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One-Sided Contracts in Competitive Consumer Markets

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ONE-SIDED CONTRACTS IN COMPETITIVE CONSUMER MARKETS

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The usual assumption in economic analysis of law is that in a competitive market without informational asymmetries, the terms of contracts between sellers and buyers will be optimal—that is, that any deviation from these terms would impose expected costs on one party that exceed benefits to the other. But could there be cases in which “one-sided” contracts—contracts containing terms that impose a greater expected cost on one side than benefit on the other—would be found in competitive markets even in the absence of fraud, prohibitive information costs, or other market imperfections? That is the possibility we explore in this Article.

We focus on the following asymmetry between seller and buyer in cases in which the latter is a consumer rather than another business or comparable entity: The seller in such a case may be deterred from behaving opportunistically by considerations of reputation; the consumer is not constrained by such considerations because he has no reputation to lose, assuming that his opportunistic behavior in a particular transaction will not become known to the market as a whole. This difference is important whenever it is difficult to specify contractual terms to cover every important contingency that courts could accurately and easily enforce. In such circumstances, opportunistic buyers might try to use “balanced” terms to press for benefits and advantages beyond those that the terms were actually intended to provide.

Slanting the terms of the contract in favor of the seller is, we show, a way of redressing the balance. The existence of a one-sided contract does not imply that the *transaction* will be one-sided, but only that the seller will have discretion with respect to how to treat the consumer. A seller concerned

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about its reputation can be expected to treat consumers better than is required by the letter of the contract. But the seller's right to stand on the contract as written will protect it against opportunistic buyers. A one-sided contract may thus be preferred *ex ante* by informed parties as a cheaper mechanism for inducing efficient outcomes, should contingencies arise during the performance of the contract, than a more "balanced" contract that, because of imperfect enforcement, could create costs as a consequence of consumers' enforcing protective provisions in the contract.

When firms are influenced by reputational considerations, contracts that appear on paper to be one-sided against the consumer may in reality be implemented in a balanced way. The distinction between contracts on paper and their actual implementation is one that has received much attention from the literature on relational contracts between businesses.¹ As our analysis highlights, however, the distinction is also relevant to contracts that businesses enter into with consumers who are not repeat players. As long as the business is a repeat player with the consumer side of the market, its expectation of doing business with other consumers in the future may dissuade it from enforcing a one-sided contract to the hilt against a particular consumer even though the business does not expect to have further dealings with that consumer.

I. EXPLAINING ONE-SIDED CONTRACTS

We consider a competitive market in which sellers offer boilerplate contracts that include terms that appear to impose on buyers expected costs that exceed expected benefits to the seller. Examples are pre-dispute mandatory-arbitration clauses, holder-in-due-course clauses, forum selection clauses in cruise-ship ticket contracts, and shrink-wrap licenses.

Contracts that contain such terms and, as is typical of such contracts, are offered to consumers on a take-it-or-leave-it basis are described by critics as "contracts of adhesion." An older, and pretty well discredited, scholarly literature thought the absence of bargaining showed that the seller must have monopoly power, enabling him to foist on consumers whatever terms he liked. But transaction costs plus agency costs, relative to the modest stakes in most consumer transactions, are sufficient explanations for why sellers

1. See, e.g., Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981); Lisa Bernstein, *Merchant Law in Merchant Court: Rethinking the Code's Search for Immanent Business Norms*, 144 U. PA. L. REV. 1765 (1996). The paper closest to our analysis in its emphasis on problems of observability by courts is Benjamin Klein's analysis of franchise agreement. See Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AM. ECON. REV. 356 (1980).

In his contribution to this symposium, Jason Johnston seeks, like us, to analyze the distinction between the language and the actual implementation of contracts in the context of contracts between businesses and consumers. See Jason Scott Johnston, *The Return of Bargain: An Economic Theory of How Standard-Form Contracts Enable Cooperative Negotiation between Businesses and Consumers*, 104 MICH. L. REV. 857 (2006). The only prior paper of which we know to have explored this issue is Clay Gillette's study of rolling contracts that consumers enter into online. See Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WIS. L. REV. 679 (2004).

prefer a form contract to individual negotiations.² Nor is it obvious why a monopolist would offer suboptimal terms rather than just charge a monopoly price for balanced terms, a price that would be higher because the consumer was receiving greater value.³

But this leaves unexplained the one-sidedness of many form contracts. Scholars often try to explain them as a result of informational problems. Consumers could be inadequately informed about the provisions included in the contracts or their consequences.⁴ Consumers' understanding could also be distorted by the kind of cognitive problems that are receiving increasing attention from economists.⁵ Or sellers could be induced to offer one-sided contracts by the presence of adverse selection, as we explain in Part IV.⁶ Scholars who advance these explanations oppose judicial enforcement of contracts of adhesion in the name of unconscionability or similar doctrines.⁷ Some courts have agreed,⁸ but most have not.⁹

Must the presence of one-sided contracts in competitive markets be due to informational problems? Are courts that enforce such contracts failing to intervene when they should? Or might there be an explanation that does not depend on assuming asymmetric information in favor of sellers or other possible sources of market failure? We show that such an explanation does exist and that, as a result, the normative inferences that can be drawn from such contracts are far from being clear and straightforward.

Many one-sided contracts are found in consumer markets that have the following characteristics: The seller side of the market consists of repeat players who have a sunk cost in a reputation for dealing "fairly" with consumers, in the sense of not taking advantage of one-sided terms as long as the consumer deals fairly with them. The buyer side of the market consists of parties that—because they do not have repeat dealings with particular

2. See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 115 (6th ed. 2003).

3. See Florencia Marotta-Wurgler, *Competition and the Quality of Standard Form Contracts: An Empirical Analysis of Software License Agreements* (NYU Law and Econ. Research Paper No. 05-11, 2005), available at <http://ssrn.com/abstracts=799274> (citing relevant sources).

4. See, e.g., Michael I. Meyerson, *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583, 594–603 (1990).

5. See, e.g., Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004); see also Paul Bennett Marrow, *The Unconscionability of a Liquidated Damages Clause: A Practical Application of Behavioral Decision Theory*, 22 PACE L. REV. 27 (2001).

6. See, e.g., Phillippe Aghion & Benjamin Hermalin, *Legal Restrictions on Private Contracts Can Enhance Efficiency*, 6 J.L. ECON. & ORG. 381 (1990); Eric A. Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283 (1995).

7. See, e.g., Meyerson, *supra* note 4, at 608–22.

8. See, e.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965); *Galligan v. Arovitch*, 219 A.2d 463 (Pa. 1966); *Sosa v. Paulos*, 924 P.2d 357 (Utah 1996); *State ex rel. Dunlap v. Berger*, 567 S.E.2d 265 (W. Va. 2002); *Pittsfield Weaving Co. v. Grove Textiles, Inc.*, 430 A.2d 638 (N.H. 1981) (*per curiam*).

9. 1 E. ALLEN FARNSWORTH, *FARNSWORTH ON CONTRACTS* § 4.28, at 560–61 (2d ed. 1998); see, e.g., *Monsanto Co. v. McFarling*, 302 F.3d 1291 (Fed. Cir. 2002); *Seekings v. Jimmy GMC of Tuscon, Inc.*, 638 P.2d 210 (Ariz. 1981).

sellers (the market is competitive, so consumers can switch easily among sellers) and because privacy rules or other barriers to pooling of information among sellers prevent sellers from comparing notes about the behavior of individual buyers—do not have a sunk cost in reputation and hence have no incentive to deal fairly with sellers in the sense of honoring the terms of the contract.

In such a situation, the optimal set of contract terms does not depend only on the relative costs and benefits associated with particular terms. It also depends on the relative propensity of the parties to behave opportunistically, that is, to take advantage of contractual terms and, in so doing, impose a cost on the other side that will exceed the benefit to the opportunistic party.

In the asymmetric-reputation case, the seller has little or no incentive to behave opportunistically because if he does, he will suffer a loss of reputation, which is a cost. The buyer, however, is not deterred by concern for reputation. Nor is he dependably deterred by threat of legal action since, given feasibility limits on drafting contract terms that are free from uncertainty, courts cannot always determine when a party is using a contract term opportunistically.

In this situation, seemingly one-sided terms may not be one-sided after all. The expected cost of the term to the buyer must be discounted by the likelihood that reputational considerations will induce the seller to treat the buyer fairly even when such treatment is not contractually required. This cost will sometimes be further reduced by sellers' disinclination to sue consumers even when they have an ethically as well as legally solid case. Sellers may still worry that a suit will injure their reputation for fair dealing (because the term is one-sided), or that the cost of the suit will be disproportionate to the expected benefit. If, therefore, we assume that a court would be able to determine only whether the litigated contract term is *on average* efficient—that is, on average, it burdens the bound party less than it benefits the obligee—a rule of unconscionability that condemned one-sided terms would systematically favor opportunistic buyers without protecting fair buyers, because the latter are protected by the sellers' investment in reputation.

Consider by way of example the following provision in the standard contract that Harvard University Press enters into with authors: "[i]f the Author fails to return the corrected proofs sheets by the date set by the Publisher, the Publisher may publish the Work without the Author's approval of proof."¹⁰ Clearly, given the importance of accuracy to the author, the publisher's enforcing this provision to the hilt would impose on the author an expected cost greater than the benefit to the publisher, especially given that the agreement does not limit the publisher's discretion in its choice of "the date set by the Publisher."

What could explain the inclusion of this provision in an agreement recently signed by this publisher and one of us and his co-author? It could not

10. See Agreement Between Harvard University Press and Lucian Bebchuk and Jesse Fried (Mar. 23, 2004) (on file with authors).

be the publisher's market power. The publisher was seeking in this case, as in many others, to compete with other publishers on other aspects of the agreement. Nor could it have been the publisher's expectation that this provision would not be noticed by the authors. Authors are in general likely to read carefully the short publication agreement. Furthermore, the authors in this case did notice the provision and asked to amend it, but the publisher indicated that its policy was not to make amendments to this provision.

Notwithstanding the publisher's insistence on retaining the provision, the publisher's agent assured the authors that they do not have to worry about this provision and other seemingly one-sided provisions included in the agreement. Although this assurance had no legal significance, the authors signed the agreement without worrying that the publisher would abuse the power given to it by the provision. Indeed, when the authors were a bit late in returning the proofs, the publisher, as expected, waited for the corrections rather than enforcing the provision.

Our explanation is that the provision is intended to protect the publisher from circumstances in which the author's delay in returning proofs is egregious. But if the provision were explicitly limited to those circumstances, enforcement would be a difficult undertaking for a court because determining "egregiousness" might well depend on information available to the parties but not easily and accurately observable by the court. The one-sided provision obviates this concern, while the publisher's reputational interest protects the authors from the publisher's taking advantage of the literal meaning of the provision.

In the circumstances we focus on, a one-sided provision allows the business discretion whether to provide the individual with protection in any given circumstances. In contrast, because a balanced provision cannot be written in an unambiguous way, whether protection will be provided in any given circumstances will be influenced by the court's discretion. In some circumstances, a strategy of discretionary protection is superior to a strategy of judicial discretion.

II. A SIMPLE MODEL

Assume a competitive market in which one side (the seller side, consisting of many sellers) faces stronger reputational constraints than the other side does (the buying side, assumed to consist of many individual consumers). The sellers are repeat-playing firms, and consumers have information about their behavior. As a result, sellers are concerned about their reputation. Buyers, however, are not concerned about investing in reputation because they buy infrequently from a given seller and sellers do not exchange information about consumers.

In some markets, of course, buyers are not indifferent to their reputation. They may be firms that are repeat players with powerful incentives to protect their reputation, while the sellers may be individuals that transact infrequently. An example is the agreements that university presses have with new authors. Our analysis applies to such markets as well. It can explain, for

example, why the agreements that those presses have with their authors include provisions that seem one-sided against the author even though authors are likely to read the terms of these agreements and there is competition among the publishers. For simplicity of exposition, however, we will assume in the model that the sellers' side of the market is the one composed of firms with reputations to protect.

Similarly, not all consumers are well informed about the behavior of sellers. Indeed, the cost of becoming informed may exceed the benefit, resulting in rational ignorance of hidden traps in contracts that competition may not dispel.¹¹ The novelty of the present analysis is that the same contract forms that are widely assumed to be based on consumer ignorance can be shown to be consistent with competition under conditions of full information.

When a contract term is on average efficient, then each buyer's expected benefit, B , exceeds the seller's expected cost, C : $C < B$. But "on average" implies that the term won't be efficient in all the circumstances to which it literally applies. Assume it will be efficient in state θ , which has a probability p of occurring, but not in any other state. Assume that the benefit to the buyer will be $B_2 > C$ in state θ but only $B_1 < C$ in the non- θ state, so that the average benefit to the buyer is

$$p(B_2) + (1-p)(B_1).$$

Assume further that courts will be unable to observe whether the state of the world in which the contract dispute arises is θ , but the parties will, though all that is necessary for our analysis to hold is that the parties have better information about the presence or absence of θ than courts have.

Sellers in our model offer to buyers identical take-it-or-leave-it contracts and are not prepared to renegotiate when the time for performance arrives. One can think of the sellers as large firms that do not trust their agents to negotiate contract changes or (a point to which we'll return) that mistrust consumers who try to negotiate over terms.

If a seller fails to comply with a contract term, the consumer will be able to obtain from a court an award of expectation damages equal to B . Because the court will not be able to distinguish perfectly between consumers who derive a large benefit from the term and consumers who derive only a small benefit, there will be a tendency to award damages equal to the average benefit of the contract term that the seller has violated. For the sake of simplicity, we assume that the same damages are awarded in all cases in this class.

Since $B > C$, if sellers' behavior is not constrained by their concern for their reputation, the protective term will be included, for without it the seller would have no incentive to confer B and so the value of the contract would not be maximized. Inclusion of the term produces an efficiency gain of $B_2 - C$

11. Richard A. Posner, *The Law and Economics of Contract Interpretation*, 83 TEX. L. REV. 1581, 1585-86 (2005).

in state θ and an efficiency loss of $C - B_1$ in the non- θ state, but the net gain is positive because

$$p(B_2 - C) + (1 - p)(C - B_1) = B - C > 0.$$

Sellers in a competitive market will offer the term because while they will be charging a price for the contract that is higher by C (since that is the cost to the seller of the term), the expected benefit to consumers will be greater and so consumers will shun sellers who fail to offer it.

This is the standard result when courts cannot observe the exact circumstances of a given case and there is no contract renegotiation; a term will be included if the average benefit exceeds the average cost. But it is no longer the case when reputational considerations are in play. For then, provided sellers' practices are known to consumers, sellers will offer only a contract that omits the term benefiting the buyer, but they will have a policy of honoring the (nonexistent) term whenever the parties are in state θ .

For example, the term might be that the buyer can return the good and get his money back, and θ might be the state in which the buyer returns it promptly without having used or damaged it. Sellers will charge a price that is higher by pC because they expect to incur a cost C with probability p , in cases in θ . But buyers will have an expected benefit of pB_2 and thus a net expected gain of $p(B_2 - C)$. When some sellers offer such contracts while following the policy just described, no seller who fails to provide such a combination will be able to attract any consumers without losing money.

It might seem that since buyers value the policy, sellers would make it a term of the contract even if they were constrained to follow the policy by their investment in reputation. But this is incorrect because, as a contract term, the policy would require adherence by the seller even when it was inefficient to provide the benefit, that is, even when the parties were in the non- θ state. Thus, if the contract provided that the buyer could return the good if dissatisfied with it, the seller would be obligated to accept the return even if the buyer, rather than actually being dissatisfied with it, had used it as much as he wanted to or had damaged it so that it was no longer valuable to him. Of course, the seller might include some qualifying language such as "reasonably dissatisfied," but the uncertainty created by such language would give the buyer some probability of being able to get away with returning the good in circumstances not intended to be covered by the clause.

III. POSITIVE AND NORMATIVE IMPLICATIONS

Our analysis has both positive and normative implications. On the positive side, it can explain the large number of cases in which sellers dependably treat consumers much better than their contracts require them to do. Sellers often accept returns in circumstances in which they are not obligated to do so. Similarly, hotels usually do not charge a guest for checking out of his room shortly after the check-out time; publishers commonly do not send a manuscript to the printer without waiting for the author's corrections when the author is late and usually overlook other small breaches as

well; airlines sometimes give people double mileage credit if a flight is delayed; and restaurants allow substitutions though the menu states "no substitutions." Such concessions are not properly regarded as advertising or price discrimination, because consumers expect them and often would be indignant if they were withheld.

But because they are not legal entitlements, the seller is not at the mercy of a buyer who would abuse them but not be amenable to legal sanctions. Suppose, for example, that instead of fixing a rigid check-out time, the contract between a hotel and its guests provided that the guest must leave at the check-out time (or pay for another day) unless he has good cause to delay his departure for a reasonable amount of time. Such a provision could be (ab)used by a guest who decides cavalierly to stay in the room, watching TV, until the evening news. With the rigid check-out rule, the hotel will be able to charge this overstaying customer for another day while waiving such charges routinely for customers who miss the check-out time in good faith and for good reason.

In the circumstances that we study in this Article, courts would do well to take a hard line in enforcing the terms of one-sided consumer contracts in the absence of evidence of fraud. Suppose the contract that a seller has with its customers does not promise them some protection X (say, forgiving charging for an entire day in the event of a short delay in checking out due to circumstances beyond a customer's control), but there is evidence that the seller does commonly accord them X. Should a court view the common practice as an implicit promise to do so? Our answer is no, because this would sacrifice the benefits of an unenforceable policy that allows the firm discretion to withhold a normally expected benefit.

There will be borderline cases because courts frequently use evidence of past practice or custom to interpret a contract. However, this is done mainly in cases in which a contractual term is ambiguous.¹² If the term is crystal clear, as the drafters of one-sided contracts will endeavor to make it, courts will generally enforce the term as written.

IV. ALTERNATIVE INFORMATION-BASED EXPLANATIONS

We enlarge briefly here on the alternative explanations mentioned earlier for one-sided contracts. These explanations are based on informational asymmetries between sellers and buyers. One explanation assumes that consumers are at an informational disadvantage. They are uninformed about the costs that the contract may impose upon them or suffer from cognitive limitations and biases when assessing these costs.

The other explanation assumes that there are two types of consumer between which the seller cannot distinguish; in other words, consumers have the informational advantage. One type, who would value a protective provision more than the other, also happens to be the one that is costlier to serve.

12. 1 MARGARET N. KNIFFIN, CORBIN ON CONTRACTS §§ 24.7, 24.9 (Joseph M. Perillo ed., rev. ed. 1998).

In these circumstances, even if the protective provision is efficient for all consumers, in equilibrium, no consumer might ask for it out of fear that doing so would make the seller suspect that the buyer was of the type that is costlier to serve.

Our explanation for one-sided contracts has two different implications, one positive and one normative, from those of the alternative, information-based explanations.¹³ The distinctive positive implication is that when our explanation is applicable, firms will not take advantage of the one-sided contracts: only in exceptional cases will they stand by the letter of the contract. In contrast, when one of the two information-based explanations applies, firms will always (or at least almost always) stick to the letter of the contract.

The normative implication is that when our explanation is applicable, the law should not intervene and provide protection not supplied by the contract, while if the seller has and is exploiting an informational advantage, there is an argument for implying protective provisions in the contract to make it less one-sided. Similarly, in the presence of inefficient pooling produced by adverse selection, imposing protective provisions could sometimes (though not always) improve matters. The challenge for future research is to try to distinguish between the domains of our explanation and the information-based explanations.

We emphasize finally that our analysis is limited to the case of repetitive selling of consumer products under conditions of good consumer information about sellers. With infrequent sales or poor information about sellers, sellers will not be constrained by reputational concerns. Our analysis is likewise inapplicable when the buying side consists not of individual consumers, but of firms that have their own reputational stake in fair dealing, so that sellers have less concern about being taken advantage of by buyers who are not reputation-constrained. It is the asymmetry of reputation concerns in the case of the repeat seller selling to a consumer that drives our analysis. The potential existence of such asymmetries is a factor to which scholars and judges should, we contend, pay close attention.

13. There is a sense in which our explanation is information-based too; but the information deficit in our analysis is not a deficit of either party to the contract, but of the court that may be called upon to enforce the contract.

