needed on the contract side are no more radical than allowing tort liability for pure economic loss flowing from defective products.

The Court has already gone some way to relaxing the privity requirement in *London Drugs Ltd. v. Kuehne & Nagel Int'l.*⁹ That decision did not go far enough to allow the implementation of a judicially implied warranty solution in a case such as *Bird*, as it held that a third party beneficiary contract must be founded on the clear intent of the parties. The reluctance to allow judicially implied third party beneficiary contracts was no doubt motivated by a desire to respect the autonomy of the parties. But if the Court is considering extending liability among parties in a contractual chain, an implied warranty which the parties are free to alter is surely more respectful of the autonomy of the parties than is judicially imposed tort liability. It would be ironic if a doctrine intended to respect party autonomy was seen to preclude an autonomy enhancing approach to extended liability for economic loss. And in any event, the respect for the intent of the parties is something of a pious sham, as the intention of the parties is determined by judicial interpretation of the contract, which in turn is largely guided by judicial policy concerns. To a large extent to

8. Note that while the Court in *Fraser-Reid*, *ibid.* declined to change the doctrine of caveat emptor, it was able to give relief to the purchaser by finding an express warranty. The desire not to make major changes to the law unless it is unavoidable is laudable, but it would have been preferable if the Court had simply held that since express warranty was found on the facts there was no need to address the issue of caveat emptor.

9. [1992] 3 S.C.R. 299 [hereinafter *London Drugs*].

imply a third party beneficiary aspect to the contract would simply make explicit what is already being done through judicial interpretation of the contract.¹⁰

But this article is not primarily concerned with whether contract law can be shaped to address the problem of caveat emptor. Apart from the foregoing remarks, I will take it as given that an implied warranty of fitness for habitation which benefits subsequent purchasers is legally possible for the Supreme Court, and no more radical than the extension of tort law which the Court has contemplated and partially carried out in *Bird*. The primary question is whether such an implied warranty is desirable as a matter of policy.

To answer this question I start with a law and economics approach to tort and contract, as it allows a unified functional analysis of contract-torts. In a context in which the parties are contractually linked, even indirectly, the central question is whether, given the impediments to a contractual allocation of risk, an allocation of risk judicially imposed through tort law can be expected to be superior to the contractual allocation of risk. Because of information asymmetries and limits on human rationality the private bargaining process can be expected to lead to a contract which is not perfectly optimal. But the existence of some imperfections in contracting does not of itself make the case for judicial intervention, because the same considerations of information asymmetries and limits on rationality also imply that judicial decisions will be imperfect. This means that we must compare the defects in the bargaining process with the expected defects in the judicial response and assess whether judicial intervention can be expected to do more harm than good. This requires a relatively detailed examination of the particular class of transactions in question, as details of the market in question, in particular its institutional structure and the nature of the item being bargained over, determine the nature and extent of imperfections in both bargaining and judicial regulation of the market. On examination of the market for buildings, I conclude that while there are significant defects in the market and the current hostility to the doctrine of caveat emptor is warranted, intervention through tort law to judicially impose terms of the relationship will do more harm than good. However, judicial intervention through an implied warranty holds considerable promise for improving the bargaining process with few adverse effects. An implied warranty would change the background rules of bargaining in a way which can be

10. See N. Siebrasse, "Third-Party Beneficiaries in the Supreme Court of Canada: Categorization and the Interpretation of Ambiguous Contracts" (1995) 45 U.T.L.J. 47.

expected to improve the outcome, while allowing the parties to fine tune their allocation of risk in a way which is binding on subsequent purchasers. The analysis of the market for structures also provides insights which may be more widely applicable.

I. *A Unified Approach to Contract and Tort*

Tort law is often said to be concerned with the deterrence of accidents and the compensation of victims. It should not be too controversial to add a concern for minimizing administrative costs of recovery. While not as prominent in traditional analyses, this concern is implicitly present, for example in the floodgates argument.¹¹ If we emphasize the need for a balance between these factors, then the traditional description of the goals of tort law is equivalent to Calabresi's seminal formulation from the law and economics perspective: tort law is aimed at reducing the costs of accidents, which entails reducing the likelihood of an accident, the harm which results if an accident does occur, and the associated administrative costs.¹² Contract law on the other hand is often seen as promoting

11. Minimizing administrative costs is as important as deterring accidents, because administrative costs are ultimately borne by the parties (through higher prices for goods, for instance) or society at large, just as are the direct costs of accidents (direct accident costs which are fully insured are borne by society at large rather than by the victim of the loss). Particularly in the area of pure economic losses, it is clear that direct losses are no different in kind than administrative costs: both are money.

12. G. Calabresi, *The Costs of Accidents: A Legal and Economic Analysis* (Yale University Press, 1970). Calabresi's formulation has fallen out of favour in the law and economics scholarship, probably because it is not susceptible to expression in mathematical terms. The goal of tort law is more often stated to be the minimization of accident costs, including administrative costs. This implies a concern with compensation, which is made clear by Calabresi, as the accident costs include the costs of bearing a large loss, which, because of risk aversion, is greater than the quantum of the loss itself. This cost can only be avoided through compensation. Thus, from an economic perspective, tort law's traditional concern for compensation is fundamentally the same as the concern for loss bearing. Phrasing the issue in terms of loss bearing ability has the salutary effect of emphasizing the importance of insurance issues, as was emphasized by La Forest J. in his decision in *Canadian National Railway Company v. Norsk Pacific Steamship Co.*, *supra* note 1. It is true that many law and economics scholars ignore compensation on the grounds that insurance is widely available: see R. Posner, *Economic Analysis of Law*, 4th ed. (Boston: Little Brown, 1992) at 165–66. But while it is true that when available, insurance is a much cheaper means of providing compensation than is tort law (see *infra* note 28), some insurance markets do not exist, or function poorly. While many economic analyses do take this into account, formal economic treatments tend to treat insurance as changing the risk aversion of the parties: see S. Shavell, *Economic Analysis of Accident Law*, (Cambridge: Harvard University Press, 1987). Calabresi's formulation, while less mathematically tractable, focuses attention on the actual compensation or insurance market in question and its possible imperfections. It should also be noted that the text refers to the need to *balance* compensation and deterrence. In a traditional formulation these are seen as complementary goals, as the victim is compensated at the same time as the tortfeasor is deterred. See *infra* note 28 discussing why these are not entirely complementary goals.

mutually beneficial exchanges and respecting the autonomy of the parties. But while the focus is different, the underlying premises of tort and contract law are the same. One way of stating the premise underlying freedom of contract is that parties with full capacity know best what is best for themselves, so that any voluntary exchange in which both parties are fully informed about, and bargain over, all aspects of the exchange, must benefit both parties. (For convenience, I will refer to the outcome of such an idealized bargaining process as an optimal contract.) "All aspects of the exchange" includes the possibility that something will go wrong. Parties to a contract routinely insert clauses which are directed to circumstances that both parties hope will never arise, for example warranty provisions in case of defects, or a liquidated damages clause. Thus the optimal contract, like tort law, will attempt to minimize the harm of any unanticipated occurrence, since both parties gain if such costs are minimized.

The goal of the parties to a contract and the goal of the courts in tort law are thus fundamentally similar. If optimal contracting were possible, judicial intervention would never be necessary, since the parties would already have provided for all contingencies. Moreover, because the parties have better information about their own needs and circumstances than does the court, the arrangements which the parties make will be better than those which the court could provide. This is the reason for a presumption in favour of private ordering.¹³ Of course, optimal contracting is never possible, even in paradigmatic contractual settings, since low transaction costs, full capacity, voluntary exchange, and full information are requirements which are never entirely fulfilled.¹⁴ But the view that the

13. The primacy of private ordering has been explicitly recognized by the courts: for instance, in *B.G. Checo Int'l Ltd. v. B.C. Hydro & Power Authority* (1993), 99 D.L.R. (4th) 577. La Forest and McLachlin JJ. for the majority noted that "[T]he only limit on the right to choose one's [cause of] action is the principle of private ordering – the right of individuals to arrange their affairs and assume risks in a different way that would be done by the law of tort" (at 584).

14. The precise scope of these conditions is also difficult to define and normatively laden. Many law and economics scholars would also add a condition that the market be perfectly competitive if the exchange is to be considered voluntary: see R.D. Cooter & T.S. Ulen, "Law and Economics" (Glenview: Scott, Foresman & Co., 1988) at 234–36. But so long as the buyer has the option of not buying, exchanges which are otherwise voluntary will be to the benefit of the buyer even if the seller is a monopolist. In any event, with perfect information, the existence of a monopoly will change the price but not the terms of the bargain (see discussion *infra* text at note 39), and the terms are the focus of this article. In a similar vein, one standard criticism from the left is that the property rights themselves ultimately define what is considered coercive: the choice to work or starve is arguably not a free choice at all: see e.g. D. Kennedy "The Stakes of Law, or Hale and Foucault" in *Sexy Dressing etc.* (Cambridge: Harvard University Press, 1993). While this argument is technically correct, and I would defend the institution of contract on other grounds, this article is not intended as a challenge

role of the court is to encourage the optimal contract is nonetheless useful: by implying that the need for judicial intervention can always be conceived of as stemming from a failure of the bargaining process, the role of the court in both tort and contract can be seen as that of promoting outcomes which approximate the optimal contract.¹⁵

There are two main strategies which the court can use to this end. Most obviously the court can attempt to impose the optimal contract directly: that is, the court can impose the result which it believes the parties would have agreed to had they bargained rationally with full information. Alternatively the court can fashion rules which allow the parties to overcome impediments to contracting.

There are two general types of situations in which the appropriate judicial response is to attempt to impose the optimal contract. One is where the source of the bargaining failure is unavoidably high transaction costs which make bargaining impossible. This is the case in paradigmatic "stranger torts" (e.g. automobile accidents) where bargaining between the parties is not possible and tort law is called upon to invent the hypothetical bargain wholesale by mimicking the result the parties would have arrived at had they been able to bargain. High transaction cost failures of bargaining also occur in classic contracts cases. Even when transaction costs are low relative to "stranger torts", it is impossible for even fully informed parties to contract over every contingency which might impact on the contract. If events unfold to reveal a contingency which the parties had not anticipated the courts may be called upon to fill in the gap with the terms the parties would have arrived at had they turned their attention to the problem.¹⁶

The court may also attempt to impose the optimal contract directly when one of the parties did not have the capacity to bargain rationally. Refusal to enforce contracts entered into by minors is an example. Here the rationale for judicial imposition of terms is quite different. When the court must impose terms which the parties had not in fact agreed to

to the mainstream views of contract and property, and I assume voluntariness throughout the article, which focuses on capacity and information. Of course, "full capacity" is also a disputable term. Economists do have technical definitions of rationality, but as I argue (see *infra* text at note 39) failure by one party to meet these criteria does not of itself justify judicial intervention. For these reasons the conditions I have set out in the text should not be taken as precisely defined technical requirements which guarantee a welfare maximizing result (with the positive normative connotations of that phrase). Rather, they are ill-defined terms which guide analysis by serving as the focus for more detailed inquiry.

15. For a good discussion of "tort as a hypothetical contract" see R.D. Cooter, "Unity in Tort Contract and Property: The Model of Precaution" (1985) 73 Cal. L. Rev. 1.

16. See e.g. Posner, *supra* note 12 at 93; F.H. Easterbrook & D.R. Fischel "The Corporate Contract" (1989) 89 Colum. L.R. 1416.

because of high transaction costs, the court can attempt to respect the autonomy of the parties by using the context provided by the contract, if there is one, or by the surrounding circumstances to decide what particular bargain these parties might have arrived at. In contrast judicial intervention justified by the irrationality or "wrong preferences" of one of the parties is inherently paternalistic: the court is simply substituting its judgment for that of the parties.

The alternative strategy is to attack the impediments to bargaining directly by fashioning legal rules which reduce transaction costs, increase the information available to the parties, or reduce incentives for strategic bargaining. This approach is most evident in legal rules which directly require disclosure of information, such as the rule against fraudulent concealment of defects in the sale of real property, but is also present in more subtle forms. For instance the rule in *Hadley v. Baxendale* has been defended on this basis.¹⁷ This is the least paternalistic strategy since it neither substitutes a hypothetical judicial bargain, nor directly imposes the court's preferences, but rather seeks to aid the parties in coming to a bargain in fact.

Direct judicial imposition of the 'terms' is a strategy more commonly associated with the high bargaining costs of the paradigmatic stranger torts, whereas background rules which encourage bargaining are associated with contract where bargaining costs are relatively low to begin with. But these are simply generalizations, and it is important to remain sensitive to the underlying policy issues, especially in cases like *Bird* which fall on the tort-contract boundary.

The Court's decision on the facts in *Bird* is difficult to justify in light of the foregoing analysis, since the existing legal framework provided clear background rules against which bargaining between sophisticated parties could take place. While the original purchaser would not be well placed to originate a warranty, it could have demanded an assignable warranty from the builder, and, as noted, would have every incentive to do so in order to maintain the resale price. Given sophisticated parties, it

17. (1854), 9 Ex. 341, 156 E.R. 145. See I. Ayres & R. Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules" (1989) 99 Yale L.J. 87; see also W. Bishop, "The Contract-Tort Boundary and the Economics of Insurance" (1983) 12 J. Legal Stud. 24, suggesting that contract law can be used to force revelation of information. Cf. Kronman, "Mistake, Disclosure, Information and the Law of Contracts" (1978) 7 J. Legal Stud. 1 arguing that requiring disclosure may reduce incentives to acquire information in the first place. On the use of contract to counter strategic bargaining see J.S. Johnston, "Strategic Bargaining and the Economic Theory of Contract Default Rules" (1990) 100 Yale L.J. 615; P. Aghion & B. Hermalin, "Legal Restrictions on Private Contracts Can Enhance Efficiency" (1990) 6 J. Law, Econ. & Org. 381; I. Ayres & R. Gertner, "Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules" (1992) 101 Yale L.J. 729.

can be presumed that the terms of the sale accounted for the fact that the builder was not providing a warranty. By allowing an action against the builder in tort, the Court allowed the plaintiff to circumvent arrangements which it had presumably entered into with full knowledge and benefitted from through a reduced sale price.¹⁸

One possible explanation for the decision is that the Court assumed that transaction costs were high and indirect contracting impossible from the mere fact that the parties were not directly in privity. In other words, the Court may simply have been fooled by the form of the relationship. But some aspects of the decision suggest that the assumption that the plaintiff was not in privity with the builder was not crucial to the decision. The Court emphasized that contractual and tortious duties can in general arise concurrently so long as the tort duty arises independently of the contractual duty.¹⁹ The question then is when does a duty arise “independently”? While in the decision the Court explicitly stated only what was needed for the case at hand, namely that “a contractor’s duty to take reasonable care arises independently of any duty in contract between the contractor and the original property owner”²⁰ the Court explained that “the duty in contract with respect to materials and workmanship flows from the terms of the contract between the contractor and the home owner [but] by contrast, the duty in tort with respect to materials and workmanship flows from the contractor’s duty to ensure that the building meets a reasonable and safe standard of construction,” and emphasized that these duties are distinct. Further, the Court relied on the authority of *Central Trust*²¹ a case in which a concurrent tort claim was allowed between parties who were in privity. It therefore appears that an original owner, who is in privity with the builder, can nonetheless rely on *Bird* to sue the builder in tort so long as the original contract does not contain an express

18. This is the crux of the criticism of *Bird* by B. Feldthusen & J.P. Palmer, “Economic Loss and the Supreme Court of Canada: an Economic Critique of *Norsk Steamship* and *Bird Construction*” (1995) 74 Can. Bar Rev. 427 and B. Feldthusen, “Winnipeg Condominium Corporation No. 36 v. *Bird Construction Co.*: Who Needs Contract Anymore?” (1995) 25 Can. Bus. L.J. 143. For sophisticated parties, establishing a broad clear rule, whether or not it is the rule the parties would bargain to, may be the best way of encouraging bargaining. In this context, the parties’ failure to change the default rule is evidence that it is in fact appropriate. To the extent that liability for dangerous defects is less clear than a pure rule of caveat emptor, perhaps because it requires drawing a distinction between dangerous and non-dangerous defects, it is worse as a matter of policy as it increases wasteful litigation without improving the substantive allocation of risk: see Feldthusen *ibid.* at 155.

19. *Supra* note 3 at 104.

20. *Ibid.* at 105.

21. *Supra* note 6.

disclaimer of liability.²² As suggested earlier, this indicates that the Court used *Bird* as an opportunity to indirectly overrule *Fraser-Reid*. The question remains why the Court would chose to do so, thereby disrupting the settled expectations of the parties.

Another possibility is that the decision of the Court was an active interference in the contract justified by the belief that the Court is better able to allocate risk between the parties than are the parties themselves. And indeed, in responding to the argument that the judiciary should refrain from disrupting the careful allocation of risk in a construction project, the Court noted that this was merely a version of the traditional judicial concern for allowing indeterminate liability²³ and then proceeded to argue that indeterminacy was not a serious problem in the circumstances. Thus, while the Court recognized the need for a careful allocation of risk, it felt competent to simply directly substitute its judgment for that of the parties as to how the risk should be allocated.

It seems most likely that a combination of these factors motivated the decision in *Bird*. The Court addressed the issue of the builder's liability as if it were an issue of first impression. It noted, for instance, that the Condominium Corporation was unable to detect the defects even after cracking first appeared, and remarked that this "illustrates the unreality of the assumption that the purchaser is better placed to detect and bear the risks of hidden defects."²⁴ But while the notion that the purchaser is best placed to protect itself against defects may have been the original justification for caveat emptor, when the law is settled and the contract is between sophisticated parties it is better described as a conclusion that an observer may draw, given that the contract did in fact allocate the risk to the purchaser. If the case had indeed been an issue of first impression, then the Court's reasons for allocating default liability to the builder would have been persuasive, and there would have been no settled expectations

22. In general, the ability of parties to a contract to sue concurrently in tort merely illustrates the role of the law in filling gaps in contracts, particularly since the tort duty to take reasonable care, for example, provides a general obligation which may apply in a variety of circumstances which are difficult to define before the fact. (Of course, the parties could insert an express equivalent term in the contract, but it is arguably more efficient to legally imply such a term if it would be routinely inserted in most contracts in any event.) But in this case, there was no gap to be filled, or more accurately, the law had already filled the gap. As between the original purchaser and the builder, the recently reaffirmed contract doctrine of caveat emptor clearly applied, and as between the builder and subsequent purchasers the traditional rule against recovery for pure economic loss in such circumstances would have applied. Given sophisticated parties who were aware of the existing law on this point, the gap filling rationale is not convincing.

23. *Supra* note 3 at 124.

24. *Ibid.* at 128.

to militate against liability. The Court may have been less than attentive to the possibility of indirect contracting both because it was overly confident in its own ability to impose the appropriate allocation of risk directly, and because of the lack of direct privity.

The foregoing arguments against the decision in *Bird* are much weaker when applied to less sophisticated parties, where bounded rationality on the part of purchasers makes much less plausible the assumption that the purchaser was aware of and accounted for the absence of an implied warranty of sound construction. In view of this, it is ironic that the problem of disturbing settled law was central to the Court's decision to reaffirm caveat emptor in *Fraser-Reid* but was entirely ignored in *Bird*. The point is much more compelling on the facts in *Bird*, which involved sophisticated parties, than on the facts in *Fraser-Reid* which concerned the purchaser of a private home.

But simply because the *prima facie* argument in favour of judicial risk allocation is stronger in the case of residential home buyers, it is not necessarily compelling. This brings us to a central theme of this article. If freedom of contract is premised on the notion that the parties know what is best for themselves, then judicial intervention is invited whenever there is reason to believe that the bargaining process was imperfect. Since the bargaining process is never perfect, it follows that judicial intervention is always justified. But in truth freedom of contract rests on a much weaker premise, namely that the parties know what is best for themselves better than do the courts. To justify direct judicial imposition of a bargain it is not sufficient to show that there may have been a breakdown in the bargaining process. We must also show that the courts are sufficiently well-equipped that judicial intervention will do more good than harm. The imperfections in judicial intervention must receive as much attention as the imperfections of the bargaining process. In the following section of this article, I will explore the ways in which asymmetry of information and bounded rationality may affect the bargaining process. I conclude that neither of these problems is sufficiently severe to justify judicial imposition of what the court believes to be the optimal contract. I then suggest that the problems which do arise may be ameliorated by an alternative strategy of fashioning rules which encourage bargaining and that a disclaimable implied warranty of fitness for habitation could be justified on this basis. In other words, caveat emptor is not a desirable rule, but it should be replaced by an approach which encourages the parties to bargain for themselves, rather than one in which the courts bargain for the parties.

II. *Impediments to Contracting*

1. *Asymmetric Information*

A bargain can be presumed to be in the best interests of both parties only if both are fully informed as to the ramifications of their decision. But information is costly to acquire, so the parties to a contract will never acquire all the information which is possibly relevant. Rather they will acquire information only to the point where it is cost-effective to do so. In other respects the parties will remain "rationally ignorant".

To see the potential consequences of rational ignorance for contracting, consider the demand for warranties in an idealized market where the sellers are repeat players and each buyer only purchases once.²⁵ The buyer's rights against the seller will depend on the terms of the contract and the background legal rules. However, there is a cost to the buyer of discovering her rights. To the extent that her rights are determined by the contract, the cost is that of the time it takes to read and understand the fine print. To the extent that her rights are determined by background rules of law, such as caveat emptor, the cost to the buyer of becoming informed about her rights will be even higher. If the cost of finding out the truth about her rights is much greater than the benefit, the effort may not be worthwhile. For example, if the product is an inexpensive consumer product which rarely malfunctions, so that the expected loss from a malfunction is very low, it may not be worth reading the fine print to discover that the manufacturer has disclaimed liability for malfunctions. Even if the possible loss from a defective product is relatively high, if the

25. The discussion in this section is adapted from A. Schwartz, "Imperfect Information in Markets for Contract Terms: The Example of Warranties and Security Interests" (1983) 69 Va. L. Rev. 1387; A. Schwartz & L. Wilde, "Intervening in Markets on the Basis of Perfect Information: A Legal and Economic Analysis" (1979) 127 U. Pa. L. Rev. 630; G. Priest, "A Theory of the Consumer Product Warranty" (1981) 90 Yale L.J. 1297; and M.A. Eisenberg, "The Limits of Cognition and the Limits of Contract" (1995) 47 Stan. L. Rev. 211. (See also A. Schwartz, "Unconscionability and Imperfect Information: A Research Agenda" (1991) 19 Can. Bus. L.J. 437.) Priest presents the classic statement of the "comparative advantage" view of warranties, i.e. that consumer product warranties allocate responsibility in a way which reflects the comparative advantage of consumers and manufacturers in reducing the costs of defects. Schwartz & Wilde and Schwartz, *ibid.* extend this by analysing the effect of costly information (rational ignorance) on the market for warranties. They consider the problem of irrationality, but are largely dismissive, primarily for the second reason discussed below (at *infra* text following note 42), namely the difficulty of making predictions based on psychological models of decision making. They are also inclined to minimize the extent of irrationality in decision making. Eisenberg discusses the implications of both irrationality and rational ignorance for a number of contract doctrines, including product warranties, but does not distinguish adequately between the normative implications of the two types of bargaining failure, nor does he fully explore the effect on the problem of irrationality of market responses to imperfect information.

cost of finding out one's legal rights is also high, it may still not be worthwhile to do so. On the other hand, while the cost to the seller of reading and understanding the fine print or discovering the background rule is no less than the cost to the buyer, the seller (in our idealized market) is a repeat player. This means that the cost need only be incurred once, and can be spread over a large number of contracts, so the cost per contract of knowing the law is much lower for the seller than for the buyer. Thus, in our simplified scenario, the seller will know the implications of the fine print, while the buyer will not.

In contrast, for the buyer (as for the seller) information about the main terms of the contract, in particular the price, is easy to grasp and is certain to be important. This suggests that the buyer will make her purchase decision only on the basis of the major terms such as price and ignore the fine print warranties. The result will be fine print unfavourable to the buyer: risk or hidden costs will be shifted to the buyer wherever possible. In a competitive market a seller is driven to include such unfavourable terms since if he does not he will be undercut in price by a competitor who lowers her costs by including the unfavourable terms. If the market is a monopoly the result is the same: while the monopolist is not driven by fear of losing business to a competitor it will include unfavourable terms in order to increase its profits.²⁶

But the case for judicial intervention is far weaker than this simplified scenario indicates. An "unfavourable" clause, that is, one which shifts the risk to the buyer, may nonetheless be *desirable* from the consumer's perspective if the cost savings more than compensate for the risks which are shifted to the consumer. Epstein gives the striking example of the warranty found on a standard box of computer diskettes, which limits liability to the replacement cost of the diskette.²⁷ The manufacturer is best able to avoid defects in the diskette, but the consumer is best able to avoid harm resulting from a defect, by backing up the information on another disk. As a consumer of diskettes, I for one, would prefer to make backup copies of my diskettes rather than paying insurance premiums to the manufacturer to cover the potentially enormous losses which could occur if some other user, for want of a backup copy, lost valuable information as a result of a defective disk.

26. The monopolist need not lower its price to compensate for unfavourable terms since the monopoly price depends on the demand curve for the good given the buyer's implicit assumptions regarding the terms.

27. R. Epstein, "Beyond Foreseeability: Consequential Damages in the Law of Contracts" (1989) 18 J. Legal Stud. 105.

Since at least some superficially unfavourable clauses are nonetheless desirable, simply striking down all clauses which limit liability would be counter-productive. Unfortunately, there is no easy test which a court can apply to determine whether a clause is undesirable from the purchaser's perspective. In a competitive market, the buyer will always get *some* benefit from an apparently unfavourable clause, because the cost savings to the seller will be passed on to the buyer through price competition between sellers. To determine whether a clause is desirable the court must calculate the magnitude of the offsetting monetary benefit from the clause and determine whether the trade-off is beneficial: in effect, the court must deduce the optimal contract. But to deduce the optimal contract in any detail is far beyond the competence of the court. As we have seen, the optimal contract strikes a balance between reducing the likelihood of an accident, minimizing the harm which results if an accident does occur, and minimizing the associated administrative costs. This requires knowledge of factors such as the details of the cost to the manufacturer of avoiding defective products, the types of damage likely to result from normal wear and tear, the consumer's use patterns and preferred trade-off between cost and quality, the risk preferences of the parties and the nature of the relevant insurance markets. These different imperatives may and often do point in different directions, and it is rare that the optimal contract will result in one party bearing all the risk.²⁸ Rather, contractual solutions

28. The two most prominent arguments in favour of strict liability for defective products, namely risk internalization and risk spreading, both fail to recognize the complexity of the trade-offs which need to be made. The risk internalization argument says that the party which creates the risk should bear it in order to have the proper incentives to minimize the expected losses. But in almost any instance both parties can take at least some steps to avoid the harm, so that optimal deterrence requires "internalizing" the risk to both parties at the same time. This means that in general it is not possible to speak of one party "creating" the risk, and so it begs the question to argue that the risk should be "internalized" to the party which creates it. The question is the complex one of what is the best allocation of different aspects of risk in light of the different steps which either party may be able to take to protect itself. In some circumstances it may be that one party is so much better placed to bear the risk that it should bear all the risk, but making this determination requires a detailed analysis. The phrase "risk internalization" is misleading at best and incoherent at worst, and should be avoided in the interests of clarity of analysis. The other main argument in favour of manufacturers' liability is that the manufacturer is better able to spread the risk. While this argument may have had general merit before the advent of well developed markets for personal insurance, it is now clear that risk can be spread much more efficiently through first party accident insurance than via tort law and ultimately through the defendant's insurer, because of reduced legal fees and administrative costs associated with first party insurance: see N. Siebrasse, "Economic Analysis of Economic Loss in The Supreme Court of Canada: Fault, Deterrence and Channeling of Losses in *CNR v. Norsk Pacific Steamship Co.*" (1994) 20 Queen's L.J. 1 at 24-28. And aside from the higher litigation costs of third party insurance, enterprise liability may lead to significant distortions in manufacturers' insurance market because of problems of adverse selection and moral hazard: see G. Priest, "The Current Insurance Crisis and Modern Tort Law"

incorporate a careful balancing of incentives for both parties. The courts when faced with the resolution of individual disputes are rarely even presented with evidence required to determine an optimal contract, and in any event there is little hope that the comprehensive information necessary to reach an optimal contract could be reliably extracted after the fact at any reasonable cost. The great advantage which the court has is that it knows which of the myriad possible states of the world actually came to pass. If the possibility was sufficiently remote or bargaining costs were sufficiently high that the parties did not bargain with it in mind, then the court may have no choice but to fill in the gap. But we can be confident that the solution imposed by the court *ex post* will be significantly inferior to that which would have been bargained for by the parties, *if* they had addressed their minds to the particular state of the world which eventuated.²⁹

This suggests that the courts should hesitate to intervene except when there is reason to believe that the parties did not contemplate a particular outcome and when there is a gross departure from the judicial estimate of the optimal contract.³⁰ These criteria are related, since a contract which apparently provides for an unreasonable outcome in a particular set of circumstances is some evidence that the parties did not turn their mind to those circumstances. But given that a court's ability to determine the optimal contract is limited we cannot conclude that a contract is in fact unreasonable simply because it appears to the court to be unreasonable.

Indeed, for a number of reasons egregious failures of bargaining due to rational ignorance are far less likely to arise than is suggested by the unrealistically simplified scenario so far described. The first reason for this is perhaps obvious, but nonetheless deserves emphasis: the argument *only* applies when the bargaining process can plausibly be thought to be impaired by rational ignorance. The facts in *Bird* are precisely those in which the rational actor model is most likely to be satisfied, and these

(1986) 96 Yale L.J. 1521 arguing that manufacturers' liability was in large part responsible for the insurance crisis of the 1980s. In some cases first-party insurance markets may be non-existent or inefficient, so that a compensatory argument can be made in favour of tort liability, but at the very least it can no longer be taken as self-evident that in general the manufacturer or seller is best placed to spread the risk through insurance.

29. See G. Hadfield, "Judicial Competence and the Interpretation of Incomplete Contracts" (1994) 23 J. Legal Stud. 159 for an exploration of the effect of limited judicial competence on the appropriate judicial strategies in filling contractual gaps.

30. Cf *Lloyds Bank v. Bundy*, [1974] 3 All ER 757 (C.A.) in which Lord Denning M.R. stated that the law would hold a contract unconscionable because of inequality of bargaining power when there was both evidence that the bargaining capacity of the plaintiff was impaired and the contract itself was a gross departure from what would have been reasonable (at 765): ignorance and lack of independent advice gives a *prima facie* justification for intervention, but unless the contract is grossly unfair, we cannot be sure that judicial intervention will do more harm than good.

facts are hardly extraordinary. If intervention is justified on the facts of *Bird*, it is justified in any contract. If the lawyers for the purchaser in *Bird* were unaware of the doctrine of caveat emptor surely the appropriate response is to encourage the purchaser to hire better lawyers in the future by holding it to its contract.

It is also an oversimplification to suggest that even relatively unsophisticated parties uniformly never read or understand the fine print. Different consumers have different search patterns, and in many situations at least some will take the trouble to inform themselves of the consequences of the fine print. If a sufficient proportion of buyers do read the fine print and it is costly to offer distinct contracts, then sellers will compete to offer good fine print terms to those consumers who do shop carefully, and other consumers can piggy back off this effort. And "fine print" is insufficiently precise: to this point I have used it as a shorthand to mean contractual terms which a one-time buyer will rationally ignore, but this does not imply that all print which is physically small will in fact be ignored. The more important the fine print clause, that is, the greater the expected value of the presence of the clause, and the less difficult it is to understand, the more likely it is that a significant number of consumers will be able to overcome the information cost barrier and inform themselves of its implications.

A related point is that if the warranty is sufficiently desirable to the consumer, it may be worthwhile for a manufacturer to offer the warranty and advertise it.³¹ The manufacturer will gain business rather than losing it, because if the warranty is desirable the higher price to the consumer is

31. Schwartz & Wilde and Schwartz, both *supra* note 25, have extensive discussions of theory and empirical evidence on consumer search patterns. Eisenberg, *supra* note 25, claims that "most form takers will find it irrational to engage in search and deliberation on any given form" at 244. He supports this assertion with a report of an informal survey of law and economics scholars which indicated that few knew of the specific terms of their chequing accounts and that few balanced their chequebooks. But this simply shows that people are sometimes rationally ignorant, which no one denies, particularly when the cost of ignorance is low. (I suggest that if monthly chequing account fees were \$50, most law and economics scholars would be aware of this fact.) One cannot conclude from this that people are ignorant of very important non-price terms in all or even most circumstances. Further, Eisenberg makes no mention of the role of advertising, as opposed to pure consumer search, in overcoming rational ignorance about egregious fine print terms. Warranty advertising is of course extensive in the case of many consumer products, e.g. automobile warranties. In the real estate market we also see advertising regarding paradigmatic fine print mortgage terms, such as the right to prepay, and the right to skip occasional payments. J.M. Ramseyer, "Products Liability Through Private Ordering: Notes on a Japanese Experiment" (1996) 144 U. Pa. L. Rev. 1823 shows that although formal Japanese products liability law prior to 1995 was a negligence regime, many manufacturers voluntarily combined voluntary safety testing with a strict liability warranty which was indicated by a standardized "SG" (Safety Goods) label.

more than offset by the protection offered. This suggests that in cases egregious enough that the courts can intervene with confidence, market forces are likely to work to overcome the problem of rational ignorance even without judicial intervention.³²

Nonetheless, it is plausible that there are cases in which rational ignorance leads a purchaser to make a decision she would not have made with full information. But the appropriate response to this type of bargaining failure is arguably not to impose judicially fashioned liability in tort, but rather to provide the relevant information so as to encourage bargaining. An implied warranty could achieve this result because a return to caveat emptor would require an express disclaimer in the contract. This would reduce the cost of discovering the relevant information, perhaps sufficiently to overcome the problem of rational ignorance. This option will be discussed at length below, after we examine a different potential justification for judicial intervention, namely irrationality on the part of the purchaser.

2. Irrationality

Good decision making also requires the ability to rationally process relevant information. Empirical research into decision making under uncertainty has demonstrated a host of systematic departures from a subjective utility maximizing models of decision making.³³ For example, studies show that in making decisions regarding uncertain events people are often over-optimistic;³⁴ that the probability of events which are easily called to mind perhaps because of wide reporting (airplane crashes) or personal experience are over-estimated ("salience" or "availability");

32. To the extent that the advertising informs the purchaser of a common issue, *e.g.* that the default rule is caveat emptor, advertising is a public good and the first to advertise will not reap all the benefits. This may be one reason why advertising competition over warranty terms may be slow to develop; see *infra* Genesis of Warranty Corporations at part VI. This suggests that advertising is more likely to develop if one manufacturer has a comparative advantage in offering a warranty, although competition for market share might often be a sufficient incentive.

33. A good review is found in C.F. Camerer & H. Kunreuther, "Decision Processes for Low Probability Events: Policy Implications" (1989) 8 J. Policy Analysis & Mgmt. 565; see also D. Kahneman, P. Slovic & A. Tversky, *Judgment Under Uncertainty: Heuristics and Biases* (New York: Cambridge University Press, 1982).

34. Most newly married couples correctly estimate the chance that a marriage will end in divorce as 50% and at the same time estimate the chance that their marriage will end in divorce as 0%; see L.A. Baker & R.E. Emory, "When Every Relationship is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage" (1993) 17 Law & Human Behav. 439. Similarly, 90% of drivers believe they are better than average: O. Svenson, "Are We All Less Risky and More Skillful Than Our Fellow Drivers?" (1981) 47 Acta Psychologica 143. This can be summed up as a belief that "it couldn't happen to me".

that low-probability high-consequence risks may be under-estimated³⁵ or over-estimated;³⁶ and that the decision taken depends strongly on the way in which the question is presented, in particular whether the decision is posed as involving gains or losses ("framing" effect).³⁷

It has been argued that this systematic "irrationality" in risk assessment may provide a good justification for judicial intervention in contracts.³⁸ Even if the rational ignorance problem is overcome and the purchaser is made aware of the risk in question, he may not give sufficient weight to the risk of the accident because of over-optimism and/or under-estimation of low-probability events. This argument is distinct from the rational ignorance argument both conceptually and in its policy implications. Because the purchaser may irrationally choose not to buy a favourable warranty even if fully informed, encouraging informed bargaining may not be a solution. We might therefore prefer that the court impose the warranty in a non-disclaimable fashion (e.g. in tort), or, conversely, that the court ignore disclaimers of warranty. But while the evidence is clear that a simple expected utility model of decision making is not always descriptively accurate, there are a number of difficulties with this argument, which may be summarized as follows: first, the normative implications of "irrational" behaviour are unclear; second, the empirical implications of these behaviour patterns are difficult to predict in any given specific set of circumstances; and third, it is by no means obvious that judges can make better risk assessments than the purchaser,

35. In a classic empirical study H. Kunreuther, et al., *Disaster Insurance Protection: Public Policy Lessons* (New York: Wiley, 1978) found that a relatively small proportion of homeowners living in hazardous areas protected themselves against flood and earthquake damage. They argue that this is because individuals refuse to attend to or worry about events whose probability is below some threshold.

36. W.A. Magat, W.K. Viscusi & J. Huber, "Risk-Dollar Tradeoffs, Risk Perceptions, and Consumer Behaviour" in W.K. Viscusi & W.A. Magat, *Learning About Risk: Consumer and Worker Responses to Hazard Information* (Cambridge: Harvard University Press, 1987) at c. 5. finding that people reported a willingness to pay the equivalent of \$120,000 to avoid a hand burn from drain opener which would be fully healed within a week.

37. In one of the best known experiments on the framing effect, the choice between two hypothetical courses of treatment for a disease was shown to depend strongly on whether the outcomes were presented in negative terms (lives lost) or positive terms (lives saved): see A. Tversky & D. Kahneman, "The Framing of Decisions and the Psychology of Choice" (1981) 211 *Science* 453. A good review is found in A. Tversky and D. Kahneman, "Rational Choice and the Framing of Decisions" in R.M. Hogarth & M.W. Reder, eds., *Rational Choice: The Contrast Between Economics and Psychology* (Chicago: University Chicago Press, 1987) [hereinafter *Rational Choice*].

38. Eisenberg, *supra* note 25; R.L. Hasen, (Comment) "Efficiency Under Informational Asymmetry: The Effect of Framing on Legal Rules" (1990) 38 U.C.L.A. L. Rev. 391. Hasen is more moderate in his recommendations than is Eisenberg, arguing mainly that irrationality in decision making must be taken into account.

since judges are as subject as anyone else to decision making biases. I will examine these issues in order.

The term “irrationality” is misleading because of its strong normative connotations: “irrational” behaviour is to be avoided.³⁹ But used descriptively it simply means behaviour inconsistent with a postulated description of rationality, which may be formal, such as expected utility theory,⁴⁰ or informal, such as the idea that paying \$120,000 to avoid a mild burn is irrational.⁴¹ These postulates of rationality may be attractive as a description of rationality but this hardly implies that the courts should step in to enforce behaviour which is rational according to these tenets. The observation that people under-estimate the probability of low-probability events is equivalent to saying that people are risk-seeking rather than risk averse with respect to low-probability events; in other words people sometimes choose to gamble. Gambling may be undesirable, but judicial intervention to prohibit it is not uncontroversial. Similarly, subjective assessment of risk can vary significantly depending on the form in which the same relevant information is presented (the framing effect), but this gives no guidance to the court in determining which of the different subjective risk assessments is “correct”. Judicial intervention to enforce “rational” behaviour is a paternalistic strategy in which the court is implicitly asserting that it knows better than the individual what is that person’s best interest. In contrast, the argument in favour of extended liability based on rational ignorance which was sketched above rests on a much weaker normative assumption, namely that more information is better than less information when a purchaser is faced with a decision. This justification fully respects the autonomy of the individual since the final decision remains with the purchaser.

In suggesting that individual irrationality is normatively suspect, I am not making the libertarian argument that the choices of the individual must be respected in all circumstances. On the contrary, I am quite willing to say that in some circumstances the individual in question just doesn’t

39. Eisenberg, *supra* note 25, refers to “cognitive deficiency” which has similarly strong normative connotations.

40. Classic statements of expected utility theory are found in J. von Neumann & O. Morgenstern, *Theory of Games and Economic Behavior* (Princeton: Princeton University Press, 1944) at 26–27 and L.J. Savage, *The Foundations of Statistics* (New York: Wiley, 1954). For a succinct summary of the basic assumptions see *Rational Choice*, *supra* note 37 at 68–69.

41. See *supra* note 36. Note that systematic under- or over-estimation of low-probability risks *per se* is not necessarily inconsistent with expected utility theory and so is not necessarily irrational in this formal sense. A refusal to buy subsidized disaster insurance may be considered irrational nonetheless because of a subjective judgment by policy makers that the cost-benefit trade-off favours insurance. On the other hand, the fact that assessment of risk changes depending on how the risk is presented (the framing effect) is formally irrational.

know what is best and social intervention in their decision-making is justified (for example in the case of present day teenagers who begin smoking with full knowledge that cigarettes cause cancer). Rather I am arguing that the simple fact of a departure from an academic model of perfect rationality is not in itself a compelling argument that the individual decision making process is so defective that judicial intervention is required. If the psychological literature is correct, most decision making under uncertainty is irrational to some extent: this does not justify ubiquitous judicial intervention. Rather, the courts should intervene only when they are satisfied that the decision-making process has failed egregiously.⁴²

A second difficulty with irrationality as a justification for judicial intervention in contracts is that psychological models of risk assessment are very difficult to apply. While studies have succeeded in demonstrating departures from utility maximizing behaviour in a wide variety of circumstances, and particularly in the assessment of low-probability risk, the psychological models are complex. Subjective assessment of risk appears to depend strongly on the specific form in which the choice is presented. We know from a specific empirical study that people tend not to buy flood insurance even at subsidized rates. At the same time, people often do purchase extended warranties on consumer goods at prices which are apparently significantly higher than is actuarially fair.⁴³ Is building warranty protection more like flood insurance or more like extended warranties on consumer goods? Psychological theories of decision making are not of much help in answering this question in the

42. This should not be taken to suggest that increasing the availability of information can be clearly demarcated from imposing a decision. Since decision-making under uncertainty has been shown to be strongly influenced by the form in which the information is presented, the choice of the form in which information is delivered is itself normatively laden. In extreme cases the manner of presenting the information may largely determine the decision. There is nonetheless an important difference between increasing the information available through the implied warranty approach and imposing a decision under the tort approach. A serious shortcoming in Eisenberg's argument (*supra* note 25) is that while he identifies rational ignorance and irrationality as separate types of "bounded rationality" he largely conflates them normatively, and uncritically assumes that failures of rationality justify judicial action.

43. The Consumer Union of the US Inc. in its 1996 Buying Guide (Consumer Reports, Vol.60 No.13) indicates that for televisions "an extended service contract is a bad investment" (at 29) and that retailers push service contracts for audio and video equipment aggressively because of estimated profits ranging from 40 to 77 percent (at 14). Cognitive psychology supports the intuition that the decision to purchase warranty protection is strongly influenced by how hard the warranty is "sold", as the risk of an event which is described in specific and concrete detail will be over-estimated. Casual observation suggests that (apparently without the benefit of formal training in the psychology of risk assessment) some discount sellers of consumer goods offer a very low price, then make a profit by selling warranties at inflated prices by emphasizing the risk of product failure.

abstract. Prediction of the direction of bias in decision-making is difficult at best and perhaps impossible without a detailed description of the decision-making context, in particular the nature of the market and the product sold.⁴⁴ This means that it is difficult to make robust normative recommendations.

Finally, there can be no doubt that judges are as susceptible to decision making biases as anyone else.⁴⁵ Indeed, one of the most compelling and well-documented biases is particularly likely to affect judges. The “hindsight” bias is the tendency to regard an event which has actually occurred as having been much more predictable than it truly was.⁴⁶ Whenever a plaintiff comes before the court having suffered a loss, we can say, with the benefit of hindsight, that it would have been better for that individual to have purchased insurance or a warranty, even though not purchasing insurance may have been entirely rational at the time of the purchase if the expected loss was smaller than the insurance premium. That is, it may be that the victim was unlucky but not irrational. The hindsight bias makes it more likely that the failure to purchase insurance will be viewed as irrational rather than simply unlucky since the probability of loss will be over-estimated by the court. Since all judicial decision making occurs with the benefit of hindsight, empirical psychology indicates that there will be a strong tendency for courts to impose over-insurance. This over-insurance by the courts is as irrational as the purported under-insurance by individuals making decisions *ex ante*, since neither is welfare maximizing. Without specific empirical research it is not possible to say which effect is worse.

44. Schwartz & Wilde, *supra* note 25, and Schwartz, *supra* note 25, emphasize the role of advertising in reducing search costs, but it is just as relevant to the problem of irrationality, as advertising by manufacturers changes the “framing” of the choice as well as providing buyers with more information. Eisenberg, *supra* note 25, does not consider this aspect of the warranties.

45. There is some evidence professionals working in their area of expertise are also susceptible to various forms of irrationality in decision making: see the description by Tversky and Kahneman of the effect of framing on a medical problem presented to physicians: *Rational Choice*, *supra* note 37 at 84ff. In any event construction is not an area of judicial expertise.

46. B. Fischhoff, “Hindsight ≠ Foresight: The Effect of Outcome Knowledge on Judgment Under Uncertainty” (1975) 1 *J. Experimental Psychology: Human Perception and Performance* 288; B. Fischhoff & R. Beyth, “I Knew It Would Happen . . . Remembered Probabilities of Once-Future Things” (1974) 13 *Organizational Behaviour and Human Performance* 1. See K.A. Kamin & J.J. Rachlinski, “Ex Post ≠ Ex Ante—Determining Liability in Hindsight” (1995) 19 *Law & Human Behav.* 89 (hindsight bias in assessing adequacy of municipal flood preparation); D.J. Lowe & P.M.J. Reckers, “The Effects of Hindsight Bias on Juror Evaluations of Auditor Decisions” (1994) 25 *Decision Sciences* 401 (hindsight bias by jurors in assessing auditor performance); J.L. Anderson, D.J. Lowe, & P.M.J. Reckers, “Evaluation of Auditor Decisions—Hindsight Bias Effects and the Expectation Gap” (1993) 14 *J. Econ. Psych.* 711 (hindsight bias in American federal and state judges in assessing auditor performance).

In summary, both rational ignorance and “irrationality” lead to contracts which differ from those which would have been entered into by fully informed subjective utility maximizing consumers. This in itself does not justify judicial intervention. Rather we must ask whether a judicially imposed solution is likely to be better than the admittedly imperfect bargain. Since the courts, like the parties, suffer from imperfect information and irrationality, there can be no presumption that bargaining failure justifies judicial intervention. This is not a prescription for non-intervention: since the parties and the courts suffer from different forms of bounded rationality, judicial intervention will be beneficial in some circumstances. It is important though, that the courts intervene only in circumstances where there is reason to think that intervention will do more good than harm.

III. *Warranties for New Homes*

1. *The New Home Warranty Programs*

This section applies the theory discussed above to warranties for structures. The justification for judicial intervention in warranty terms depends on the functioning of the market in question, and there are several distinct markets for structures. The first we will examine is the market for residences, as purchasers are most likely to be unsophisticated.

Intuition suggests that for residential home buyers at least, who do not have ready access to alternative insurance against defective homes, the optimal contract for purchase of a home would include a warranty against defects. Builder/developers will often engage in many more home transactions than will residential buyers, and the law of caveat emptor in home sales is both counter-intuitive and difficult for an unaided home buyer to discover. Thus we should be alerted to the problem of distortion of the market because of rational ignorance.

But, as noted, the simple rational ignorance story is too pessimistic. In the case of buildings, New Home Warranty Corporations have been privately established in each province to provide warranties (the “Warranty”) for new residences,⁴⁷ except in Ontario which has an equivalent

47. New Home Warranty of British Columbia Inc. (British Columbia and the Yukon); New Home Warranty Corp. of Alberta; New Home Warranty Program of Saskatchewan; New Home Warranty Program of Manitoba Inc.; La Garantie des maisons neuves de l'APCHQ, Les Plans de Garantie de l'ACQ Inc (Quebec); the Atlantic New Home Warranty Corp. (all the Atlantic provinces). These programs are all non-profit organizations organized by builders. An independent program, the National Home Warranty Program, started operation in 1990 in Alberta and has recently moved into B.C.

statutorily established program.⁴⁸ While some details vary between jurisdictions, the broad outline of the program and many of the details are common. The Corporations are non-profit corporations whose members are residential home builders. Builders must apply and be accepted into the program. Builders who are members can enroll any residential unit they construct in the program on payment of a fee ranging from roughly \$150–\$900 per residential unit for five year protection.⁴⁹ The majority of homes would be covered for \$400 or less. In some jurisdictions member builders are obliged to enroll all homes they construct in the program, but even in those where there is no such requirement essentially all homes built by a member builder are enrolled, no doubt because builders who are eligible for the warranty program find that offering a home with a warranty makes it more attractive, despite the modest increase in price. Since most established builders are members of their regional or provincial Warranty Corporation the individual homes which are not covered are primarily those built by individuals building homes for themselves, or by small builders who build houses for sale on an occasional basis, as well as mobile homes and housing built under social housing programs. The result is that a large proportion of new homes in Canada are covered by such Warranty protection.⁵⁰

An express warranty is of course much easier to read than the judicial decisions establishing the default rule of caveat emptor. Not only are the warranties themselves reasonably free of legalese, but the Corporations also provide brochures which accurately explain and describe the warranty and crucial terms. This supports the theoretical argument that builders will find it in their interest to inform the public of the terms of the fine print, in order to attract business. The information asymmetry problem is overcome by advertising, at least for those prospective purchasers who inquire seriously about a new home which is covered by the Program. Further, there is some spillover of information since it is the practice of most real estate agents to inform a prospective purchaser of the

48. *Ontario New Home Warranties Plan Act*, S.O. 1976, c. 52, R.S.O. 1990, c. O.31.

49. The basis for determining the enrolment fee varies between jurisdictions. A sliding scale based on the price of the house is the most common factor, although it is not used universally, and builder experience and/or type of residence are also considered in some jurisdictions.

50. The Warranty Corporations generally indicate that a significant majority of commercial residential builders are enrolled, although there appear to be significant variations in coverage between jurisdictions, and coverage in urban areas is higher throughout the country, as more homes in rural areas are built by builders who are not commercial builders. Overall, at least half of new homes, excluding mobile homes and social housing, are covered, and the proportion is probably significantly higher. In Ontario all new homes except those built and occupied by the home owner are covered by the program since all builders and vendors of new homes must be registered under the *Ontario New Home Warranties Act*, *supra* note 48, s. 6.

warranty when showing a home which is eligible. Presumably most purchasers then notice the omission when no mention is made of a warranty when they view a home which is not covered by the program. Thus in many cases even a purchaser who does not ultimately purchase a home which is covered will be aware that their home is not covered by a warranty. While this fits the argument made earlier suggesting that market forces will drive vendors to provide warranties where it is desirable to do so, we shall see that the Warranty Corporations did not arise simply as a market response to information failure.⁵¹ Nonetheless, the existence of the Warranty Program must be taken into account when deciding whether builder's liability should be extended in tort.

We should not expect the Warranty which is offered to be optimal in a strong sense. To fashion the optimal warranty the Warranty Corporation would need to know the distribution of marginal costs of improvement in construction techniques of its members, the statistical marginal benefit of these construction techniques in terms of reducing defects, the risk preference distribution of the buyers, and the details of a number of other factors which will be discussed below. Corporations, like individuals, are faced with limited information processing capacity and are unlikely to be able to correctly amass and process the information needed to optimize perfectly through *ex ante* calculations. Rather, optimizing behaviour can be expected to arise, if at all, as a result of a sort of natural selection from among the various quasi-random attempts at optimization, so that only those firms which offer the best products, perhaps through luck as much as planning, will survive and prosper.⁵² The selection pressure comes from competitive forces (a firm with a good warranty will have more sales than a firm with a poor warranty), the shareholders' pursuit of maximum share value, and the threat of managerial displacement by takeovers.⁵³

These selection pressures are weak in the case of the Warranty Programs. The profit pressure felt by a monopolist is absent because there

51. See Genesis of Warranty Corporations, *infra* part VI.

52. Different consumers have different tastes for risk, so, neglecting transaction costs, individually optimal warranties would be different for every buyer. But we cannot neglect transaction costs, and having only one warranty company undoubtedly reduces the administrative costs of offering the warranty, which may, on the whole, more than compensate for the lack of variety: see *e.g.* B. Klein, "Transaction Costs Determinants of "Unfair" Contractual Arrangements" (1979) 70 *Am. Econ. Rev. Pap. & Proc.* 356.

53. For classic statements of this position see A. Alchian, "Uncertainty, Evolution and Economic Theory" (1950) 58 *J. Pol. Econ.* 211 and M. Friedman, "The Methodology of Positive Economics" in M. Friedman, *Essays in Positive Economics* (Chicago: University Chicago Press, 1953). The optimization is "quasi-random" because, given that the firms have incentives to attempt to maximize, the strategies which are attempted will not be entirely random even if bounded rationality introduces an element of noise.

is no real monopoly. Individual builders are still in competition over price, which implies that the gains from the warranty will be reaped primarily by the consumer. Nor do managers face the discipline of a takeover market. Perhaps most importantly, direct selection pressure from competition over warranty terms is weak. Since there has traditionally been only one Warranty Corporation in most jurisdictions⁵⁴ the main alternative is to buy from a non-member builder, who is small and almost certainly does not offer any significant warranty protection (recall that the Programs only cover residences).⁵⁵ An independent insurer, the National Home Warranty Program started operation in 1990 in Alberta and has recently moved into B.C., but it competes solely on price, offering the same warranty coverage as the Warranty Corporation of the jurisdiction in which it operates. Thus competition does not create significant pressure to experiment with warranty terms. On the other side of the bargain, it also seems unlikely that purchasers will demand changes in the terms so long as they are roughly acceptable because once a reasonable warranty is offered the effort required to demand small improvements is disproportionate to the possible benefit and precise calculations of the optimal bargain are probably beyond the information processing abilities of the purchasers.⁵⁶

But a comparative analysis is required. In order to justify judicial intervention it is not enough to show that the contract which the parties arrive at is non-optimal: it must also be shown that the courts can do better. Thus for the purpose of my argument I do not need to claim that the Warranty offered by the Corporations is optimal in any strong sense, but only that it is plausibly as good or better than that which could be

54. An exception is Quebec, which has had two competing warranty programs for a considerable time.

55. An informal warranty may be offered—"I'll fix any problems"—but this is unlikely to credibly extend to major structural defects as the small builders who are not members of the Program will often be financially unable to guarantee protection, and may well have disappeared by the time problems appear. One of the major advantages of the Warranty Program is that the Corporation takes ultimate responsibility for repairing major structural defects, thus eliminating the problem of impecunious builders.

56. These points are variations on rational ignorance and irrationality. I argue that these problems of bounded rationality prevent bargaining to the optimal contract even though they do not prevent reaching a roughly optimal contract because as the contract approaches the optimal contract the effect of rational ignorance and irrationality increases because of decreasing returns to the effort expended. Note that the benefits to an individual consumer of demanding different terms are very small because the standard form contract is unlikely to be changed for a single transaction. Nonetheless, it is plausible that a purchaser might express a preference at low cost and that these preferences would be reflected in an updated contract if they were expressed sufficiently consistently. See Priest, *supra* note 25, who argues more strongly that the warranties terms for consumer products are optimal, but in the context of an environment with much greater selection pressures.

fashioned by the courts. While the Warranty Corporations may not be forced by competitive pressures to arrive at the optimal warranty, they have as much incentive as the courts to attempt to fashion the optimal contract, because once the purchaser is aware of the existence of the warranty and has her attention drawn to it, a better warranty makes the property more attractive. And while the Warranty Programs do not have complete information, they have far more information about the industry structure and costs than do the courts. Thus both the Warranty Corporations and the courts are likely to try to write the best warranty, but the Corporations have more information on which to base their attempt.

2. *The Substantive Warranty Terms*

Even though the rational ignorance problem is largely overcome for homes covered by the Warranty Program, and assuming that the Warranty Programs do try, at least weakly, to develop a warranty which is attractive to purchasers, irrational decision making is still a concern. If purchasers systematically misperceive risks then the contract they request may not be in their own best interest. As noted, psychological models of decision making do not allow us to decide this without specific empirical study. But rather than studying the decision-making process involved in buying home warranty protection, we can examine the results, that is, the warranties themselves. If the protection offered by the Warranty is obviously deficient this may indicate bargaining failure because of irrationality by the purchaser and judicial intervention may be justified (with the by-now standard caveat that the courts are also affected by irrationality). This means that a more detailed examination of the terms of the Warranty is called for in order to determine how it attempts to achieve the goal of deterring accidents while compensating victims of defective construction and minimizing administrative costs. In so doing we will explore issues of more general concern, in particular the problem of indeterminacy in recovery for pure economic loss and the reasonable discoverability rule for the running of limitations periods in tort.

A first point to note is that while the Warranty Program ultimately guarantees that the Warranty will be satisfied, the liability imposed by the warranty nonetheless provides strong incentives to the builder to take care in building. This is because the builder is typically primarily liable under the terms of the Warranty, with the Warranty Program providing only a guarantee if the builder does not satisfy its obligations. Further, builders who have poor records will eventually be expelled from the Program and, in some jurisdictions, will pay higher premiums to enroll their houses.

The Warranty expressly extends to subsequent purchasers.⁵⁷ This is significant because it shows that in fact, and not just in principle, the contractual chain between the builder and a subsequent purchaser is sufficiently short that encouraging a contractually based solution is a feasible approach for the courts to take. In this respect the warranty is as favourable to the buyer as tort law.

The main barrier to extending recovery for pure economic loss has been the courts' long-standing concern with the spectre of "liability in an indeterminate amount for an indeterminate time to an indeterminate class."⁵⁸ In *Bird* the Court responded to this concern by noting that liability would be limited to a defined class of persons (namely the inhabitants of the building), for a limited period (the life of the building) and for a limited amount (the cost of repairs). The Warranty coverage addresses all of these considerations directly. The Warranty provides coverage of "major structural defects" for a term of five years, and coverage of other latent defects in materials and workmanship for a term of one year, up to a specified dollar limit.⁵⁹ Harm to persons or other property is expressly excluded.⁶⁰ As compared to tort recovery, the Warranty coverage is both more 'determinate' and more restricted in scope. In order to assess whether the coverage offered by the Warranty presents a better trade-off than that available through tort law we need to explore the functions of the Warranty limitations in more detail.

The underlying reasons for the courts' concern regarding indeterminate liability have rarely been clearly articulated. La Forest J.'s position in his decision in *CNR v. Norsk Pacific Steamship Co.*, that indeterminacy is a concern because it may increase the cost of insurance, was a significant step forward in this regard.⁶¹ The intuition behind this assertion is evidently that just as a riskier investment demands a higher rate of return, a riskier insurance exposure demands higher premiums. But this

57. B.C. cl. 5; Alta. cl. 8; Sask. cl. 4.5; Man. cl. 14; Que. (APCHQ) cl. 2.1.3; Atlantic Clause 10. The Ontario statutory warranty applies directly to the home rather than to the purchaser.

58. *Ultramares Corp. v. Touche Niven & Co.* 174 N.E. 441 (N.Y. Ct. App. 1931) per Cardozo C.J. at 444, quoted in *Bird*, *supra* note 3 at 124; in *Norsk*, *supra* note 1 at 1137 per McLachlin J.

59. B.C. cl. 2(c) and 3(c); Alta. cl. 2(b), 3(b); Sask. cl. 2.2, 2.3; Man. 3, 8; Que. (APCHQ) cl. 2.1.2, 2.1.3; Atlantic cl. 2(b), 6. The Ontario coverage is two years for materials and workmanship, and water penetration (Reg. 892 ss. 14, 15(3)), and seven years for major structural defects (Reg 892, s. 16).

60. B.C. cl. 6(d); Alta. cl. 6(c); Sask. cl. 4.3; Man. cl. 10; Ont. Reg 892, s. 6(6); Que. (APCHQ) cl. 3.1; Atlantic cl. 8.

61. "Estimating liability is, of course, a key aspect to the pricing of insurance for potential tortfeasors." *Norsk*, *supra* note 1 at 1105 and see the discussion in Part IV of his decision, especially at 1116–25.

intuition needs to be made more precise. "Indeterminacy" in insurance can refer either to variability in the size of individual claims (the variance or standard deviation of the claims distribution, to use more technical language) or uncertainty in the size of the average claim (uncertainty in the mean of the distribution).⁶² These types of uncertainty are distinct because given a sufficiently large statistical base, the average claim may be well defined even though the size of any individual claim is highly variable. It appears that in raising the issue of indeterminacy in the context of increased recovery for pure economic loss, the courts are concerned with variability in the size of individual claims, as allowing recovery for pure economic loss will increase the range of claims by pushing up the size of the top awards.⁶³ But the theory and practice of insurance pricing indicate that it is uncertainty in the mean of the distribution which has the most significant effect on the price and availability of insurance. Increased variance of the distribution will be important only in unusual circumstances.

Consider first the effect of increased uncertainty on the size of individual claims. Insurance reduces risks by pooling, but in principle the uncertainty cannot be eliminated for any finite pool of risks. In a simple model, with normally distributed uncorrelated claims, the reserve per exposure unit required to maintain a given risk of ruin (i.e. the risk that the reserve will not be sufficient to satisfy all the claims) increases with the variability of the claims, and decreases as the number of exposure units increases (because more units allow greater statistical predictability).⁶⁴ But in practice the effect of increased variability of individual claims is likely to be very small. In the first place, the reserve per claim is small. For example, if there are 10,000 exposure units, and the standard deviation of the claims distribution is equal to the mean, a reserve equal to about 2.5% of the expected average claim is sufficient to maintain a risk

62. Sometimes "indeterminacy" seems to be used to refer to a claim which is potentially very large. This can be very misleading. The fact that the average loss resulting from a certain type of activity is very large is no reason to deny liability, since this means the activity is very harmful. While the distinction between large and indeterminate losses is clear in principle, it may be confusing in practice. For example, a change in tort law which introduces the potential for a few very large claims will increase the variability of individual claims and the size of the average claim. The uncertainty of the average claim will also increase, since time is needed to develop a statistical basis for predicting future claims after a change in the law.

63. The size of the average claim will of course also increase, and this will lead to an increase in premiums, but this is good or bad depending on whether the increased recovery serves the goals of deterrence and compensation.

64. More precisely, the required reserve per unit is proportional to the variance of the claims distribution and inversely proportional to the square root of the number of exposure units: see J.D. Cummins, "Insurer's Risk: A Restatement" (1974) 41 J. Risk & Ins. 147 for an explanation of the basic model.

of ruin of 1%.⁶⁵ In other words, even if the reserve had to be established anew every year out of premium income, the “risk premium” would only be about 3% of the total premium. But the reserve is not established anew each year out of premium income. Rather it is rather built up by raising outside equity, or by retained earnings over a period of time. Once the reserve is built up, the cost of maintaining the reserve, which is ultimately passed on to policyholders, is the cost of that capital. So, if the standard deviation doubled so that the reserve requirement increased by 3%, the increased annual premium would not be 3%, but simply the interest on that extra amount. At an interest rate of say, 15%, that would be only an extra 0.5% on top of the premium. Further, the policy holder does not need to pay even the entire interest on the extra reserve, as the insurer will invest the reserve. The extra cost which flows through to the policy holder is only the difference between the interest rate earned by the insurance company and the rate of return which could be earned on the same capital by the policy holder or investor.⁶⁶ This may be significant, since insurers generally invest very conservatively, but the extra investment income could well cover half the cost of the capital. So, in the simple example I have given, if the standard deviation of the claims doubled, an insurer who wished to maintain a 1% risk of ruin would only need to increase premiums by at most 0.25%.⁶⁷

Increased variance in individual claims may be important in some instances. If the size of the market is small, and the insurer is small and specialized and so cannot pool risks across lines, a larger claims variance may significantly increase reserve requirements, since the required reserve is inversely related to the number of exposure units. Increased indeterminacy of individual claims may also have an impact on the availability of insurance when the increased indeterminacy results from the addition of a group of high-risk insureds to the pool. If this group

65. *Ibid.* at 150.

66. Further, we need to look not just at the cost of the particular type of insurance which is most salient in the case at hand, but at the overall insurance costs of those who are likely to be victims. Expanded coverage of one type of insurance, e.g. builder's liability, increases the indeterminacy and thus the premiums for that type of insurance, but may reduce the indeterminacy and the premiums for another type of insurance (or equivalently, reduce the risk from being entirely uninsured for a given type of loss). The net effect is important to the insured, and not just the increase or decrease in premiums for one particular type of insurance. It is not possible to generalize about the net effect on indeterminacy resulting from increased recovery for pure economic loss.

67. A 1% risk of ruin may be on the high side, and the assumption that the mean equals the standard deviation is not necessarily realistic for any particular type of loss (although in home warranty claims it probably overestimates the risk), but the important point is that the manner in which the reserve is financed greatly reduces the impact of increased claims variance on insurance premiums.

cannot be separately identified, premiums for the group as a whole will increase, and low-risk insureds will have to pay premiums which do not reflect their risk. This may result in "unravelling" of the risk pool as low-risk insureds drop out entirely. This is not really a problem of indeterminacy in the claim distribution, but rather a problem of proper categorization of risks. It is a particular problem in third-party liability insurance.⁶⁸

Uncertainty in the average claim, on the other hand, is very important to insurance pricing and availability. The previous discussion of financing of the risk reserve considered a static analysis, that is, what risk premium is required in the steady state to maintain adequate reserves. Insurance cycles generally, and many aspects of the insurance crisis of the mid-1980s in particular, such as drastically increased prices and the unavailability of some types of insurance, are best explained as being due to capacity constraints in the insurance industry resulting from capital market imperfections.⁶⁹ Internal capital is less expensive than tapping the stock market as a means of building up the reserves necessary to support underwriting. As a result, if a shock to the market depletes reserves, premiums will rise and underwriting will be curtailed so that excess profits can rebuild the reserves.

Perhaps counter-intuitively, a market with high claims variability is no more likely than a market with low claims variability to suffer shocks, since a market with higher claims variability will in general have a correspondingly higher reserve. Bad years which deplete the reserves are likely to happen with equal frequency in either type of market. Rather, shocks to the market result primarily from uncertainty in average claims. If an insurer has underestimated its average claim, reserves can soon be depleted, since high losses in a bad year will not be compensated for by surpluses in a good year. The difference between the estimated mean loss

68. See G.L. Priest, "The Current Insurance Crisis and Modern Tort Law" (1987) 96 Yale L.J. 1521.

69. Part of the reason for price increase for liability insurance was simply due to expanding tort liability (see P. Danzon, "The Frequency and Severity of Medical Malpractice Claims: New Evidence" (1986) 49 Law & Contemp. Probs. 57 and S. Harrington & R. Litan, "Causes of the Liability Insurance Crisis" (1988) 239 Science 737) but many specific aspects of the crisis can only or best be explained by the capacity constraint theory, which is developed in R.A. Winter, "The Dynamics of Competitive Insurance Markets" (1994) 3 J. Fin. Intermediation 379; R.A. Winter, "The Liability Crisis and the Dynamics of Competitive Insurance Markets" (1988) 5 Yale J. on Reg. 455; A. Gron, "Capacity Constraints and Cycles in Property-Casualty Insurance Markets" (1994) 25 RAND J. Econ. 110; A. Gron, "Evidence of Capacity Constraints in Insurance Markets" (1994) 37 J. Law & Econ. 349. A relatively accessible discussion is found in R.A. Winter, "The Liability Insurance Market" (1991) 5 J. Econ. Perspectives 115; and see G. Niehaus & A. Terry, "Evidence on the Time Series Properties of Insurance Premiums and Causes of the Underwriting Cycle: New Support for the Capital Market Imperfection Hypothesis" (1993) 60 J. Risk & Ins. 466.

and the actual mean loss represents a direct net reduction in the insurer's reserves.

There are a number of sources of uncertainty in the average claim size. New products or technologies may have uncertain average claims simply because the claims history is not long enough to build up a good statistical understanding of the risk. While this uncertainty is transitional in the sense that eventually a statistical base for assessing the risk will be built up, for products which have 'long-tail' risks, the transitional phase may last for decades. Uncertainty regarding inflation also affects average claims. But the source of uncertainty which is most relevant to tort law is "socio-legal" risk, that is, uncertainty in the state of the tort law or insurance law which causes a correlated increase in claims. Thus, it is not the increased range in the size of claims resulting from increased recovery for pure economic loss which is most troublesome, but the uncertainty engendered by the changing state of the law. In short, the court can best promote the affordability and availability of insurance by ensuring stability in the law.⁷⁰

To return to the warranty programs in particular, the dollar limit on the Corporation's liability is primarily determined by actuarial reserve requirements, and illustrates some of these issues. Since it takes time to build up adequate reserves, and the reserves are established by enrollment fees, the cap in all jurisdictions was initially relatively low, \$20,000, in order that the initial fees could be set at reasonable levels. Typically as the program matures and adequate reserves are built up, the cap increases to cover the full market value of the home.⁷¹ However, as noted, a jurisdiction with fewer units covered is inherently riskier than a jurisdiction with many units. Even in the smaller jurisdictions, the numbers are probably sufficiently large that the small numbers problem would not be severe, except that claims may be significantly correlated. In particular, claims from a large number of units in a single poorly constructed subdivision, or from increased exposure when a large builder fails, are major sources of correlated risk for the Warranty Corporations. This means that at a given cap on liability, small jurisdictions require higher reserves to

70. See M. Trebilcock, "The Social Insurance Dilemma of Modern North American Tort Law" (1987) 24 San Diego L. Rev. 929 detailing the sources of socio-legal risk in the United States which contributed to the insurance crisis. Trebilcock argues that one reason for an insurance crisis in Canada which mirrored that in the United States in some respects, despite significant differences in our tort law, is an insurer expectation that our tort system would converge with that in the U.S.

71. In Quebec the APCHQ covers the full amount of the price of the house, to a limit of \$200,000 (unless a higher limit is approved). Other jurisdictions cap liability below the price of many houses. The current limits are: B.C. \$100,000; Alta. \$60,000; Sask. \$20,000; Man. \$30,000; Ont. \$100,000; Atlantic \$30,000.

maintain the same risk of ruin as larger jurisdictions. This makes it more difficult for small Warranty Corporations to build up adequate reserves while charging reasonable premiums. As a consequence, liability caps tend to be lower in smaller jurisdictions.

From this we can see that caps on liability plausibly benefit the purchaser. The ability to recover the full market value of the home in a tort claim is valuable only to the extent that the builder is able to satisfy the claim. But to have an equity cushion available with which to satisfy a claim is itself a cost, which must be passed on to the purchaser. The size of the equity cushion which a builder requires is determined by exactly the same principles that determine the reserve which a Warranty Corporation needs to maintain a given risk of ruin. In effect, the higher limits under a tort claim are beneficial only if the builder has self-insured against any claims. But self-insurance is more expensive than pooled insurance because, as we have just seen, an insurer with fewer exposure units needs larger reserves for a given risk of ruin. So, if tort liability allows actual recovery of claims in excess of the cap under the Warranty, this results in higher costs which are passed on to the purchaser. Again, on a comparative cost-benefit analysis, it is entirely plausible that the Warranty provides a better deal. In any event, in practice, claims which are significantly above the limits are rare, and if they do occur, are likely to bankrupt the builder, particularly if the builder has systematically engaged in a poor practice.

But as noted, the concerns over indeterminacy which La Forest J. raised in *Bird* are addressed primarily at uncertainty in individual claims. While this uncertainty can have a significant effect on premiums in smaller jurisdictions, where the risk pool is small, it does not explain why larger jurisdictions, which have raised the dollar cap on claims, retain a strict contractual claims period and exclude liability for personal injury. To understand these limits, we must recognize that controlling indeterminacy is not the only, and perhaps not even the primary reason for these warranty terms in question. Cardozo CJ's felicitous phrase has been something of a red herring. The real issue, as La Forest J. pointed out in *Norsk*, is loss bearing ability, that is, the cost of insurance.⁷² While indeterminacy is one factor affecting the cost and availability of insurance, it is by no means the only factor, or even the most important one.

72. *Norsk*, *supra* note 1 at 1161–72. La Forest J. then analyzed the insurance issue largely in terms of indeterminacy of recovery. This was arguably appropriate on the facts in *Norsk* as it may be that indeterminacy of the loss from Norsk's perspective is a significant factor. However, other issues, in particular the ability of CN to take steps to mitigate the loss (the moral hazard issue, in insurance terminology), were also relevant: see Siebrasse, *supra* note 28 at 29–34.

From the perspective of the consumer both products liability in tort and contractual warranties provide a form of insurance, and the same factors which affect insurance prices will affect the implicit price of a warranty.⁷³ Further, moral hazard, adverse selection and administrative costs are all significant concerns in writing insurance contracts. For example, regardless of indeterminacy, third-party liability insurance is a more expensive way of providing protection than first-party insurance against the same loss, because of its higher administrative costs.⁷⁴ A focus on indeterminacy alone neglects these other issues, and in general it is wrong to conclude that simply because indeterminacy of recovery is not significantly increased by a change in tort law, insurance will not become more expensive.

Consider the exclusion in the Warranty of liability for harm to persons. This contractual rule is exactly the contrary of the traditional rule in tort law, which allows recovery only for harm occurring to persons or other property. It also conflicts with the imperative of protecting "the bodily integrity of inhabitants of buildings" which La Forest J. emphasized in *Bird*.⁷⁵ But the reason for the limitation is apparent if we think of the Warranty as providing a type of insurance. Let us assume that the average homeowner wants insurance against both personal injury and damage to the house such as cracked foundations. If we are concerned with minimizing the overall cost of insurance, the question is whether it is cheaper to buy insurance against personal injury due to housing related accidents from the New Home Warranty Corporation, or from a more conventional disability insurer. It is probable that a disability insurer will be able to offer insurance against personal injury more cheaply than will a building insurer simply because it specializes in doing so. Insurance companies do not simply provide compensation for claims but generally attempt to minimize claims both by controlling the sources of risk and by controlling the cost of remedying the harm after an accident occurs. Different types of insurers become specialists in controlling different types of costs. The New Home Warranty Corporations may and do monitor the quality of the builders who are enrolled, disseminate information about good building

73. The strong functional similarities between warranties and insurance are widely recognized in academic writing: see e.g. P.M. Danzon, "Tort Reform and the Role of Government in Private Insurance Markets" (1984) 13 J. Legal Stud. 517; R. Epstein, "Products Liability as an Insurance Market" (1985) 14 J. Legal Stud. 645. In some cases it may be difficult to distinguish between a contract of insurance and a warranty: see the cases discussed in M.G. Baer & J.A. Rendall, *Cases on the Canadian Law of Insurance*, 4th ed. (Toronto: Carswell, 1988) at 73-76.

74. See Siebrasse, *supra* note 28.

75. *Supra* note 3 at 122.

practices, and/or provide information to homeowners about how to prevent deterioration of the home.⁷⁶ The disability insurer, on the other hand, has more experience in dealing with accident victims, and so can more effectively monitor the victim's recovery and reduce excessive claims due to incidence of malingering. The health insurer can also tailor the amount of coverage to the particular insured, for example by selling low-cost term insurance to individuals with medium term family responsibilities. Further, the homeowner's disability insurance would undoubtedly continue to cover building related injuries even if the builder were liable for defective housing causing personal injury, thus leading to the moral hazard problems and unwarranted administrative costs of double recovery.

Thus for reasons unrelated to indeterminacy, from a compensation perspective separate health insurance and building insurance is probably preferable to overlapping insurance for personal injuries due to defective buildings. It is true that the deterrent effect of liability is diminished to the extent that the limitations exclude claims from accident victims who could not have taken any steps to protect themselves from injury. However, despite occasional disasters, structural defects do not usually pose a threat to the health of the building inhabitants, so that the additional deterrence effect of liability to persons is unlikely to be significant.

If personal injury from dangerous buildings is relatively rare then all of the effects on insurance costs described above will be small. This implies that excluding liability for injury to persons is unlikely to have much real effect on the overall cost of insurance. But the point is that there are good reasons why a rational well informed consumer would not want the builder's liability to extend to personal injury: by excluding builder's liability for personal injury and buying separate personal injury insurance, a homeowner can achieve the same insurance coverage while minimizing transactions costs, thus achieving a net saving. Thus the Warranty arguably provides optimal protection, from a social as well as an individual perspective.⁷⁷

76. All of these activities are undertaken by varying degrees by some or all of the Warranty Corporations.

77. One might suggest that the builder should be made liable because not all homeowners are sufficiently rational to purchase disability insurance. However, placing liability on the builder for personal injuries will not remedy this problem to any significant degree as few personal injuries are a result of building defects, so that those without disability insurance will remain largely without coverage. And ultimately this line of argument leads to the conclusion that liability should be spread as widely as possible in order that someone in the chain can be counted on to have insurance. While this motivation no doubt lies behind much of the expansion of tort law in recent decades, it is an extremely inefficient method of providing

The exclusion of consequential losses is also desirable for the same reasons: the builder is not an efficient insurer against business interruption or harm to other chattels. One argument often advanced in favour of extending tort recovery for pure economic loss is the illogicality of allowing recovery for consequential economic loss while denying recovery for pure economic loss: the nature of the economic loss itself might be exactly the same, and recovery is allowed in one case and denied in another simply because in one case the negligence fortuitously led to physical loss in addition to the economic loss. The argument I have advanced here and elsewhere suggests that this distinction is indeed illogical, but the problem arises because it is wrong as a matter of policy to allow recovery of the economic loss in *either* case.⁷⁸ If the illogicality is to be remedied, it should be done by refusing to allow recovery of consequential economic loss generally. I recognize that as a practical matter recovery of consequential economic loss is too well established to be disturbed, but we should not compound the error. To cure the illogicality by allowing more general recovery of pure economic loss would be to sacrifice good policy at the altar of logical neatness.

Consider next the limitation on the duration of coverage, which is typically five years from the date of occupancy in the case of major structural defects and one year from the date of occupancy for other ("minor") defects.⁷⁹ This is more limited than the liability in tort law, which would run for 6 years from the time the defect was reasonably discoverable. In *Bird La Forest J.* stated that liability for an indeterminate time would not be a significant concern as liability would be limited to the life of the building at the outside, and most likely to a much shorter period. He noted that "With the passage of time, it will become increasingly difficult for the owners of a building to prove at trial that any deterioration of the building is attributable to the initial negligence of the contractor and not simply to the inevitable wear and tear suffered by every building."⁸⁰ While this is quite true, it illustrates the way in which the focus on indeterminacy has misdirected the debate. The issue is not the possibility of proof, which does prevent open-ended or potentially infinite liability,

insurance. If universal insurance coverage is desired, it is far less expensive and more effective to accomplish it legislatively, through a universal plan, rather than through indiscriminately expanding tort liability.

78. See Siebrasse, *supra* note 28 at 22ff for a discussion of insurance and consequential loss.

79. B.C., Alberta and Saskatchewan allow the buyer the option of purchasing an additional five years' protection against major structural defects, thus extending the major defects warranty to a total of ten years. In Ontario the protection against major structural defects is seven years (Reg. 892, s. 16).

80. *Supra* note 3 at 126.

as La Forest J. argues. The problem is excessive cost of proof of negligence or lack thereof. If the administrative costs associated with a given claim increase as time passes, then at some point the cost of shifting additional risk to the builder becomes larger than the cost to the homeowner of bearing the risk herself, even when the possibility of decreased incentives to build carefully is taken into account. If the courts were consistently entirely accurate in their determination of the cause of the defect, and plaintiffs with unfounded claims bore all of the builder's litigation expenses, and builders could themselves consistently accurately identify valid claims and settle them without litigation, then allowing recovery for an unlimited period while requiring proof of causation would not increase insurance costs. If, as seems likely, not all of these conditions are satisfied then the cost of litigation and settling invalid claims will be passed on to all home buyers through increased prices. A strict time limitation which bars claims arising after considerable time has passed whether or not they were discoverable, reduces these costs by barring the claims which are most likely to be costly to litigate.

This argument is perhaps more intuitively obvious in the context of personal property. Should the purchaser of a used car be able to sue the manufacturer in tort for the cost of replacing the transmission six months after the express major components warranty expires? The answer must be no. Under La Forest J.'s analysis, the mechanism for rejecting such claims is the difficulty which the plaintiff would have in proving negligence after the warranty period expires. This mechanism would evidently be costly. It is apparent that a strict time limit could be beneficial to both parties in reducing these costs, and so reducing the cost of the car in the first place.⁸¹

81. In *City of Kamloops v. Nielsen*, [1984] 2 S.C.R. 2 the Supreme Court held that the limitation period begins to run in tort when the damage is reasonably discoverable, rather than when the damage occurred. The latter rule was rejected because of the "injustice of a law which statute-bars a claim before the plaintiff is even aware of its existence" (at 36). The argument made in the text suggests that this point is not entirely persuasive. The fact that a limitation period running from the date of performance may, in some specific cases, statute-bar a claim before the plaintiff is aware of its existence, does not imply that the rule is undesirable, since a strict cut-off will lower litigation costs, and so, indirectly, the cost of the service in question. Whether the reduced cost outweighs the unfairness in individual cases (that is, whether a well-informed purchaser would choose a strict cut-off over a reasonable discoverability rule in return for a price reduction) depends in part on the proportion of true defects which will normally be detected before the expiry of the limitation period. A strict cut-off which nonetheless encompasses the great majority of defects may be desirable even if it unfairly makes recovery impossible in some cases. This is of course very context dependent, so that it is difficult to say whether the use of the general discoverability rule in tort law generally is desirable. However, the matter is not so clear cut as the Court in *Kamloops* indicated.

While the case for a strict cut-off of claims is a strong one, whether the particular claims period in the warranty is optimal is a separate question. A strict limitation period does cut off some legitimate claims and so shifts some of the risk to the buyer. But the risk that the buyer bears may be quite small and more than compensated for by the reduced cost if the majority of true defects will become apparent within the limitation period. An important factor in determining the optimal claims period is therefore the proportion of true defects which appear within that period. In the case of minor latent defects, such as crooked hinges or a shaky bannister, the source of the defect becomes more difficult to prove as time goes on and most true defects will be discoverable in less than a year (in most cases they will be discoverable almost immediately) so it is clear that a short limitation period provides the best cost-benefit trade-off.

The trade-off is not so clear in the case of major structural defects. Defects will not manifest themselves immediately, so a very short period is not desirable. But neither is indefinite protection desirable. After a very long time some cracks may be expected in even well-constructed foundations because of inevitable subsidence, and in some cases flaws may arise because of failure by the buyer to notice and take preventative measures against problems such as excessive water build-up and freezing against the foundations. Some intermediate term of protection is probably best, but empirical information is needed to set an optimal term. That information is not presently available for Canada, as the Warranty Corporations have kept track of defects only during the period of warranty coverage, that is, five years, or seven years in Ontario.⁸² Evidence from England, in which a warranty program with a ten year claims period has been in operation since 1936, indicates that 70% of claims are made within the last three years of the ten year warranty period. The American experience is apparently similar.⁸³ Further, the claims profile typically rises steadily through the third, fourth and fifth years before leveling off.⁸⁴ Given this pattern, it seems unlikely that claims will suddenly drop off in the sixth year. Between the international experience

82. The failure of the Warranty Corporations to collect the more extensive information necessary to determine the optimal claims period is itself a sign of market failure. This behaviour is not due entirely to the weak competitive pressures in the home warranty market, as a very similar behaviour is exhibited by automobile insurers, who, despite a competitive market, failed to collect the information needed to ensure their insurance rating categories were optimal, or even rational: see *Zurich Insurance Co. v. Ontario Human Rights Commission* (1992), 93 D.L.R. (4th) 346 (S.C.C.). There is probably a significant free-rider problem in collecting this information.

83. Michael Hall, Deputy Chief Executive of National House Building Council, personal communication with the author.

84. *Ibid.*

and the claims profile in Canada in the first five years, it seems likely that a significant number of defects would be discoverable after the fifth year. This indicates that a strict five year limitation is not optimal from the purchaser's perspective. However, we must keep in mind the need for a comparative analysis: while a strict five year cut-off may not be optimal, a tort rule of six years from reasonable discoverability certainly is not, and is very likely worse. Further, while the competitive pressures in the home warranty industry are weak, change does occur as new information surfaces. In large part because of the English experience, albeit indirectly, Warranty Programs in three jurisdictions now offer an optimal extra five years protection for an additional fee.⁸⁵ So, the limitation period offered by the Warranty Programs may evolve towards optimality, whereas the tort law is fixed at a non-optimal duration.

The Warranty provides for strict liability for specified defects. This is perhaps not surprising, but it is nonetheless significant. Strict liability is obviously more advantageous to the buyer than is liability for negligence in tort. While it is commonplace in contractual warranties, it is not inevitable, as a "best efforts" warranty is possible. That the warranty provides for strict liability indicates that it is not just a marketing ploy which takes away in the fine print what it promises in the bold type. Strict liability is substantively preferable in these circumstances because it has lower administrative costs than a negligence standard, and the cap on claim amounts and the limitation on the period during which claims can be made provide sufficient incentives for the homeowner to maintain the building properly.

Finally, the warranty covers neither patent defects (defined, as at common law, as defects which could have been discovered by a reasonably prudent inspection) nor defects which are not preventible by the builder, such as defects in material supplied by the purchaser, normal

85. B.C., Alberta and Saskatchewan offer extended warranty coverage for an additional fee ranging from \$140 to \$280. The extended warranty is not particularly popular, with roughly 15–20% of homeowners electing to purchase it. Of course, the purchasers have even less knowledge than the builders about the rate of defects appearing in the second five-year period, so the low rate of purchase of the extended warranty cannot be taken to mean the extended warranty is not desirable. Rational ignorance and irrationality no doubt dominate decision making on the point. Alberta has offered an extended warranty since 1986, and has had no claims to date. However, the statistical base is still very small: even if claims rates in the second five-year period continued the plateau observed in the final year of the first five-year coverage, actuarial projections would suggest that perhaps twenty claims would have been observed. The fact that no claims at all have been observed may be explained by lack of consumer awareness. Apparently in the early years in which American firms offered an extended warranty very few claims were reported, but as consumer awareness increased (especially among subsequent purchasers) the claim rate in the extended period rose dramatically: Michael Hall, personal communication with the author.

cracks in paint or drywall, damage resulting from normal wear and tear, or inadequate or improper maintenance, defects resulting from an act of God or a third party, and damage caused by the purchaser or their agents. These limitations reflect tort doctrines and serve variously to absolve the builder of liability which it could not prevent, and to ensure that the purchaser has adequate incentive to avoid causing harm himself.

IV. *The Implications of Extended Tort Liability*

The preceding discussion was not an attempt to show directly that the warranty terms offered by the Warranty Corporations across the country are in fact optimal: the detailed information required to determine the optimal contract is as far beyond my reach as it is beyond the reach of the courts. Rather I argued the Warranty companies have an incentive to offer optimal terms, that they have more relevant information than the courts, and that an examination of the terms actually offered represent a careful balancing of risks and costs which is plausibly superior to that which could be offered by tort law once it is recognized that a trade-off must be made between protection and cost, as increased costs due to increased tort liability will ultimately be passed back to the buyer. Although it is probable that both rational ignorance and irrationality in decision making mean that the Warranty is not optimal, the failure of the bargaining process is not so egregious as to justify judicial intervention. From this we may conclude that from the point of view of the homeowner the protection offered by the Warranties represents a better trade-off between protection and cost than does protection which could be offered by the courts through tort law. A judicial extension of liability beyond the Warranty could be justified as being in the interest of the buyer only if the courts are willing to make a number of specific factual assumptions on matters about which the builders are much better informed than the courts.

It follows that extension of liability in tort will be detrimental to home buyers who are now covered by the Warranty program (which is the majority of residential home buyers) because it would impede the ability of the parties to allocate risk more efficiently than can the courts. If liability is imposed in tort, then the builder and initial purchaser can of course modify their tort obligations through contract, but subsequent purchasers will not be bound by this agreement. The builder might insure against this increased liability (most probably through the New Home Warranty Corporation which already has a quality monitoring system in place and which could therefore provide the lowest cost insurance), but these increased insurance costs would be passed on to the buyers, and

indirectly, to the subsequent purchaser. Since, on the argument developed above, the protection currently offered to the homeowners (including subsequent homeowners) through the Warranty program is closer to the optimum than is tort protection, the value to the homeowner of the additional judicially imposed protection would be less than the increased cost of housing.⁸⁶

The same argument applies to cases involving sophisticated commercial buyers and builders. As we have already seen, there is every reason to think that they are fully capable of deciding their own best interest, so at best there will be no gains from extended liability as the parties contract around the tort rule. It is true that even sophisticated parties are not always perfectly rational, and in some instances mistakes may be made. However, where both parties are sophisticated, the mistakes are as likely to be made by either side, so there are no obvious gains to be had from shifting the presumptive liability: all that could be accomplished is that in the future, buyers will have a windfall when the seller makes a mistake, rather than conversely as was the case before *Bird*. Since neither side is more or less likely to make mistakes, there are no net gains.

If liability were extended in tort the parties might attempt to contract back to the optimal position by a condition that the initial purchaser would agree to include a limitation of builder's liability clause in any sale to a subsequent purchaser and agree to indemnify the builder for any losses resulting from its failure to do so. While this mechanism could be used to allocate risk despite extended liability in tort it would be more expensive than the current warranty which benefits subsequent purchasers. The builder would have to increase the price of the protection it offered to account for the risk that the indemnification agreement would be worthless because the initial purchaser was judgment proof. More importantly, this scheme would expose a solvent initial purchaser to a serious risk in the case that he failed to include the limitation of liability clause in the subsequent sale agreement. This risk may be overlooked because of rational ignorance and irrationality: if we are willing to impose tort liability because of such concerns, then we should probably also declare such clauses unconscionable. To the extent that claims resulting from failure to include a limitation of liability clause were covered by the malpractice insurance of the lawyer handling the sale for the initial purchaser, the price charged would increase to account for the additional transaction costs associated with this indirect form of insurance.

86. Builders might choose to carry the risk of extra exposure themselves rather than purchase insurance. This would also lead to higher cost housing as it would increase the riskiness of the enterprise, and builders would demand a greater return to compensate for the extra risk. Again, the increased price would not be worth the increased protection.

But even if extended builders' liability cannot be justified in respect of sophisticated purchasers of commercial property or purchasers of homes covered by the Warranty Program this leaves two significant groups who may be insufficiently protected. The Warranty programs cover essentially only residential construction,⁸⁷ and while many commercial buyers are sufficiently sophisticated to protect themselves, some may not be.⁸⁸ Further, as noted earlier, a significant number of new homes are not covered by a New Home Warranty Plan. Homes not covered are primarily owner constructed homes and homes built by small-scale builders who build only infrequently. Whether or not such small scale builders are aware of the benefits of offering warranty protection by joining the Warranty Company they are typically not eligible to join, as the Corporations impose standards for membership, including financial stability and/or experience in the building trade. In either of these cases, the problems of bounded rationality again suggest that buyers may fail to adequately protect themselves. If this is the case, then it might be suggested that extending tort liability will benefit these groups sufficiently to outweigh the harm to groups which are currently protected by private warranty or other means such as first-party insurance or self-insurance, particularly if the more sophisticated groups can minimize the cost increases due to tort liability through the suggested mechanism of indemnification agreements.

There are several problems with this argument in the context of dealings between small builders who are not presently members of the Corporation and residential home buyers. In the first place, it is not clear whether the optimal contract would provide for builder's liability. In the case of a warranty issued through the Warranty Corporation, the value of the warranty is simply equal to the expected loss (the probability of a defect multiplied by the cost of rectifying it). A warranty by a small builder is worth less than this to the buyer, because of the significant likelihood that the builder would not be financially able to carry out the repairs or to satisfy a judgment against him. In other words, the value to the buyer of the warranty will be discounted by the not insignificant probability that the builder will be impecunious.⁸⁹ At the same time,

87. The New Home Warranty Corp. of B.C. covers some split residential/commercial buildings, *e.g.* a corner store with a residence above.

88. For completeness, the category of unsophisticated commercial buyers buying from unsophisticated commercial builders should be considered. This is unlikely to be a large category, and in any event the arguments parallel those of the residential builders buying from non-member builders.

89. The turnover rate among smaller builders is very high: the New Home Warranty Corporation of British Columbia reports an 80% mortality rate over three years. The Atlantic

because the legal system is costly, prone to delay and subject to judicial error, the parties may prefer an informal warranty, where the builder agrees implicitly or explicitly to repair any defects which become apparent, thereby avoiding the expense of relying on the formal legal system. The purchaser would rely on the builder's reputation rather than a formal legal guarantee to ensure that defects are repaired.⁹⁰ Parties might choose to rely on a smaller builder's reputation while requiring a warranty from a larger builder for two reasons. First, on the deterrence side, a smaller builder is often a member of the local community in which the home is built, in which case reputation would be relatively easy to verify, and loss of a good reputation is a strong sanction.

At the same time, from the point of view of compensation, a small builder, often one or two individuals, will be roughly as risk averse as the home buyer, so there are no gains to be had from shifting the risk from the purchaser to the builder. This means that the compensation rationale for a warranty is weak. The deterrent effect of the warranty may also be weak. In the first place, even if the optimal contract would have a warranty provision, tort liability to the same effect will not necessarily have any effect if the builder is unsophisticated, since increased liability does not increase the incentive to work carefully unless the builder is aware of his or her increased exposure. And even if the builder is aware of the law, an individual builder is as subject to "irrational" risk assessment as the purchaser. A large builder may have had sufficient experience to have a good statistical idea of its potential exposure, and will likely have been involved in some defective construction, thus increasing the salience of the possibility of a building defect. A small builder, without this breadth of experience, is much more likely to be over-optimistic about the chance of a defect. In other words, the builders who are least likely to be enrolled in the warranty program are those who are also least likely to be influenced to take extra care in construction by the prospect of liability in tort.

New Home Warranty Corporation has 970 current members and has a total of approximately 3000 members since its inception, and has only 27 members who have been members for the entire twenty years of its existence. As noted earlier, under the Warranty Program the Warranty Corporation guarantees the satisfaction of the Warranty terms if the builder does not carry out its obligations, so eliminating the risk of a judgment proof defendant which the purchaser faces when dealing with a small builder.

90. See L. Bernstein, "Merchant Law in a Merchant Court: Rethinking the Code's Search for Immanent Business Norms" (1996) 144 U. Pa. L. Rev. 1765 who notes (at 1790-91) that in order to avoid the costs of the legal system computer software manufacturers often disclaim all warranties in a shrink-wrap agreement, but in practice are willing to satisfy reasonable complaints.

It might be suggested that even if tort liability will not induce extra care in such a case, it may at least prevent a builder from deliberately cutting corners to reduce cost. A warranty is one response to this problem, but given the problems with enforcing a warranty in court, a purchaser may rationally choose to rely on the builder's reputation instead. In sum, a warranty provided by a small builder may not be very valuable, either for deterrence nor the compensation purposes, and given the transaction costs associated with a formal warranty, a purchaser might rationally choose to rely on the builder's reputation to give the incentives which might otherwise be provided by a warranty. Even though the purchaser may ultimately regret such a choice in some cases, it is not necessarily irrational for the buyer to agree not to require a warranty in return for a lower price.

In dealings between two unsophisticated parties, both parties may be unaware of the precise legal rules, in which case the price paid for the home will reflect the understanding by the parties of the allocation of risk. This understanding may not change even if the legal rules change. If neither the deterrence or compensation functions of tort law are likely to be well served by extending liability, the best rule is one which accords with the understanding of the parties. This will at least prevent windfall gains or losses. It is not obvious that the implicit understanding includes builders' liability, particularly since it is not clear that the optimal risk allocation includes builders' liability. While caveat emptor seems counter-intuitive, the buyer no doubt realizes that purchasing a home from a small builder is a riskier proposition than buying one from an established builder, if only because of the possibility of the builder being unable to satisfy a claim. Further, as noted earlier, information from real estate agents about homes which are covered by a Warranty Program may alert the purchaser to the fact that the home which he ultimately buys is not covered. Thus it seems unlikely that caveat emptor leads to systematic windfalls to the builders, and it is possible that extended liability would result in windfalls to the purchaser.

This is not to argue that we can conclude firmly that there are no gains to be had from extending tort liability in the context of unsophisticated builders and residential home owners, although this may be the case. My main point is that the potential gains are significantly more limited than a more simplistic analysis suggests.

Finally, the effect of extended tort liability on transactions involving sophisticated commercial builders and unsophisticated buyers is also uncertain. On the one hand unsophisticated buyers may be taken advantage of by sellers, as the simple story suggests, but on the other hand we have seen that builders have incentives to advertise their warranty to

unsophisticated builders, and this and reputation effects may lead to protection of even unsophisticated commercial buyers.

In summary, while there are very probably at least some parties who do not now receive the protection they would have desired because of the problem of bounded rationality, these parties do not form an identifiable class, and may be relatively few in number. On the other hand, we know that in the majority of cases, namely sophisticated commercial purchasers and residential purchaser now covered by a Warranty Program, extending liability in tort will be detrimental to the purchaser. The case for extending tort liability is therefore far from compelling.

V. *Implied Warranty*

1. *Rational Ignorance*

The prospect of imposing liability in tort gives rise to a dichotomous choice between leaving some groups unprotected and judicially disrupting the satisfactory arrangements of other groups. This dichotomy is unwarranted: it arises because the tort model views imposing judicial solutions as the only approach to remedying imperfect bargaining. Another option is to impose liability which can be modified by contract, in particular an implied third-party beneficiary warranty. The functional significance of this approach is that modification of the implied warranty by an express warranty would in principle be binding, even with respect to third parties, because the third-party rights derive from the warranty.⁹¹ (It is possible that such a result could be arrived at through a tort analysis but for clarity of discussion I will, for now, assume that contractual modification of tort liability would not be binding on a third party.)

An initial reaction to this suggestion might be that the builder will just disclaim the implied warranty. This misses the point of the earlier discussion of rational ignorance. If the purchaser is willing to pay more for the warranty than it costs to provide it, then the builder has every incentive to provide the warranty and make a profit from doing so. If the buyer is not willing to pay as much as the warranty costs, then it is not desirable. The problem arises when, because of rational ignorance, a

91. This is not to say that all disclaimers would necessarily be binding: the circumstances in which the disclaimer is made would certainly be relevant, as they are now in sale of goods law. Refusing to recognize a disclaimer is justified when there is reason to believe the bargaining process has failed and that the courts can impose a better solution. This raises the same issues that were discussed in the text in the context of the choice between imposing initial liability in tort or contract, except that the relevant consideration will be applied to the specific facts of the disclaimer.

buyer mistakenly believes that she is getting a warranty, in which case the seller can charge a price commensurate with warranty protection without actually providing it. An implied warranty addresses this problem by increasing the availability of warranty information. In other words, this approach adopts the strategy of using background rules to encourage bargaining.

An implied warranty is clearly superior to tort liability in the case of sophisticated commercial parties or residential purchasers of a home covered by the Warranty Program because it does not affect their bargain. It also offers unambiguous gains in cases in which sophisticated sellers take advantage of unsophisticated commercial buyers by not offering warranty protection, because it would encourage informed bargaining. Sophisticated builders, who by definition are aware of and properly assess their legal position, selling commercial property to unsophisticated buyers would have to either expressly modify or disclaim the implied warranty if they did not wish to remain liable. This would lower the unsophisticated buyer's cost of discovering the governing rules of the transaction. It is true that inserting a disclaimer of liability in the contract is not quite the same as actively advertising a warranty, but, as discussed above, it is not accurate to say that purchasers never read the fine print. The likelihood that a purchaser will read and understand information provided with the product depends on the expected usefulness of the information and the format in which it is presented.⁹² In any event, we do not need to rely solely on the purchaser reading the contract in detail. In the case of unsophisticated parties, whether commercial or residential buyers, it seems likely that a failure by the real estate agent or lawyer handling the transaction to point out a disclaimer of liability would be considered professional negligence. In contrast, failure to explain that the existing law does not provide an implied warranty is probably not negligence, because it is impractical to explain all relevant background law. Further, in the American jurisdictions which have adopted an implied warranty approach, a disclaimer which is not prominent or clearly explained will be held not to be effective.⁹³

Thus the presence of an express warranty or disclaimer is likely to significantly improve the purchaser's information. The buyer might choose not to buy the home on discovering that it was not protected, or might negotiate a lower price, or might decide that the risk was acceptable. In any case, there is no unfairness. And of course if the seller chooses

92. See J.R. Bettman, J.W. Payne & R. Staelin, "Cognitive Considerations in Presenting Risk Information" in Viscusi & Magat, *supra* note 36 at c. 2.

93. Jones, *supra* note 5 at 1069.

not to disclaim, the parties will be in the same situation as if liability were based in tort.

In many cases the seller will modify the implied warranty. The modifications would be binding on the subsequent purchasers, because their rights would be derived from the contract and the express terms would displace the implied terms. This possibility is not unfair: on the contrary, it is the real advantage of an implied warranty approach. The judicially implied warranty itself will be as blunt an instrument as tort law, and if modifications are not binding on subsequent purchasers, the net effect will be the same as if tort liability were extended. By allowing modifications the parties can tailor the agreement more precisely than could be done by the courts. The Court in *Bird* remarked that "there is no logical reason for allowing the contractor to rely upon a contract made with the original owner to shield him or her from liability to subsequent purchasers. . . ."⁹⁴ With respect, this is not correct. Rational purchasers contemplating selling their homes will demand good warranties in order to improve the resale price. Slightly less rational purchasers who fail to consider the possibility of resale will nonetheless demand a good warranties to protect themselves. In either case, the original owner is a good proxy for a subsequent purchaser. Of course, the original purchaser might fail to demand adequate protection because of bounded rationality, whether or not they are contemplating resale. In this case the contract made between the original owner and the builder will not adequately protect a subsequent purchaser, but neither will it adequately protect the original owner. So, either the contract between the original purchaser and the builder can be relied upon to protect both the original purchaser and the subsequent purchaser, or it cannot be relied upon to protect either. Either the court should intervene to protect both parties, or it can rely on the contracting process.

This informational argument in favour of imposing liability is weakest in the context of small scale home builders. Since these builders are almost as likely as the purchasers to suffer from bounded rationality in contracting, the present problem of buyers not insisting on a warranty would simply be replaced by the problem of builders not contracting out of liability. It is difficult to judge whether there would be any net effect.

In summary, in comparison with the present regime, tort liability would result in net losses for transactions involving sophisticated buyers and sellers, whereas an implied warranty regime would retain the status quo. Tort liability would result in uncertain gains for transactions

94. *Supra* note 3 at 125.

involving sophisticated builders and unsophisticated buyers, whereas an implied warranty would result in clear gains. And both the tort and implied warranty approaches have ambiguous effects on transactions involving two unsophisticated parties. If these conclusions are correct then an implied warranty approach to extended liability would be clearly superior to extended liability in tort. The fundamental reason for this superiority is that an implied warranty approach recognizes that asymmetry of information may impede bargaining. By shifting the presumptive liability to the party with the lowest information costs, it lowers the cost of bargaining, thus encouraging private ordering, rather than imposing judicial ordering.⁹⁵

2. *Irrationality*

An implied warranty approach may also address some of the concerns raised by the problem of irrational decision making. As noted earlier, some studies show that people under-estimate low probability risks of a large loss, such as a major structural defect, while others show over estimation of such risks. One plausible reconciliation of the evidence suggests that the direction of the bias depends on the form in which the choice is presented: if the risk is salient or people are forced to confront it they may over-estimate the risk, but otherwise it may be ignored entirely. In either case the probability of the harm is adjusted to a level which we are cognitively equipped to recognize: in the first case, when the risk must be addressed, its probability is estimated at a sufficiently high level to be processed, whereas in the second case it is simply ignored entirely.⁹⁶ When the background rule is caveat emptor the default position

95. Since in Ontario builders and vendors of new homes must be registered under the *Ontario New Home Warranties Act*, *supra* note 48 and the warranty is not disclaimable (s. 13(6)) the Ontario approach is more akin to a tort claim than to an implied warranty as discussed in the text, except that the terms of the protection are decided by the legislature rather than the courts. This has two potential shortcomings which reflect arguments made in the text against tort liability. First, some builders who, in other jurisdictions, would build without being members of the Warranty Program, are prohibited from building in Ontario. This is detrimental to some informed consumers who might knowingly choose to purchase from such a builder even without warranty protection. Secondly, it does not allow the parties to modify the terms of their agreement. However, this second point is less objectionable than in the context of tort liability. The legislature sets the terms of the warranty by regulation, but this is with the advice of the Corporation set up under the act to administer the Plan. This Corporation has access to the same information and serves the same role as the private Corporations in other jurisdictions, and so probably is equally able to set appropriate terms. Any presumption in favour of greater efficiency of private companies is not as strong when there is no competition in the private sector.

96. *Supra* note 36.

is no protection and the purchaser is not required to consider the risk in "deciding" not to purchase protection. On the other hand, when the background rule is an implied warranty, a decision not to acquire protection would require accepting a disclaimer clause in the agreement. The presence of an express warranty or even a disclaimer clause would require the purchaser to consider the risk actively and thus may tend to induce an over-estimation of the risk. This increases the attractiveness of the warranty and makes it less likely that the purchaser would accept a disclaimer. Of course the manner in which the information is presented will undoubtedly have a significant effect on the perceived risk. A purchaser is more likely to value the warranty protection highly if presented with a brochure that asks (as does the Manitoba New Home Warranty Program brochure) "Would you make a major purchase without a warranty?" and details the risks and coverage, than if the information is presented in a passing mention of a disclaimer of liability by a real estate agent. Again the requirement of a clear disclaimer helps address this problem.

A different and well established psychological phenomenon is the "endowment effect".⁹⁷ The minimum amount that an individual is willing to accept to sell something they presently own is generally significantly more than the maximum price that they are willing to pay to acquire it. To see how this may affect the choice of warranty protection consider the choice between contract A, which offers a house without warranty protection, and contract B, which offers the same house with warranty protection at a price \$350 higher than contract A. If caveat emptor is the background rule, contract A would be silent on the issue of warranty protection and contract B would contain an express warranty. If an implied warranty is the background rule, contract A would have an express disclaimer of warranty and contract B would be silent. The endowment effect suggests that once the consumer has decided to purchase the home, with caveat emptor as a background rule the choice will be whether to pay \$350 to acquire a warranty, whereas with an implied warranty background rule, the decision will be whether to sell the warranty for \$350. If this characterization is correct, the endowment effect predicts that significantly more people will choose the warranty in the second scenario. This conclusion is tentative because, while the endowment effect is strong and well established, it is difficult to know if this assessment of when the warranty will be perceived as being bought or sold is accurate.

97. See D. Kahneman, J.L. Knetsch & R.H. Thaler, "Anomalies: The Endowment Effect, Loss Aversion and Status Quo Bias" (1991) 5 J. Econ. Perspectives 193.

Finally, the “follow the leader” effect is significant in decision making under uncertainty, for example in the adoption of new technology,⁹⁸ and in their classic study of flood insurance Kunreuther et al. found that “by far” the most important determinants of the decision to buy insurance were whether the person knew someone who had purchased insurance and the perceived seriousness of the problem.⁹⁹ This suggests that if significant numbers of buyers do choose warranty protection, it will be more difficult for builders who do not wish to offer such protection to convince a purchaser to accept a disclaimer of liability.

As we have already noted, it is difficult to draw conclusions from psychological studies of decision making without a specific context for the decision-making. The foregoing discussion nonetheless suggests, albeit tentatively, that a disclaimable implied warranty of fitness for habitation will make it more likely that people will choose warranty protection.

VI. *Genesis of the Warranty Corporations*

The greatest potential gains from an implied warranty are in cases in which asymmetry of ignorance resulting from rational ignorance is greatest, namely in the case of residential home buyers dealing with sophisticated builders. Because the Warranty Corporations provide warranty protection in precisely these cases, the remaining gains to be had from extending liability in other categories of relationships are likely to be modest. However, this should not be taken as uncritical support for the position that judicial intervention is generally pointless because market forces will already have arrived at the optimal result. The private New Home Warranty Corporations did not arise spontaneously as a market response to the inefficient common law rule of caveat emptor. Rather, they were all founded in the mid-1970s, in response to government pressure which itself was apparently stimulated by concerns about building quality during the housing boom of the early 1970s.¹⁰⁰

98. E.M. Rogers & F.F. Shoemaker, *Communication of Innovations* (New York: Free Press, 1971).

99. *Supra* note 35 at 130. See also *supra* note 97. “Follow the leader” is very plausibly a rational strategy given limited information and costly learning: see G. Ellison & D. Fudenberg, “Rules of Thumb for Social Learning” (1993) 101 J. Pol. Econ. 612.

100. The federal government apparently took the initiative in pressing either for industry warranty programs or for provincial legislation, which is why the warranty programs were all established at almost the same time. The Alberta plan was the first to be operational, set up in 1974, and the remainder, including the Ontario plan, were established two years later. In Ontario mandatory legislation was enacted, and in British Columbia the government introduced Bill 43 in 1975 which would have established a legislated warranty scheme, but the Bill was abandoned after industry lobbying persuaded the B.C. government that an industry plan

This might be thought to show that builders “don’t care” about providing protection and thus rebut the argument made earlier that it is in builders’ own self-interest to provide warranty protection where it is desirable to do so. But since the New Home Warranty Corporations have been established we have seen an expansion of liability in several jurisdictions, both through an increase in the cap on liability and in the length of protection available. This is inconsistent with the view that the builders have simply reluctantly bowed to government pressure. An alternative explanation for the late arrival of warranty programs is a combination of bounded rationality in consumer decision making and considerable collective action problems involved in setting up a warranty program. Self-insurance by individual builders is not feasible, for reasons discussed above. An insurer needs to cover a significant portion of the market in order for there to be any real insurance. But since the construction market is very competitive all the gains from providing a desirable warranty accrue to the home buyer and not to the builder. This means that the builder’s incentive to provide such a warranty is increased market share rather than increased profits; but obviously not all builders can increase their market share simultaneously. At the same time, even the incentive to take market share from uninsured builders is minimal, because, as we have seen, bounded rationality is likely to suppress the demand for warranties at the time of purchase given a background rule of *caveat emptor*, while at the same time once the defects become manifest hindsight makes the warranties appear imperative. It is therefore not surprising that the perceived public need for warranty protection arose after a boom in the housing market. Even if the quality of housing built in the boom was much the same as at any other time, given that many homes were built in the same period, a larger number of homeowners would retrospectively realize the need for a warranty at approximately the same time, thus giving rise to a louder call for warranty protection.¹⁰¹ This suggests that the industry as a whole will not organize to provide a Warranty Corporation without an external impetus.

As it happened, the necessary external impetus was provided by the threat of legislative action. I suggest the impetus could equally have come via the courts, through imposition of liability for defective work, whether through tort or contract. In other words the main benefit of extended

would be preferable. In other jurisdictions the threat of legislation was sufficient to induce the builders to organize.

101. See R.G. Noll & J.E. Krier, “Some Implications of Cognitive Psychology for Risk Regulation” (1990) 19 *J.Legal Stud.* 747 for a general discussion of the implications of cognitive psychology for the demand for public regulation of risks.

builders liability arguably would have been in overcoming institutional inertia and encouraging the development of the institutional infrastructure necessary to support warranty protection. This benefit of imposing liability will not now be realized in the specific context of new home warranties as Warranty Corporations have arisen because of legislative pressure, but this does not imply that judicial intervention of this type is never justified because the market response will always be optimal.

VII. *Miscellaneous*

1. *Defective chattels*

I have argued that the desirability of tort liability depends on the details of the market for the goods in question. I argued that in the context of real property liability on the builder for personal injury is probably undesirable. The same argument does not apply in the context of personal property for a number of reasons. Chattels are more likely than real property to cause personal injury, and low probability risks of a serious personal injury are precisely those types of risk which psychological evidence indicates are most likely to be poorly assessed.¹⁰² As important, the arguments in favour of a disclaimable implied warranty made in this article apply only when the parties are joined in a contractual chain. Personal property is more likely to injure someone who is not even indirectly linked with the manufacturer. At the same time, the deterrent value of liability may be significant since, unlike the case with defective structures, the exposure from a contractual liability to repair or replace the defective product itself may often be small in relation to the exposure from liability for personal injury.¹⁰³ And, as discussed above, while liability for personal injury resulting from shoddy structures is probably not necessary or strictly desirable, it will likely have little impact on the price or availability of housing. This suggests that while different arguments apply to different aspects of the problem, when added together the present regime of tort liability for personal injury and warranty coverage for pure economic loss may be satisfactory.

Further, while the above example illustrates that the analysis in this article is not directly applicable to personal property, extension of warranty protection to subsequent purchasers who are not in privity is

102. But see Ramseyer, *supra* note 31.

103. This is a tentative suggestion, and should by no means be taken as a recommendation that contracting out of liability for physical harm should be prohibited.

probably desirable in the context of personal property,¹⁰⁴ and extending liability in tort is likely undesirable, for much the same reasons as were given in the context of real property.¹⁰⁵

2. *Concurrency*

This article began by decrying the use of tort law as a way of avoiding contract doctrine. In a way, the suggestion that liability for defective buildings should rest in contract is a way of using contract to avoid a defect in tort, namely the difficulty of modifying tort liability. Ultimately the choice should not be framed in terms of a choice between tort and contract. If severe bargaining failure occurs, so that a judicially imposed solution is desirable, then this should be available in contract law as well as through tort law, or the purchaser may be at a disadvantage. More generally, different bodies of doctrine may address the same or different policy considerations. When the policies promoted differ, it is unobjectionable if the different bodies of doctrine give different results when applied on the same facts.¹⁰⁶ In such a case it is essential that the body of doctrine most favourable to the plaintiff (which is the cause of action which will inevitably be chosen) be confined strictly to its appropriate domain, as defined by the factual circumstances of the case. On the other hand, two bodies of doctrine may differ, not because they promote

104. In its *Report on Consumer Warranties and Guarantees in the Sale of Goods* (1976) at 74–76 the Ontario Law Reform Commission recommended that the requirement of privity be abolished in the sale of consumer goods, and this recommendation has been implemented to at least some degree in some jurisdictions: see the discussion in G.H.L. Fridman, *Sale of Goods in Canada*, 4th ed. (Toronto: Carswell, 1995) at 451–54.

105. I have argued elsewhere that the bar of recovery for pure economic loss is also justified in cases where there is no contractual link, but for quite different reasons, primarily the high transaction costs associated with such an action: see Siebrasse, *supra* note 28. See also Feldthusen & Palmer, *supra* note 18 noting that much pure economic loss is not a true social loss.

106. See e.g. *Canson Enterprises v. Broughton & Co.*, [1991] 3 S.C.R. 534 in which the issue was the overlap between law and equity. McLachlin J. (for herself, Lamer C.J. and L'Heureux-Dubé J.) insisted on basing her reasoning on principles of equity, on the ground that the principles sought to be advanced by the law of fiduciary obligations are distinct from those of tort and contract (at 543). La Forest J. (for himself, Sopinka, Gonthier and Cory JJ.) was of the view that equity and law have mingled and so in many cases could draw on each other, but nonetheless conceded that when there are different policy objectives equity could and should achieve a different result (at 586–87). A similar debate occurs in *Norberg v. Wynrib*, [1992] 2 S.C.R. 226 in which McLachlin J. (for herself and L'Heureux-Dubé J.) insisted on the fiduciary nature of the relationship while La Forest J. (for himself, Gonthier and Cory JJ.) was of the view that tort law principles could encompass the unequal power relationship which he acknowledged was a significant factor in the case. This represents a debate over whether tort law and the law of fiduciary relationships do indeed advance different underlying policies, while acknowledging that to the extent that they do, different results may be appropriate.

different underlying policies, but because they characteristically apply in different circumstances. In this case it is desirable that the two bodies of doctrine give the same result in cases in which both may apply.¹⁰⁷ Conversely, if two bodies of doctrine give different results on the same facts, then either they address different underlying policy considerations, and their respective spheres of application should be clearly demarcated; or they are both addressing the same policy concerns, in which case different results indicate that one body of doctrine, at least, is substantively wrong in its application to the facts. If, as I have argued, in at least some circumstances in which parties are not in privity, a contractual approach should nonetheless be adopted because the parties can modify their relationship through indirect contracting, then this result should be available in tort as well. In other words, recovery of pure economic loss in tort might be desirable if parties not in privity were able to modify their obligations by indirect contracting. A step in this direction was taken by McLachlin J. in her decision in *London Drugs*¹⁰⁸ in which she held that a contract could be part of the “concatenation of circumstances” which could limit a defendant’s duty of care in tort. Further development in this direction would be essential if the Court were to continue to rely primarily on tort law in contract-tort contexts. If the Court begins to use a contract based approach, then any grand unification of tort and contract becomes less pressing.

107. This issue is being worked through by the Supreme Court. In *Rainbow Industrial Caterers Ltd. v. Canadian National Railway Co.*, [1991] 3 S.C.R. 3 the majority approved a calculation of damages in a tort action for negligent misrepresentation inducing a contract which was higher than would have resulted from an action for breach of contract: the plaintiff had apparently entered into a bad bargain, but this was not considered in calculating tort damages to put the plaintiff back in the position it would have been in had the contract not been entered into. But subsequently, in *B.G. Checo*, *supra* note 13 the majority noted that “in situations of concurrent liability in tort and contract, however, it would seem anomalous to award a different level of damages for what is essentially the same wrong on the basis of the form of action chosen, though, of course, particular circumstances or policy may dictate such a course” (at 38). The Court in *Checo* found on the facts that Checo would have entered into the contract in any event, but at a higher price, thus minimizing the difference between the tort and contract measures, and further remarks on “a tendency towards similar damages in tort and contract can be identified even in *Rainbow* situations” (at 40). However, the Court indicated that the higher price would not simply reflect the cost of doing the work, but also a markup for profit. (Damages were assessed accordingly when remitted to the trial judge: (1994), 109 D.L.R. (4th) 1.) This markup would presumably not be included in a contract claim in which Checo would simply be reimbursed for the extra expense incurred by Hydro’s breach of contract. Thus a wedge between the tort and contract measure of damages was reintroduced and the tort standard was applied.

108. *Supra* note 9.

Conclusion

Bounded rationality in risk assessment by purchasers is a valid concern and justifies the Court's intuition in *Bird Construction* that liability for defective structures should be imposed on builders. However, I have argued that this liability should be imposed through a third-party beneficiary warranty implied in contract rather than through tort liability. Doctrinally, modifying contract law to allow for such implied warranties is no more drastic than modifying tort law to allow expanded recovery for pure economic loss. In *London Drugs* the Court insisted that any third-party beneficiary warranty be based on the intent of the parties, thus evidencing a concern for the autonomy of the contracting parties. I share entirely this concern for freedom of contract, and I have argued that it is much better served by an implied warranty which the parties are then free to vary rather than tort liability which is beyond the parties' control. The autonomy of the parties is not interfered with any less if the judicial intervention is labelled "tort" rather than "contract". A third-party beneficiary warranty approach to extended liability for defective structures is thus more respectful of the autonomy of the parties than is tort law, even if the warranty is judicially implied. I have argued that it would be ironic if a doctrine intended to respect party autonomy was seen to preclude an autonomy enhancing approach to extended liability for economic loss.

Functionally, imposing liability in contract allows the parties to fine tune the risk allocation more easily than can be done if liability is initially imposed in tort, since any modifications to the implied warranty agreed to by the initial purchaser would be binding on the subsequent purchaser. The initial purchaser can be counted on to serve the interest of the subsequent purchaser for purely selfish reasons: if she is not contemplating the possibility of later selling the structure, she will negotiate the best possible warranty for herself, and if she is contemplating selling, the purchaser will want a good warranty as this will raise the resale price. The subsequent purchaser is therefore as well protected through contract as through tort. The real issue is whether the initial purchaser can be counted on to adequately protect herself through contract. This means that the choice between imposing liability in contract or tort depends on whether the courts or the parties are best able to allocate the risk in question.

While it is true that the purchaser is not likely to make an optimal decision because of bounded rationality, the court also suffers from bounded rationality. In the abstract we cannot say whether the court's allocation of risk will be superior to that which was arrived at by the parties, particularly since the vendor has significant incentives to offer a good warranty. A detailed cost-benefit examination of the warranty offered by the New Home Warranty Corporations shows that it is not

obviously inferior to protection which would be offered by tort law. Further, warranty provisions can and do evolve as the parties obtain more information.

Detailed examination of the contract provisions also lead to observations of broader interest. In particular, the concern for indeterminacy in recovery of pure economic loss is misleading. La Forest J.'s observation in *Norsk* that indeterminacy is important because of its effect on insurance premiums was very helpful in focusing the debate, but insurance theory indicates that increasing the variability of claims is unlikely to have a significant impact on insurance premiums in the long run.¹⁰⁹ Rather, it is indeterminacy resulting from uncertainty in the law and from transitional problems as the law changes, which may lead to significant problems in the insurance market. Further, indeterminacy is not the only factor determining the cost of insurance. Allowing expanded recovery for pure economic loss may well lead to higher insurance premiums because of increased transaction costs. Transaction cost issues deserve to be placed at the centre of the inquiry.

In particular, when transaction costs are considered, we can see considerable merit in the combination of strict liability with a strictly limited claims period, as opposed to the tort regime of negligence and a limitations period based on reasonable discoverability. While a strict cut-off for claims may lead to unfairness in some instances, it should significantly reduce transaction costs and consequently price as compared to the reasonable discoverability rule, and even a well informed purchaser might prefer the strict cut-off in return for a lower price. Which regime is to be preferred depends on the length of the strict claims period and the distribution of discoverability of defects over time. If most claims are likely to appear within the limitation period, then a strict cut-off is likely to be desirable. While the available evidence indicates that the strict five year limitation period in place in most New Home Warranty periods may be too short, the warranties are evolving towards a longer limitation period as more information becomes available.

In summary, the providers of the warranty have more information than the courts and just as much incentive to provide a good warranty, and the protection actually provided embodies trade-offs between cost and scope of protection which appear to be well founded. Thus we can conclude that the warranty offered by the Warranty Programs is at least as good and probably better than that which tort law would provide. If this is the case, expanding builder's liability in tort would make purchasers who are

109. Although it may be significant in specialized insurance markets in smaller jurisdictions.

already covered by the Warranty Programs worse off. Gains to other groups are ambiguous at best. Therefore, expanded liability in tort is not desirable. However, expanded liability through an implied third-party beneficiary warranty of fitness for habitation would not adversely affect any group of purchasers and would make some types of purchasers better off by improving their information.¹¹⁰ Expanded liability in contract is therefore to be preferred over tort liability.

Refusing to further extend liability for pure economic loss in tort maintains the distinction between allowing recovery of consequential economic loss while refusing recovery for pure economic loss. This distinction is evidently illogical when we compare cases where the nature of the economic loss is the same and the difference stems from the fortuitous fact of the absence of physical harm. I have argued that the distinction is indeed illogical, but from a policy perspective the error is in allowing recovery of consequential economic loss, not in denying recovery of pure economic loss. It is better to maintain an illogical distinction than to compound the error by extending tort recovery for pure economic loss.

Because the Warranty Programs already cover those parties whose contracting would be most likely to benefit from placing liability on the builder, even the gains from an implied warranty of fitness for habitation may be relatively small. But this leads to what is perhaps the most interesting issue raised in this article. We have seen that the establishment of the Warranty Programs was subject to significant collective action problems: the costs of setting up the program would be borne by a relatively small group who took the initiative, but the program would necessarily cover all builders in order to establish a sufficiently large risk pool. So long as any benefits from offering a warranty would accrue to the purchaser rather than to the builder, no builder would have a sufficient individual incentive to set up a warranty program. However, if the default rule had placed liability on the builder, the builder's incentives to create the warranty program would have been much stronger. I suggest that had the courts implied a warranty of fitness for habitation before the 1970s, we would have seen warranty programs set up on the initiative of the builders rather than on the initiative of the government. Thus the nature of the liability regime can be important in influencing the development of risk reducing institutions.

110. This echoes Calabresi's third guideline for deciding where liability should initially be placed, which, as he puts it in *The Costs of Accidents*, *supra* n.9 at 150, "is to allocate accident costs in such a way as to maximize the likelihood that errors in allocation will be corrected in the market."

I have argued that in deciding whether tort or contractual liability is preferable, a comparative institutional analysis is needed, which compares the strengths and weaknesses of the market and judicial responses. A thorough analysis of this sort depends on the particular institutional and psychological details of the market for the goods in question and so conclusions cannot easily be generalized. But the market for new home warranties does show that despite very significant problems of bounded rationality and lack of competition, the market response to the problem of building defects has been reasonably good. This at least provides some reason for optimism in other contexts. Further, an implied warranty approach allows greater judicial precision in responding to specific problems. In a tort approach the court must structure all aspects of the relationship, regardless of whether the market response is adequate or even preferable on a given point. Under an implied warranty approach the court can impose more stringent conditions on particular types of terms, for instance by systematically holding certain types of terms to be unconscionable. In other words, using tort law the court has to regulate categories of relationship, but using contract law it can regulate categories of contractual terms. For these reasons I suggest that greater reliance on contractual solutions may generally be advisable, and should certainly always be considered.