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The Microfoundations of Standard Form Contracts: Price Discrimination vs. Behavioral Bias

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THE MICROFOUNDATIONS OF STANDARD FORM CONTRACTS: PRICE DISCRIMINATION VS. BEHAVIORAL BIAS

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THE MICROFOUNDATIONS OF STANDARD FORM
CONTRACTS: PRICE DISCRIMINATION VS.
BEHAVIORAL BIAS

JONATHAN KLICK*

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I. INTRODUCTION

Standard form contracts appear to present a problem for the efficiency claims of those adhering to the positive law and economics school.¹ Indeed, if we envision economic bargaining as movements within an Edgeworth box toward the Pareto set,² one does not quite know what to do with standard form contracts. This disconnect between bargaining theory and empirical observation led some legal scholars to view form contracts as adhesion contracts, implying that they are the result of a powerful party thrusting its preferences on a helpless party.³ The take-it-or-leave-it nature of these contracts, which are generally drafted by the seller of a good or service, casts doubt on the usual assumption that market competition maximizes consumer surplus.

However, the idealized world of the Edgeworth box does not discuss the process by which buyers and sellers choose a particular point on the core of the contract curve within the box, and in reality, those dynamics will be beset by transactions costs.⁴ Because those transactions costs reduce total surplus, individuals will have the incentive to mitigate them. Market forces, then, will tend to drive profit-maximizing sellers to settle on standard contract terms that

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1. For a discussion of the lines of separation among the major movements in law and economics, see Francesco Parisi & Jonathan Klick, *Functional Law and Economics: The Search for Value-Neutral Principles of Lawmaking*, 79 CHI.-KENT L. REV. 431 (2004).

2. See ANDREU MAS-COLELL ET AL., MICROECONOMIC THEORY 515-25 (1995). An *Edgeworth box* is a graphical device which may be used to depict a simple economy with two commodities and two consumers. *Id.* at 515-16. The *Pareto set* is the collection of all “Pareto optimal allocations”—outcomes to which “there is no alternative feasible outcome at which every individual in the economy is at least as well off and some individual is strictly better off.” *Id.* at 522-23.

3. See, e.g., Friedrich Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 632 (1943).

4. Defining a determinative solution to which point will be reached along the contract curve is a difficult task and requires some fairly restrictive assumptions. For one example of how scholars have attempted to solve this problem, see John F. Nash, Jr., *The Bargaining Problem*, 18 ECONOMETRICA 155, 155-62 (1950).

are optimal in terms of maximizing total surplus generated through trade.⁵ Standardizing terms eliminates the need for a producer to bargain with all of his customers individually, saving the attendant costs of bargaining, including the agency costs involved in delegating bargaining authority to nonowner operators. Cooter and Ulen make a point to differentiate between standardized contracts that increase efficiency and contracts of adhesion that result from a seller's monopoly position in the market.⁶

In judging the welfare implication of standardization, then, Cooter and Ulen suggest that the important question is whether the underlying market is competitive or monopolistic.⁷ Posner echoes this when he writes that the important consideration is "whether competition forces sellers to incorporate in their standard contracts terms that protect the purchasers."⁸

This efficiency view implies that in competitive markets, standardized terms will benefit buyers. A corollary to this is that if we observe "abusive" standardized terms, the market is presumptively monopolistic. Casual observation suggests that standardized contracts are nearly ubiquitous,⁹ and a great many of the standardized terms appear to benefit the seller to the potential detriment of the buyer.

What can we make of this inconvenient mismatch between theory and data? If abusive contract terms are the norm, does that imply that many markets are monopolistic? Such a deduction flies in the face of modern industrial organization, which suggests that the conditions required for competition are relatively lenient. The theory of contestable markets tells us that as long as market entry and exit are reasonably easy, markets will generate competitive outcomes.¹⁰ Further, contestable markets theory implies that technological advances will lead to easier entry and greater competition. While we should be observing increasing competition, we also appear to be seeing an increase in the use of supposedly abusive standardized contract terms.

5. See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 4.8, at 116 (6th ed. 2003).

6. ROBERT COOTER & THOMAS ULEN, *LAW AND ECONOMICS* 288 (4th ed. 2004).

7. *Id.* at 289.

8. POSNER, *supra* note 5, § 4.8, at 116.

9. For example, Hillman and Rachlinski suggest that "[p]eople encounter standard forms in most of their contractual endeavors." Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429, 435 (2002) (citing John J.A. Burke, *Contracts as Commodity: A Nonfiction Approach*, 24 SETON HALL LEGIS. J. 285, 290 (2000)).

10. See WILLIAM J. BAUMOL ET AL., *CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE* 4-5 (rev. ed. 1988); William J. Baumol, *Contestable Markets: An Uprising in the Theory of Industry Structure*, 72 AM. ECON. REV. 1 (1982); William J. Baumol et al., *Contestable Markets: An Uprising in the Theory of Industry Structure: Reply*, 73 AM. ECON. REV. 491 (1983).

Inconvenient empirical observations such as this have provided the major impetus for the behavioral economics movement. When parsimonious models constructed from concave utility functions failed to provide implications that survive testing, some economists began to look to psychology for insights to explain the data. While there are certainly gains from interdisciplinary trade to be exploited, many law and economics scholars seem to forget what the comparative advantage of economic analysis is: Economic theory generates testable hypotheses about cross-sectional and time-series variation in behavior.

Once theories are rigorously tested, they can provide insight for policy. If the theory fails to be supported by the data, we should reject the theory, not the method. Lack of empirical support does not suggest that some other particular explanation is correct; it merely indicates that the tested theory is not correct. In the early stages of the behavioral economics movement, too often researchers have simply taken some anomalous behavior observed in the lab and used it as the presumptive null hypothesis that is accepted when the tested hypothesis, generated by theory, is rejected.

This research strategy could be profitable if the empirical tests were particularly powerful. However, for most applications, while the microfoundations of the economic theory are reasonably well specified, the behavioral explanation is often invoked without specifying its foundations. Such an asymmetry leaves little confidence that a powerful empirical test can be designed.

Fortunately, it appears as though we are on the cusp of a more sophisticated integration of psychological insights into the ex ante assumptions of economic models. This “second-wave behavioral economics” moves beyond the ex post rationalizations of anomalous empirical results and ad hoc criticisms of conventional economic theory by helping to fill out some of the microfoundations of behavior without abandoning useful economic methods for generating and testing hypotheses.¹¹ This movement will eventually allow economic research to better inform policy and judicial decisions. However, until the movement becomes sufficiently embedded and developed, it is premature to use first-stage behavioral criticisms to supplant insights from conventional economics in the public decisionmaking process.

In the meantime, law and economics scholars working on applied issues should be careful not to invoke behavioral explanations—developed atheoretically on the basis of observation as opposed to rigorous testing—simply because existing economic theory is not borne out empirically. Instead, we should adopt behavioral explana-

11. For a helpful discussion of the integration of this “second-wave,” see Matthew Rabin, *A Perspective on Psychology and Economics*, 46 *EUR. ECON. REV.* 657 (2002).

tions only if they can explain systematic cross-sectional and time-series variation, while keeping in mind that conventional theory might provide some unexplored insights.

Standard form contracts provide an illustration of an application for which a behavioral explanation has been suggested because conventional theory has not yet been predictive of empirical observation. Work by Russell Korobkin provides the strongest argument that bounded rationality and status quo bias lay at the foundation of “abusive” standardized terms and lays out the policy implications of these biases.¹²

However, although these behavioral biases are consistent with casual observation of the incidence of standard form contracts, standard economic theory provides an unexplored explanation that is consistent with the casual empirics too. Specifically, standard form contracts can exist in fairly competitive markets if consumers exhibit heterogeneity in time values and sellers can engage in price discrimination on the basis of that heterogeneity through the use of standardized contracts. By accepting default terms, high-time-value individuals acquire the product at a higher quality-adjusted price without expending time to dicker over individual contract terms. Low-time-value individuals, on the other hand, willingly expend time haggling over unattractive terms to secure a lower quality-adjusted price.

This Comment reviews Korobkin’s argument regarding behavioral bias as the root of standardized contract terms that favor sellers. Part II briefly discusses the correlates of these biases, suggested by experimental work, that will be useful in generating predictions about cross-sectional variation. Part III presents the price discrimination model of standardized contracts. Part IV concludes with a discussion of what empirical evidence would provide powerful support for the competing explanations of standardized contracts.

II. STANDARDIZED CONTRACTS AS ARTIFACTS OF BEHAVIORAL BIAS

In a series of articles, Russell Korobkin has isolated two behavioral biases that contribute to the existence of standard form contracts.¹³ Status quo bias is the tendency of individuals to accept existing or default orderings as normative or preferred simply because the ordering constitutes the status quo.¹⁴ In the contract case, this bias

12. See Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1208-44 (2003).

13. See Russell Korobkin, *Behavioral Economics, Contract Formation, and Contract Law*, in BEHAVIORAL LAW AND ECONOMICS 116 (Cass R. Sunstein ed., 2000); Korobkin, *supra* note 12.

14. See William Samuelson & Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 J. RISK & UNCERTAINTY 7, 8-10 (1988). For a formal incorporation of status quo bias

manifests itself in an individual's propensity to accept default or form terms without bargaining over them to achieve more favorable terms.¹⁵ However, while status quo bias might explain why Coasian bargaining does not take place in individual transactions, it is less powerful as an explanation of why abusive terms could exist in equilibrium. We would expect competitive forces to eliminate abusive terms in the long run, because consumers would be drawn to sellers offering more attractive standard terms as long as search costs are low and entry is easy.

To explain the durability of abusive terms, Korobkin invokes the notion of bounded rationality, suggesting that consumers will not consider all dimensions of product quality because of a limited ability to process complex information.¹⁶ While consumers will pay attention to and bargain over salient terms, such as price, they will ignore non-salient terms.¹⁷ Sellers will have the incentive to exploit this limited rationality by proposing abusive non-salient terms and competing only on the basis of salient terms.¹⁸

Korobkin provides substantial experimental evidence that consumers disregard some product attributes in their decisionmaking.¹⁹ For example, one review of existing studies cited by Korobkin suggests that consumers generally only compare three products and that the comparison focuses on no more than five product dimensions,²⁰ although there does appear to be heterogeneity across consumers²¹ depending on the individuals' processing abilities.²²

Given that consumers will generally consider fewer than the total number of distinct product attributes, Korobkin suggests that contract terms will often be ignored as consumers devote their attention and information-processing resources to comparing salient attributes such as price, appearance, and product function.²³ Further, even if consumers wanted to compare products based on a multitude of terms, behavioral research suggests that individuals have difficulties

in a rational choice framework, see Yusufcan Masatlioglu & Efe A. Ok, *Rational Choice with Status Quo Bias*, 121 J. ECON. THEORY 1 (2005).

15. See Korobkin, *supra* note 13.

16. Korobkin, *supra* note 12, at 1226-29.

17. *Id.* at 1229-34.

18. See *id.* at 1234.

19. *Id.* at 1226-29.

20. See Denis A. Lussier & Richard W. Olshavsky, *Task Complexity and Contingent Processing in Brand Choice*, 6 J. CONSUMER RES. 154, 155 (1979).

21. Richard W. Olshavsky, *Task Complexity and Contingent Processing in Decision Making: A Replication and Extension*, 24 ORGANIZATIONAL BEHAV. & HUM. PERFORMANCE 300 (1979).

22. See James Onken et al., *Individual Differences in the Use of Simplification Strategies in a Complex Decision-Making Task*, 11 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 14 (1985).

23. Korobkin, *supra* note 12, at 1230.

in making trade-offs over dissimilar product attributes.²⁴ That is, consumers might be unwilling to implicitly price some product attributes, particularly those attributes with strong emotional implications, such as safety.²⁵ Even if individuals were willing to make trade-offs regarding these emotion-laden attributes, Korobkin draws on the experimental evidence that individuals are generally poor probabilistic thinkers to suggest that individuals will make these trade-offs inefficiently when it comes to terms that only bind with low probability, such as arbitration requirements.²⁶

Korobkin argues that as firms compete on the basis of salient product attributes, they have an incentive to offer inefficient non-salient contract terms.²⁷ That is, if individuals pay the most attention to price, sellers will use their savings from providing low-quality (ignored) contract terms to lower prices, lowering the total surplus generated from trade.²⁸

Korobkin provides numerical examples in which competition over salient features leads to an efficiency loss in situations where salience is homogenous across consumers, heterogeneous but randomly distributed across consumers, heterogeneous across strategic consumers, and endogenous.²⁹ In each case, Korobkin argues that the likelihood of sellers finding it profitable to offer only efficient contract terms regarding non-salient features is vanishingly low, leading to aggregate welfare losses.³⁰

To remedy this possibility of equilibrium inefficient contract terms, Korobkin suggests that courts enforce all terms that were clearly salient *ex ante*, as well as terms for which this determination is ambiguous.³¹ Litigants wishing to invalidate a particular term should be required to present evidence of its non-salience and its inefficiency.³² If the court determines that the contested term was non-salient and inefficient, it should allow for significant penalties in order to incentivize sellers to draft efficient contract terms.³³

Regarding the determination of what constitutes an efficient term, Korobkin suggests that litigants could present studies detailing the

24. *Id.*

25. *See id.*; Jane Beattie & Jonathan Baron, *Investigating the Effect of Stimulus Range on Attribute Weight*, 17 J. EXPERIMENTAL PSYCHOL.: HUM. PERCEPTION & PERFORMANCE 571, 571 (1991).

26. Korobkin, *supra* note 12, at 1232-34.

27. *Id.* at 1234.

28. *Id.*

29. *Id.* at 1232-41.

30. *Id.*

31. *Id.* at 1280.

32. *Id.* at 1280-81.

33. *See id.* at 1284-90 (suggesting nonenforcement as a default remedy for unconscionable terms).

relative values of buyers' willingness to pay for high- and low-quality contract terms net of the marginal savings to the seller in providing the low-quality term.³⁴ Such studies, however, will be plagued by many problems. Analysis of market data would not be possible, presumably, given the assumption that the term is non-salient. Therefore, it is unlikely buyers will have priced the term. On the other hand, survey results come with their own substantial shortcomings.³⁵ Recognizing that this kind of direct evidence might be difficult to collect, Korobkin defaults to the efficiency precepts that are presented in the law and economics literature, such as assigning risks to the party best able to minimize expected losses.³⁶

Korobkin's explanation and examples are rhetorically persuasive. Further, his argument is advanced by the significant laboratory evidence of individuals' behavioral biases.³⁷ Before we adopt his prescriptions, however, it might be profitable to inquire whether his hypothesis stands up to empirical testing. The argument certainly is consistent with the casual observation that potentially abusive contract terms can be found in the real world. However, it is not clear that the bounded rationality explanation is the best explanation for this observation.³⁸

A handful of limitations or potential inconsistencies inherent in the model that is implicit behind Korobkin's illustrations might limit its acceptability a priori. The most obvious inconsistency is the different treatment of buyers and sellers. While buyers are assumed to suffer from significant behavioral biases that are not corrected in any evolutionary sense,³⁹ sellers are assumed to be able to capitalize on these biases, despite the fact that doing so would require significant information and information-processing capabilities.⁴⁰ Perhaps the feedback mechanisms on the supply side are stronger, making seller biases more costly and leading to their remedy through attrition of

34. See *id.* at 1284.

35. See, e.g., Peter A. Diamond & Jerry A. Hausman, *Contingent Valuation: Is Some Number Better than No Number?*, J. ECON. PERSP., Autumn 1994, at 45 (discussing the flaws of contingent value surveys).

36. Korobkin, *supra* note 12, at 1284.

37. *Id.* at 1225-33.

38. In truth, it is not at all clear that abusive terms do exist. Despite Korobkin's citation of canonical law and economics literature on what constitutes efficiency in these contexts, some scholars, such as James Buchanan, would argue that value maximization is tautologically the result of trade. "Individuals make their evaluations of the two commodities only as the trading process takes place, and, without trade, there could be no means of determining what value is at all." GEOFFREY BRENNAN & JAMES M. BUCHANAN, *THE REASON OF RULES: CONSTITUTIONAL POLITICAL ECONOMY* 28 (2000). Thus, any evaluation of efficiency independent of the trading is impossible. For further discussion of this point, see Parisi & Klick, *supra* note 1; and Jonathan Klick & Francesco Parisi, *Wealth, Utility, and the Human Dimension*, 2 N.Y.U. J.L. & LIBERTY (forthcoming 2005).

39. See Korobkin, *supra* note 12, at 1218-34.

40. See *id.* at 1234-39.

firms that fail to exploit buyer biases. However, one could argue that a court system that ruthlessly enforces contracts would make buyer biases more costly, leading to their mitigation or elimination. It is not at all clear that we are better off, in a dynamic sense, when existing biases are reinforced through the protective shield of courts.

Further, it is not evident from Korobkin's presentation whether the low-price/inefficient non-salient-terms result is sustainable in equilibrium even in a system that enforces all contract terms. Korobkin too easily rejects the argument that consumers' salience profiles will change once a low-probability event occurs, imposing a reputation cost on firms offering inefficient contract terms.⁴¹ This is a bit cavalier since much depends on the product involved and the salience differentials held by consumers. Formal modeling of the conditions under which reputation lacks disciplinary force might allow us to better target the areas where Korobkin's prescriptions are most necessary, without applying them across the board, even in situations where abusive contract terms are a disequilibrium phenomenon that will be remedied without judicial intervention. Perhaps more importantly, by asserting that such low-probability events will have little effect on seller incentives,⁴² Korobkin is unwittingly suggesting that the welfare increases from his prescriptions will be quite small and may well not be cost-justified, even if they require only trivial inquiry costs. That is, perhaps the reason that certain terms are systematically non-salient is because their ultimate importance is trivial.

Lastly, Korobkin's examples assume that all markets are pooled such that sellers will offer all customers an identical product even if their preferences and salience profiles are heterogeneous.⁴³ However, it could be the case that firms offer differentiated products to consumers and use the standard form contract to engage in a type of price discrimination. While such price discrimination may fall short of first-best efficiency, it may be welfare-enhancing relative to the pooled equilibrium, suggesting that failure to enforce the standardized terms would harm consumers as a group if the standardized contract is the most efficient way to sustain a separating equilibrium. This will be the subject of the following Part.⁴⁴

Before scholars can attempt to investigate whether the bounded rationality model of form contracts fits the data better than these competing stories (or others that have not been mentioned), it is necessary to identify the comparative statistics yielded by Korobkin's argument. A theory must be predictive of variation to be powerful. As

41. *See id.* at 1240.

42. *See id.*

43. *See id.* at 1235.

44. *See infra* Part III.

discussed above, our relative ignorance of the microfoundations of behavioral biases limits our ability to derive formal comparative statistics; improvement on this front will allow researchers to craft more powerful empirical tests. However, Korobkin's article provides some clues as to what underlying variables should correlate well with systematic limitations in rationality.

For example, since it appears that individuals with superior cognitive abilities can evaluate more product dimensions,⁴⁵ we should expect that the likelihood of inefficient standardized terms decreases as average customer cognitive ability increases.

Another covariate suggested by Korobkin's work involves consumer heterogeneity.⁴⁶ As variance in salience profiles in the market increases, we should expect that fewer terms are immune from competitive pressures. This implies that markets with increasingly heterogeneous consumers should exhibit fewer inefficient standardized terms.

Lastly, despite Korobkin's pessimism regarding the ability of reputation concerns to remedy inefficient standardized terms,⁴⁷ on the margin, we should observe a lower likelihood of inefficient terms as average consumer experience in the market increases. That is, even with very small probability events, the more exposure consumers have in a market, the higher the cumulative probability of an individually small probability event occurring. As such an event occurs for more individuals (and as publicity of these events spreads), we get closer to the tipping point between salient and non-salient for the inefficient standardized term.

Greg Mitchell offers some other sources of variation in behavioral bias in general.⁴⁸ Some of these might prove to be systematically important in determining deviations from rationality in the contract context specifically. Among these differences are sex differences,⁴⁹ disposition differences,⁵⁰ cultural differences,⁵¹ and developmental differences.⁵² Identifying the specific correlations between these characteristics and the increasing propensity to make boundedly rational decisions in contract-context experiments would help researchers develop powerful tests once they are ready to analyze field data.

45. See Korobkin, *supra* note 12, at 1227-28 & n.83 (citing Olshavsky, *supra* note 21, at 314; Onken et al., *supra* note 22).

46. See *id.* at 1236-39.

47. See *id.* at 1239-41.

48. See Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics' Equal Incompetence*, 91 GEO. L.J. 67, 139-60 (2002).

49. *Id.* at 140-42.

50. *Id.* at 142-47.

51. *Id.* at 147-56.

52. *Id.* at 156-60.

III. PRICE DISCRIMINATION THROUGH STANDARDIZED CONTRACTS

Price discrimination occurs when multiple units of the “same” good are sold at unequal prices either to the same customer or to multiple customers.⁵³ Although many discussions of price discrimination assume a significant degree of monopoly power on the part of the discriminator, price discrimination can exist in a zero-profit equilibrium in which total consumer welfare is improved relative to the nondiscriminatory case.⁵⁴ For example, in markets where suppliers must pay a fixed cost before they can sell a product, each seller’s price must contain a return on the initial investment.⁵⁵ If that return represents an economic profit, other firms will find it advantageous to enter the market, pushing the return down to the prevailing opportunity cost of funds. If firms can separate submarkets composed of low and high demanders, they can increase their up-front investment by recouping more of the investment from the high demanders and less from the low demanders. This price discrimination increases total output relative to the pooled equilibrium, increasing total welfare.

In the monopolistic case, price discrimination allows the producer to extract more surplus from its trades, and consumer welfare can be increased relative to the nondiscriminatory monopoly case because of the attendant output increase that results from the discrimination.⁵⁶ In the extreme case of first-degree price discrimination, the competitive output is produced as each consumer is charged his reservation price for each unit of the good.⁵⁷

Without making any assumptions about the underlying market structures in which we observe standardized contracts,⁵⁸ I conjecture that standardized contracts provide a mechanism by which firms can engage in second-degree price discrimination. Specifically, if a firm serves customers with varying time preferences, it can use its contracts to extract greater surplus from high-time-value individuals, who are unwilling to dicker over multiple contract terms, without losing low-time-value customers, who are willing to bargain in order

53. JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 133 (1988).

54. *Id.* at 139.

55. For an illustration of this in the pharmaceutical industry, see Jonathan Klick, *Drug Re-Importation’s No-Win Solution*, *REGULATION*, Spring 2002, at 6.

56. The dynamic efficiency of this outcome is questionable given that if the monopoly position is sustainable, firms will dissipate the expected rents in trying to secure the monopoly. See Gordon Tullock, *The Welfare Costs of Tariffs, Monopolies, and Theft*, 5 *W. ECON. J.* 224, 231 (1967).

57. TIROLE, *supra* note 53, at 136.

58. Indeed, it may well be the case that both zero-profit and monopoly-profit industries use standardized contracts to price discriminate.

to get the product at a lower real price. Effectively, bargaining is analogous to clipping coupons to get a better deal on a product.⁵⁹

For illustration purposes, I modify a model first proposed by Raymond Chiang and Chester Spatt.⁶⁰ In that model, consumers differ in terms of their reservation price and time values.⁶¹ In order to extract more surplus from the high-time-value types, the seller bundles his good with a “bad” (for example, time spent waiting), allowing individuals to trade off time for a lower price.⁶² The model is presented in general terms, so Chiang and Spatt do not specify how time is traded for a lower price in the mathematics; but they offer some examples in their text, such as selling a good for a lower price in outlets that are located farther away from the majority of the population, charging more in outlets that have shorter wait times, or allowing bargaining over price.⁶³ They also allow for generality concerning the number of consumer types, requiring only that the number be finite.⁶⁴

To apply the model to the form contract context, I impose a bit more structure on the model and I restrict attention to two types of consumers: high-time-value individuals and low-time-value individuals. Further, to simplify the discussion, I assume that there are only two customers: one of each type. Lastly, with respect to the customers, I assume that the high-time-value individual also has a high reservation price for the good, while the low-time-value person has a lower reservation price for the good.⁶⁵ Thus, customer 1 values time at H units (measured in terms of a numeraire good) per unit of time spent waiting (t) and has a reservation value for the good of v_H . Customer 2 values time at L units (again denominated in the numeraire) per t and has a reservation value of v_L . Ex ante the seller cannot distinguish between the two types, but he knows the underlying parameter values.

The seller of the good chooses the nominal price (p) and initially offers contract terms such that the real price of the good is $\beta(t=0)p = p$. That is, if there is no bargaining (and thus $t=0$), the consumer simply takes the offered (and presumably “abusive”) contract terms and pays an effective price of p . However, if the consumer

59. See Chakravarthi Narasimhan, *A Price Discrimination Theory of Coupons*, 3 *MARKETING SCI.* 128 (1984).

60. See Raymond Chiang & Chester S. Spatt, *Imperfect Price Discrimination and Welfare*, 49 *REV. ECON. STUD.* 155 (1982).

61. *Id.* at 157-67.

62. *Id.* at 155-57.

63. *Id.* at 155.

64. *Id.* at 157.

65. This restriction is imposed solely to expedite the discussion. As shown in the more general model presented by Chiang and Spatt, dropping these restrictions generates conclusions that carry the same intuition.

spends time bargaining, he can improve the contract terms such that $\beta(t > 0)p < p$. That is, his real price will be less than the nominal price because the governing contract terms will be more favorable to him if he spends time bargaining. Presumably there is some minimum real price that serves as the seller's reservation price, which will serve as the stopping point for the seller.

The seller's maximization problem will then be to develop a form contract and nominal sales price that generate the highest profit from the two customers. If we assume that the customers do not differ in their bargaining abilities,⁶⁶ the seller will develop a bargaining schedule $\beta(t)p$ that maximizes the following equation: $\beta(t_1)p + \beta(t_2)p - \varphi \cdot (t_1 + t_2) - 2 \cdot C$, where φ represents the seller's per unit time cost and C represents the constant cost of production. In the way I have set up the maximand, if the seller chooses not to price discriminate, he will simply choose the p that maximizes profit with zero time spent bargaining. Assuming an interior solution, this p will be equal to the low person's value if $2 \cdot v_L > v_H$, or it will be equal to the high person's value if $v_H > 2 \cdot v_L$. However, under a range of conditions, the seller might be able to improve his profit if he price discriminates.

To effectively price discriminate, the seller needs to impose four additional conditions on his maximization problem. First, he needs to include participation constraints for each buyer, such that each is better off purchasing the good than not purchasing the good. Thus:

$$\begin{aligned} v_H - \beta(t_1)p - Ht_1 &> 0 \\ v_L - \beta(t_2)p - Lt_2 &> 0 \end{aligned}$$

Also, to avoid the possibility that either customer will find it advantageous to select the contract that was meant for the other customer, the seller must impose self-selection or incentive-compatibility constraints such that:

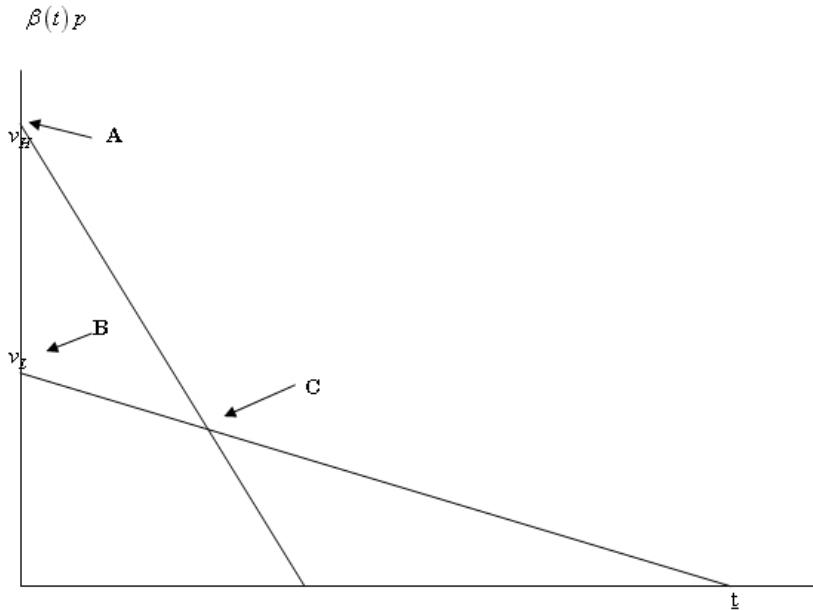
$$\begin{aligned} v_H - \beta(t_1)p - Ht_1 &> v_H - \beta(t_2)p - Ht_2 \\ v_L - \beta(t_2)p - Lt_2 &> v_L - \beta(t_1)p - Lt_1 \end{aligned}$$

Given the assumptions about the relevant parameters, only the low-value customer's participation constraint and the high-value customer's self-selection constraint will bind. That is, there is no rele-

66. Bargaining ability presumably includes the speed of reading the contract and comprehension of the terms (that is, the ability to price the terms). This assumption could be relaxed in a more general model, but the underlying intuition would not change.

vant set of contracts and prices that would entice the low-value person to purchase the good without also enticing the high-value person to purchase the good (given that the seller also values time). Further, there is no concern that the low-value person will attempt to pose as the high-value person.

Assuming that a separating equilibrium exists, the seller's strategy can be represented by the following graph:



In the graph, A and C represent the two contracts that will be offered in the separating equilibrium. The high-value customer will pay the nominal price, will not bargain over any of the contract terms, and will reach the A contract terms, while the low-value customer will invest time bargaining to reach the C contract terms. Effectively, the seller exploits the consumers' differences in time values to induce them to reveal their value type, earning greater profits than he would make if he chose either of the pooling contracts individually (A, where he sells just to the high-value person, or B, where he sells to both people at a lower effective price).

Whether this price discrimination scheme is stable depends on the underlying market. If some fixed cost is required to operate in this market, this strategy could be sustainable and even the second most efficient, as there may be no economic rents accruing to the seller in the long term. Short-term revenues would simply serve as the normal return for the up-front investment. If revenues yielded an economic profit, other firms would undertake the fixed cost to enter the market, but there is no reason why a separating equilibrium would not be sustainable. Obviously, if there are stronger barriers to entry,

the firm could sustain the separating equilibrium and earn economic profits.

While this price discrimination argument is consistent with standardized contract terms that do not favor consumers, it is not necessarily superior to Korobkin's explanation (or other explanations yet to be identified). As discussed in the section on his behavioral bias explanation, it is necessary to identify what this model predicts about cross-sectional variation.

Two components of the model are very helpful in terms of comparing its predictive power relative to Korobkin's. First, while Korobkin's model implies that abusive standardized terms should be more likely to appear when consumers are more homogenous,⁶⁷ the price discrimination model suggests that abusive terms are more likely when consumer heterogeneity is greater. That is, a separating equilibrium is more likely to be optimal when there is relatively high variance in consumer preferences. In Korobkin's illustrations, it is clear that homogeneity in preferences will imply that relatively more product attributes are non-salient.⁶⁸ Thus, in empirical research, the two hypotheses have directly opposite predictions about the correlation between consumer heterogeneity and the incidence of abusive standardized terms.⁶⁹

The second component of the price discrimination model that could be exploited is the requirement that there are no arbitrage opportunities. That is, if resale of the product is relatively easy, low-time-value consumers could acquire the product at the lower effective price and then resell it to the high-value consumers. Such arbitrage opportunities will make the price discrimination equilibrium unstable, and the seller will default to one of the pooling equilibriums. This component is useful because there is no obvious connection between ease of resale and Korobkin's behavioral bias explanation. While the behavioral explanation implies no correlation between arbitrage opportunities and abusive standardized terms, the price dis-

67. Korobkin, *supra* note 12, at 1235-39.

68. *See id.*

69. Some of Korobkin's comments delivered in this Symposium, where this Article was first presented, suggest a useful testable implication of the price discrimination model. Specifically, Korobkin mentioned that we might expect more niche marketing in a price discrimination context. My interpretation of this comment is that it would be possible to exploit systematic differences between high- and low-time-value individuals to proxy for discount rates in examining the relationship between the incidence of form contracts and time values. For example, if we make the plausible assumption that only low-time-value individuals will be willing to shop at specialty stores (because specialty stores entail more search costs and do not allow for economies of scale in shopping) while both types will be willing to shop at "one-stop" shopping outlets, we might expect a higher incidence of "abusive" form contract terms at the latter outlets relative to the former if the price discrimination model is predictive.

crimination model suggests that there should be fewer abusive standardized terms in markets where resale is easy.⁷⁰

IV. CONCLUSION

While I am not aware of any comprehensive dataset, aggregated at either the firm or the industry level, empirical testing is clearly important before we advance policy prescriptions regarding the treatment of standardized terms in the courts. While we might wish to protect consumers from their cognitive biases (though we should worry about the attendant moral hazard), it is not obvious that we should be troubled by a seller's ability to induce consumers to self-select the deal that they want on the basis of their time preferences. Indeed, this kind of price discrimination takes place in many forms without prompting condemnation. If standard form contracts serve the same purpose as coupons,⁷¹ it probably does not make sense to discourage them through the courts.

As a broader matter, we need to be more hesitant in using insights from psychology to rationalize unexpected empirical observations *ex post*. In gaining from interdisciplinary trade with the field of psychology, law and economics scholars must be careful to retain the virtues that have made economics the imperial science. Careful *ex ante* specification generates testable hypotheses about cross-sectional and time-series variation and allows us to construct powerful statistical tests. Failure to confirm a particular hypothesis does not immediately suggest that a different hypothesis is correct even if experimental evidence suggests that it is consistent with what we observe. Instead, we should allow experimental evidence to suggest alternate hypotheses and to inform our modeling assumptions, but specifying a model is still important if we hope to develop powerful tests. These are all necessary conditions for generating robust and effective policy prescriptions.

70. To illustrate, the price discrimination model would be consistent with the casual observation that rental services (for example, car rentals, hotels, and the like) appear to exhibit a relatively high incidence of potentially abusive standardized terms, given that resale of rental services is fairly difficult. For that matter, we might expect that services, in general, are more likely to come bundled with abusive terms than are goods, since resale is easier with goods.

71. See *supra* note 59 and accompanying text (analogizing bargaining to clipping coupons).

