Spring 1990

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Recommended Citation

The Efficient Consumer Form Contract: Law and Economics Meet the Real World, 24 Ga. L. Rev. 583 (1990)

THE EFFICIENT CONSUMER FORM CONTRACT: LAW AND ECONOMICS MEETS THE REAL WORLD

*Michael I. Meyerson**

"Law and economics" has been hailed by its supporters as the only intellectually valid means for analyzing legal issues.[1] Its critics have dismissed law and economics as amoral and biased against the poor.[2] Ironically, each side in this frequently acrimonious debate has much to offer those in the opposing camp. This Article reflects a modest attempt to bridge the chasm.

One need not believe that money is everything in order to believe that the effect a given legal rule has on total societal wealth is relevant in decisionmaking. But this admission does not consign one to a legal world where the wealthy win as a matter of right and legal rulings are sold to the highest bidder. It may be surprising to the detractors of law and economics, but the proper application of principles of economic analysis need not lead to anti-poor results. If all relevant factors are considered, the concerns of fairness and of efficiency may coincide more often than partisans of either side in this debate have cared to admit.[3]

Analysis based on efficiency tends to produce results of fairness when economic principles are properly applied to certain legal situations, such as interpretation of consumer form contracts. The economic analysis of a complex problem begins with the selection of simplifying assumptions.[4] A simplified model is considerably easier

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[1] *See, e.g.*, R. POSNER, ECONOMIC ANALYSIS OF LAW 3 (2d ed. 1977).

[2] *See, e.g.*, Leff, ECONOMIC ANALYSIS OF LAW: *Some Realism About Nominalism* (Book Review), 60 VA. L. REV. 451 (1974).

[3] As a guide to the uninitiated, a discussion of the meaning and validity of "efficiency" is contained in the Appendix to this Article. *See infra* text accompanying notes 208-32.

[4] *See, e.g.*, A. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 3-4 (1983) (noting that

to understand and to control, and it tends to yield more useful hypotheses.[5] That certain common assumptions, such as "perfect information" or "perfect competition," are patently untrue and unrealistic is unimportant in this analysis. In part, this is because a simple model will prove to be sufficient for many situations, especially when the hypotheses developed from it square with empirical research.[6]

More importantly, once the basic principles have been established, real world complexities can be added where needed to adjust the model to address a wider variety of situations.[7] The classic analogy is to Galileo's theory on the behavior of falling bodies:[8] Even though the theory is only correct for objects falling in a vacuum, it has helped our basic understanding of gravity. Moreover, by adjusting the theory for factors such as air pressure, scientists are able to predict accurately the differences between falling apples and falling feathers.

One of the arts of the economist, therefore, is to create the simplified model and then to select which complicating factors to add. While many have criticized the reliance on simplified models,[9] the true problem lies not with economic analysis but with the analyst.[10] Significant relevant factors must be included or the model may lead to grossly inaccurate predictions.[11] Put another way, not-

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economists solve complex sets of problems by isolating one or two problems and making simplifying assumptions that eliminate the others).

[5] Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 301 (1979) [hereinafter Posner, *Uses and Abuses*].

[6] A. POLINSKY, *supra* note 4, at 4.

[7] *See id.* at 3-4 (stating that, by adding enough "special cases," one can get the full picture); Posner, *Uses and Abuses*, *supra* note 5, at 303-04 (stating that more complex models can be created to correct false assumptions).

[8] Posner, *Uses and Abuses*, *supra* note 5, at 301-04. In an earlier work, Posner referred to "Newton's law of falling bodies," R. POSNER, *supra* note 1, at 13, but the analogy remains the same.

[9] *E.g.*, Kornhauser, *A Guide to the Perplexed Claims of Efficiency in the Law*, 8 HOFSTRA L. REV. 591, 625 (1980) (terming assumptions used in economic analysis of law "counterfactual"); Rizzo, *The Mirage of Efficiency*, 8 HOFSTRA L. REV. 641, 647 (1980) (stating that what appears efficient under streamlined model, may not be when other, real-world factors are included).

[10] A. POLINSKY, *supra* note 4, at 126 (describing how faulty application of economic principles generates many of examples used in criticism of economic analysis as theory).

[11] *Cf.* Rizzo, *supra* note 9, at 658 (stating that while it is easy to show that efficiency leads to desirable results in a simplified model, it is necessary to show the results hold for the real world as well).

withstanding the brilliance of Galileo's falling bodies theory, it cannot help you to catch a falling leaf unless you accurately include the special physical characteristics of the leaf in your model.

This Article will attempt to describe the special characteristics of the consumer form contract so that a proper economic model can be created. Part I of the Article describes the classic simplified model used to evaluate contract law. This section describes the basic assumptions economists use when analyzing contracts and demonstrates how, under this analysis, reliance on individual sovereignty leads to economic efficiency.

Part II paints an economic portrait of consumer form contracts. This section establishes that the most important special characteristic of these contracts is that one party, the consumer, typically lacks accurate information concerning the terms of the contract and finds it inefficient to acquire the correct information. This imperfect consumer information causes a tendency toward inefficiency in transactions involving consumer form contracts.

Part III of this Article creates a paradigm for interpreting consumer form contracts that encourages economically efficient transactions. The goal is to induce the party with the lower information costs, the seller, to disclose inefficient contract terms to the consumer. Accordingly, consumer form contracts should be construed as consisting of three types of terms: those explicitly agreed to by both parties; those the seller led the consumer to believe would be in the contract; and "default" terms—presumptively efficient terms that the parties would likely have chosen had the consumer been fully informed. Of course, both parties are free to select any terms they wish, as long as there has been actual, knowing assent on both sides.

I. THE ECONOMIC ANALYSIS OF CONTRACTS

A. *Fundamental Economic Assumptions of Contract Law*

1. The Paradigm of the Efficient Contract. For the study of contract law in general, one of the most important economic assumptions is the assumption of "utility maximization." Individuals are presumed to act to maximize their total benefits minus costs.[12]

[12] A. POLINSKY, *supra* note 4, at 10. Similarly, it is presumed that business firms attempt to maximize profits. *Id.*; *see also* Posner, *The Ethical and Political Basis of the Efficiency*

Thus, if voluntary exchange is permitted, resources will gravitate toward their most valuable use.[13] For example, if *A* owns a tractor worth $100 to her but worth $150 to *B*, they will both be better off if *B* purchases the tractor for any sum between $100 and $150. Presumably, in a free market, the sale will take place. Moreover, societal wealth will also be increased by the sale, since both parties' individual wealth has increased.[14]

In a free market, exchanges among knowledgeable rational people are expected to result in Pareto superior results, meaning that, after the transaction, at least one person is better off and no one is worse off.[15] Because it is not rational to accept a deal that is not perceived to be in one's self-interest, what each party relinquishes in a bargain will be seen by that party as less valuable than what is received.[16] Voluntary negotiations, therefore, are presumed to achieve Pareto superior results because of the assumption of utility maximization; in other words, voluntary negotiations tend to produce efficient results.

One corollary of this principle is that government involvement in

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Norm in Common Law Adjudication, 8 HOFSTRA L. REV. 487, 497 (1980) [hereinafter Posner, *Common Law Adjudication*] (stating that free market "maximizes autonomous, utility-seeking behavior").

[13] A. KRONMAN & R. POSNER, THE ECONOMICS OF CONTRACT LAW 1-2 (1979); R. POSNER, *supra* note 1, at 9-10. Put in slightly different terms, freedom of contract serves the utilitarian function of maximizing the welfare of the contracting parties, and thus society as a whole. Epstein, *Unconscionability: A Critical Reappraisal*, 18 J.L. & ECON. 293, 293 (1975).

[14] *See, e.g.*, Seita, *Uncertainty and Contract Law*, 46 U. PITT. L. REV. 75, 86 (1984). In mathematical terms, and assuming a sale price of $135, societal wealth could be computed as follows:

A_0 = *A*'s wealth before the sale
B_0 = *B*'s wealth before the sale
W_0 = Societal wealth before the sale
A_1 = *A*'s wealth after the sale
B_1 = *B*'s wealth after the sale
W_1 = Societal wealth after the sale
$A_0 + B_0 = W_0$; $100 + 135 = 235 = W_0$
$A_1 + B_1 = W_1$; $135 + 150 = 285 = W_1$.

[15] Coleman, *Efficiency, Utility and Wealth Maximization*, 8 HOFSTRA L. REV. 509, 516 (1980). For a fuller discussion of "Pareto superiority," see *infra* text accompanying notes 211-12.

[16] *See* R. POSNER, *supra* note 1, at 3 (stating that each person is presumed to be "rational maximizer of his . . . self-interest"). This principle has also been termed the presumption of "consumer sovereignty." A. POLINSKY, *supra* note 4, at 10. As one early court decision stated, "The judgment of the purchaser is the best arbiter of whether the thing is of any value, and how great, to him." Hardesty v. Smith, 3 Ind. 39, 41 (1851).

the marketplace is a second-best solution.[17] Because any government intervention imposes costs and risks inefficiencies, such intervention should occur only when the benefits of regulation exceed the costs.[18]

There is, however, universal recognition that the law should supply generalized contract terms so that contracting parties need not specify them.[19] Another fundamental principle of the economic analysis of contract law is that a fully specified contract will be efficient.[20] No contract, however, can be fully specified. There are simply too many conditions and contingencies regarding even the simplest transaction.[21] So-called "default terms" or "gap fillers" reduce the complexity and cost of contract negotiation and help resolve disputes arising out of issues on which a given contract is silent.[22] To be consistent with the principle that efficient contracts arise from voluntary negotiations, default rules must approximate what the parties would have agreed to had they negotiated the issue.[23] The rules would then tend to be efficient since both parties,

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[17] *See* Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 U. PA. L. REV. 630, 679 (1979) (labeling court's remedy second-best because judicial power cannot encourage markets to move toward competitive equilibrium but can only strike offensive terms or price).

[18] *See, e.g.*, Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 18 (1960) (implying that government intervention should not be viewed as best way to reduce market costs because it will not always increase efficiency); Craswell, *Interpreting Deceptive Advertising*, 65 B.U.L. REV. 658, 726 (1985) (stating intervention should occur if it produces lower administrative costs without substantially increasing injury to the consumer); Darby & Karni, *Free Competition and the Optimal Amount of Fraud*, 16 J.L. & ECON. 67, 83 (1973) (emphasizing that government intervention can improve resource allocation when benefits of improved monitoring exceed costs).

[19] *See generally* J. BENTHAM, *A General View of a Complete Code of Laws*, in 3 THE WORKS OF JEREMY BENTHAM 155, 191 (J. Bowring ed. 1843) (stating that every country has laws supplying omitted contract terms).

[20] A. POLINSKY, *supra* note 4, at 29; *see also* R. POSNER, *supra* note 1, at 11.

[21] *See, e.g.*, G. TULLOCK, THE LOGIC OF LAW 47 (1971) (stating that to put all conditions into contract involving bills and notes would exceed one hundred pages); A. POLINSKY, *supra* note 4, at 29 (stating that cost of negotiations leads parties to ignore relatively unimportant contingencies).

[22] A. KRONMAN & R. POSNER, *supra* note 13, at 4; A. POLINSKY, *supra* note 4, at 25 (characterizing contract law as method for filling in missing terms parties find too costly to negotiate themselves); Posner & Rosenfield, *Impossibility and Related Doctrines in Contract Law: An Economic Analysis*, 6 J. LEGAL STUD. 83, 88 (1977) (stating that all contracts incorporate such legal rules).

[23] A. POLINSKY, *supra* note 4, at 25 & n.16 (presuming that parties would have bargained cooperatively); Posner & Rosenfield, *supra* note 22, at 88 (identifying one purpose of contract law as supplying terms parties probably would have adopted explicitly through

presumably, would have negotiated efficient terms.[24] Presumably, any inefficient default rule would be negated through negotiation.[25]

The paradigm of the efficient contract, thus, is a contract that contains two types of terms. The first type is the product of a voluntary bargain, which the parties believe to be in their individual self-interest. The second type is governmentally created to reflect a hypothesized negotiated bargaining process and is supplied by contract law when the parties either do not decide on a particular issue or affirmatively choose to use the default rules.

2. Nonenforcement of Negotiated Contracts. Not all negotiated contracts, however, are actually efficient. Because the paradigm rests on the assumption that the parties are knowledgeable and rational, problems arise, for example, with contracts entered into by minors or persons who are mentally incompetent.[26] The economic justification for nonenforcement of these contracts is that these parties are "incapable of judging their self-interest," and "[i]f someone cannot judge what is in his self-interest, there is no presumption that the contracts he makes increase value."[27]

The protection for minors is premised on the assumption that

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negotiation).

[24] Because a more efficient exchange leads to a larger potential profit, the parties would presumably negotiate efficient terms. Posner & Rosenfield, *supra* note 22, at 89. This presumption, however, may not hold in all cases. Assume *A* is a knowledgeable seller fully aware of a particular risk and *B* is an ignorant buyer. If the risk would more efficiently be allocated to *A*, an allocation to *B* would result in an inefficient contract. Since *A* is the only party to know of the risk, *A* could place the risk on *B* at no cost to *A*. *A* might thus be able to receive 100% of the benefit from a small, inefficient pie, but only, say, 50% of a larger, efficient pie. If the size of the increase does not make up for the loss *A* suffers by sharing, the larger pie will not result in larger profits for *A*. Hence, *A* may well prefer the inefficient solution.

[25] A. KRONMAN & R. POSNER, *supra* note 13, at 6; Schwartz, *Proposals for Products Liability Reform: A Theoretical Synthesis*, 97 YALE L.J. 353, 358 (1988). This principle follows from the Coase theorem: given perfect information and zero transaction costs, parties will achieve efficient results despite an inefficient rule of law, by one party paying the other a sum less than the cost of the inefficiency. Coase, *supra* note 18, at 8.

[26] *Cf.* RESTATEMENT (SECOND) OF CONTRACTS §§ 14-15 (1979). Contracts entered into by minors are dealt with by § 14 (minors "have the capacity to incur only voidable contractual duties"). Section 15, addressing the problems inherent in contracting with mentally incompetent persons, reveals the policy behind allowing their contracts to be voidable: "A person incurs only voidable contractual duties . . . if by reason of mental illness or defect . . . he is unable to understand in a reasonable manner the nature and consequence of the transaction . . . ." Note that concerns of fairness and proper application of economic principles lead to the same result.

[27] R. POSNER, *supra* note 1, at 80.

the young will be less likely to understand the consequences of a transaction, the nature of their true self-interest, and the extent to which a particular transaction will serve that self-interest, even if properly identified.[28] Of course, not all sane adults are capable of judging their self-interest either, and many minors do possess such ability. Nonetheless, in the interest of administrative convenience, age has been treated as a convenient criterion for determining those most likely to be unable to protect their self-interest in negotiations.[29]

Other contracts that may not be enforced are those induced by deliberate dishonesty.[30] A party misled as to the utility to be derived from a proposed transaction cannot properly evaluate the true benefits and costs of the deal.[31] The presumption that the agreement will lead to a value-increasing exchange, therefore, is rebutted.[32]

Economic theory thus creates a model whereby efficiency is promoted by the general enforcement of contracts. Individual and societal wealth are presumed maximized through the voluntary transactions of rational people, each pursuing his or her own self-interest. In situations where people are incapable of judging whether a particular transaction will advance their self-interest, wealth maximization cannot be presumed and the contract will be voidable.

B. The Paradigm of the Efficient Contract Term

Under fundamental economic theory, contracting parties can decide not only the value of a given good or service, but the value of

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[28] A. KRONMAN & R. POSNER, *supra* note 13, at 255. *But see* Epstein, *supra* note 13, at 301 (stating that nonenforcement increases price or prevents contracting altogether by competent children).

[29] A. KRONMAN & R. POSNER, *supra* note 13, at 255; *see also* Epstein, *supra* note 13, at 300 (stating that "it is quite likely that most, though not all, infants will be unable to protect their own interests in negotiation, even in transactions not vitiated by fraud").

[30] *See* Epstein, *supra* note 13, at 298 (identifying fraudulent misrepresentation as common-law defense to a contract suit).

[31] *See generally* Kronman, *Mistake Disclosure, Information and the Law of Contracts*, 7 J. LEGAL STUD. 1 (1978) (discussing in part effects of mistaken beliefs concerning a good or service).

[32] R. POSNER, *supra* note 1, at 80. Because the cost of uncovering misrepresentation is a "deadweight social loss," nonenforcement of this type of contract serves a salutary purpose by discouraging such conduct. *Id.* at 79, 82.

individual contract clauses.[33] Returning to the example of the consumer purchasing the tractor, let us assume contract negotiations occur between two parties with perfect knowledge of both the physical characteristics of the tractor and the significance of the legal terms used in the contract.[34] Assume, additionally, that there is a competitive market in long-run equilibrium, so that the total price equals the seller's cost.[35] This competitive price is the only efficient price, because only those who value the good more than it costs the seller will make the purchase.[36] There is no need for government regulation of the truly competitive market, because the market will generate the price that is utility-maximizing for consumers.[37]

This model works for contract terms other than price as well. Once again, let *A* own a tractor worth $100 to her but worth $150 to *B*. *A* proposes a sale price of $135, payable at $45 a year for four years.[38] The contract *A* offers contains one extra provision, an "add-on" clause, that permits the seller to repossess not only the tractor but all items previously sold by the seller to the buyer if a single payment is missed.[39]

In order for *B* to decide whether the sale would increase his net wealth, he will have to evaluate the "price" to him of this contract provision. Because of his perfect knowledge, he is able to understand, at no additional cost, the legal significance of the clause; *B*

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[33] *See, e.g.*, Schwartz, *supra* note 25, at 373 (noting that in some consumer contract situations, consumers will shop around for contract clauses that reflect their preferences).

[34] *See, e.g.*, Kornhauser, *supra* note 9, at 636 n.105 (stating that "reasonable person" envisioned in contract law must have knowledge of the law).

[35] A. POLINSKY, *supra* note 4, at 85-87. Generally, a competitive market means that there are many firms offering the same commodity, so that no one seller has control over price. If a market is in long-run equilibrium (that is, all firms who wish to be in the market are in, and all who wish to be out are gone), price equals cost. When price exceeds cost, the excess profits will draw in new sellers, and when price is less than cost, some sellers will leave the market. When "cost" is used in this context, it includes return on investment as well as the cost of production. Similarly, "price" includes the present value of the sale price plus the expected present value of money paid due to contract clauses. *Id.*

[36] *Id.* at 87.

[37] Schwartz & Wilde, *supra* note 17, at 668.

[38] For simplicity's sake, we can ignore both the interest cost and the time value of money in considering the value of the sale price.

[39] For one court's treatment of such an add-on clause, see Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965) (holding sales contract with add-on clause unconscionable and, therefore, unenforceable); *see also infra* text accompanying notes 157-59.

may then ascertain its present value.[40] The higher the cost of the provision to *B*, the lower the price *B* will be willing to pay towards the purchase.[41]

Most contract provisions serve to allocate risks between the contracting parties.[42] To an economist, "risk" is a known probability that an unfavorable outcome will occur.[43] The cost of any contract provision to *B* is essentially the value of a particular risk being placed on *A*, or the cost to *B* of having to bear that risk himself. This cost can be evaluated as the probability of the loss occurring multiplied by the magnitude of the loss that would be suffered if the risk materializes.[44] Both of these factors must be known in order for a contracting party to make a rational decision. Because we have assumed that *A* and *B* possess perfect knowledge, we can assume that they know both of these factors as well as the way that the contract clause will shift the risk.

The cost of the add-on clause to *B* is, therefore, the probability that the risk represented by the clause will be realized, multiplied by the loss *B* will suffer in that event. The risk represented by this clause can be defined as the probability that both of the following will occur: (1) that *B* will miss a payment, and (2) that *A* will repossess all previously purchased items. The loss that *B* may suffer because of the add-on clause is the difference between (1) the amount of loss suffered by the repossession of all previously purchased items, including loss of use and cost of replacement, and (2) the amount of loss that would be suffered from repossession of only the tractor, plus costs associated with a court action for the difference between the amount of outstanding debt and the present value of the tractor.[45]

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[40] *See, e.g.*, Darby & Karni, *supra* note 18, at 81 (stating that consumer considering purchasing durable good, "essentially compares the discounted value of the expected future service stream with the discounted value of the price and repair costs").

[41] *Id.*

[42] Posner & Rosenfield, *supra* note 22, at 88 (stating that fundamental purpose of contracts is allocation of those risks created by noninstantaneous transactions).

[43] Seita, *supra* note 14, at 81. While "risk" is measurable, "uncertainty" is an unknown probability of loss, and is unmeasurable and uninsurable. *Id.* A similar distinction can be drawn between "predictive error" and a "genuine mistake." The former occurs because it is not cost justified to increase knowledge in order to avoid the error. A mistake, on the other hand, occurs even though the uncertainty is curable at a reasonable cost. Kronman, *supra* note 31, at 2 n.1 (1978).

[44] Seita, *supra* note 14, at 82.

[45] Mathematically, the cost of the add-on clause can be represented as follows. $C = R \times L$

The add-on clause can also be viewed as a provision of value to *A*. The clause may compensate for the loss in value of the last-purchased item by increasing the collateral available to the seller.[46] Thus, the cost to *A* of providing financing will be decreased; this savings may also be passed on to the buyer.[47]

Returning to the proposed tractor sale, because *B* values the tractor at $150 and the proposed sale price is $135, if the cost to *B* of the add-on clause is less than $15, the exchange will increase his total utility and he will sign the contract. If the cost exceeds $15, however, he would be paying more than the tractor is worth to him

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where C is the cost to B of the clause; R is the risk involved; and L is the loss that will be suffered by B if the risk occurs. $R = P_1 \times P_2$, where P_1 represents the probability that B will miss a payment and P_2 is the probability that A will repossess all previously purchased items. Let L_1 be the loss suffered from a repossession of all previously purchased items, including loss of use and cost of replacement. Then let L_2 represent the loss to B from repossession of only the tractor and L_3 equal the court costs and damages award associated with a legal action to recover the difference between the value of the tractor and the outstanding debt. The value of L_3 must be discounted by the probability that legal action will be brought and by the probability of the seller's success (which may be reduced, for example, if the tractor is defective and the buyer has a valid counterclaim). Thus, $L = L_1 - (L_2 + L_3)$.

[46] *See* R. POSNER, *supra* note 1, at 86-87. Posner notes that if the seller did not include any term allowing add-on repossession in the contract, a default occurring early in the term of the contract would probably confer a loss on the seller as the payments he would have received would most likely not cover the depreciation of the single item. *Id.* If the seller is required by law to return to the buyer all gain from repossession that exceeds the value of the money owed, plus interests and costs, the seller would not be gaining a windfall, but would merely be collecting that to which he is entitled. Epstein, *supra* note 13, at 307-08.

[47] R. POSNER, *supra* note 1, at 87 (explaining that, without add-on clause, seller would be forced to either increase size of the downpayment required or increase amount of payments due early in repayment schedule).

The actual value of the add-on clause will also be affected by whether the parties are "risk-neutral," "risk-averse" or "risk-seeking." Parties are risk-neutral if they only care about the "expected value" of a future occurrence, that is, the magnitude of potential loss or gain multiplied by its probability. A. POLINSKY, *supra* note 4, at 27. Risk-aversion, represented by the purchase of insurance, occurs when a party accepts a lower expected value in exchange for a decreased probability of risk. *See* Posner & Rosenfield, *supra* note 22, at 91 (identifying as risk-averse, people who would willingly pay substantial sum to avoid uncertainty of risk). Risk-seeking, as exemplified by the purchase of a lottery ticket, occurs when a party enters into a contract because of a desire for the potential gain, even though the expected value of that gain is less than the purchase price because of its small probability. *See* A. KRONMAN & R. POSNER, *supra* note 13, at 36.

A party who is risk-averse will pay more to avoid a risk than a risk-neutral or risk-seeking party. Posner & Rosenfield, *supra* note 22, at 91. Thus, the value to *B* of a contract without an add-on clause will be higher if *B* is risk-averse to the possibility of missing a payment on the tractor. Since the essential calculations are unaffected by these individual preferences, it is simpler to assume the parties are risk-neutral.

and, therefore, *B* will forego the deal.[48] If *B* is choosing between *A* and a second seller, *C*, and *C* offers a sale price of $140 without an add-on clause, a similar calculation is necessary. If the cost of the clause is less than $5 (the difference between *A*'s and *C*'s sale prices), *B* will sign the contract with *A*; if it exceeds $5, B will buy from *C*.[49]

Therefore, in an efficient market with perfectly informed parties, an add-on clause may well be good for the purchaser. Because it decreases the seller's costs, it may result in lower prices. Consumers could then determine whether their savings exceeded the cost of the clause; if so, they would accept it willingly.[50]

In such a world, prohibiting the add-on clause would harm consumers by raising prices and by depriving consumers of the right to elect to pay a lower price for a less favorable contract.[51] Such a prohibition would also impair efficiency by forcing the use of a more inefficient credit arrangement and by preventing the parties from negotiating the optimal deal for each.[52]

In theory, voluntary negotiations between knowledgeable and rational consumers tend to produce efficient contracts. Economic theory holds that general enforcement of these efficient contracts leads to wealth maximization for society and for individual parties. But this theory produces optimal results only when its simplifying assumptions approximate a given situation. When the special characteristics of a given situation are not replicated by the model, inefficiency and unfairness result.

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[48] For contract terms in general, an informed buyer will agree to a purchase if $V > P + T$, where V is the value to the buyer of the item to be purchased, P is the sale price and T is the aggregate cost of contract terms to the buyer.

[49] In a perfectly competitive market, the cost of the clause will be exactly the difference between *A*'s and *C*'s sale price, and the purchasing decision will depend on whether *B* is risk-averse to the possibility of default.

[50] A prospective purchaser would discount the savings resulting from the presence of the add-on clause by his individual risk aversion. *See* Posner & Rosenfield, *supra* note 22, at 91. *See also supra* note 47.

[51] *See, e.g.*, Schwartz & Wilde, *supra* note 17, at 667.

[52] *See, e.g.*, Epstein, *supra* note 13, at 309. Epstein believes that, because the sale of the loan with a waiver-of-defense clause to a third party is efficient, raising the cost of such sale to third parties will force sellers to less efficient forms of purchase arrangements, such as cash sales. *Id. See generally* R. POSNER, *supra* note 1, at 87.

II. An Economic Portrait of Consumer Form Contracts

Although fundamental economic principles lead to a conclusion that contracts that are entered into voluntarily will tend to be efficient, the assumptions underlying those principles must be reexamined for consumer form contracts. Creation of these contracts differs dramatically from the classic paradigm. Significant factors, the most important being the lack of consumer knowledge as to many contract terms, must be added to the basic model so that an accurate economic analysis may be performed.

A. *Definition of the Consumer Form Contract*

The standard form contract is the most common type of contract entered into by consumers.[53] Generally, these contracts are offered on a "take-it-or-leave-it" basis, with the purchaser presenting the consumer with a preprinted form detailing the obligations of both parties.[54] Form contracts can benefit both consumers and sellers by reducing the cost of negotiation and by limiting the time each party has to spend on bargaining.[55] One complaint frequently raised about standard form contracts, however, is that, because these contracts are not subject to negotiation, consumers generally will be worse off because of their use.[56] The term "contract of adhesion"[57] is often used to describe these agreements as consumers are forced to "adhere" to the terms as drafted by the seller. Commentators have argued that the resulting contracts are likely to contain unreasonable terms because consumers do not "dicker" over most of these terms,[58] and "have no reasonable choice but to

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[53] *See* Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 Harv. L. Rev. 529, 529 (1971) (estimating that 99% of all consumer contracts are standard form contracts).

[54] *See, e.g.*, R. Posner, *supra* note 1, at 84-85.

[55] *See id.* at 85; Posner & Rosenfield, *supra* note 22, at 88; Seita, *supra* note 14, at 136.

[56] *See, e.g.*, Kessler, *Contracts of Adhesion—Some Thoughts About Freedom to Contract*, 43 Colum. L. Rev. 629, 637 (1943).

[57] The term "adhesion contract" is taken from a French author, Raymond Saleilles, who used it to describe certain contracts "in which a single will is exclusively predominant, acting as a unilateral will which dictates its law, no longer to an individual, but to an indeterminate collectivity." R. Saleilles, De La Declaration de Volonte, sec. 89, at 229-30 (1901), *translated in* Patterson, *The Interpretation and Construction of Contracts*, 64 Colum. L. Rev. 833, 856 (1964).

[58] K. Llewellyn, The Common Law Tradition 370 (1960).

make the contract."[59]

The lack of ability to negotiate, however, does not make the form contract per se unfair or inefficient. When a person purchases a newspaper at a newsstand, there is no negotiation with the dealer over the price to be charged. The paper is offered on a "take-it-or-leave-it" basis. Similarly, a shopper filling his basket with groceries at the supermarket is not usually given the opportunity to negotiate over the ripeness of a melon or the length of time a gallon of milk will keep. Nonetheless, consumers are well able to determine the subjective value of such purchases and can find a different seller, or forego a particular purchase altogether, if the deal is not perceived to be in their best interest.[60] Accordingly, the presumption that resources will move towards their most valued use remains sound, even in these nonnegotiated transactions.

The characteristic of form contracts that raises the greatest concern for efficiency is not, therefore, that they are offered on a take-it-or-leave-it basis. Rather, inefficient transactions occur because consumers do not read form contracts, or do not understand the terms, and are thus unaware of their contents.[61] Moreover, the businesses that draft these contracts do so knowing that they will not be read by the typical consumer.[62]

Of course, consumers are usually aware of certain contract terms. They generally understand the central terms, such as price, but do not know of or do not understand many subordinate terms.[63] Certainly, the typical borrower knows who the creditor is, how much is being borrowed, the amount and duration of monthly payments and, perhaps, such items as what is serving as collateral.[64] Typical

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[59] Slawson, *supra* note 53, at 549-50; *see also* Kessler, *supra* note 56, at 632 (arguing that consumers are not generally able to shop around because either contract drafter has monopoly or all competitors use same clauses). *But see* Schwartz, *supra* note 25, at 373 (suggesting that in certain situations consumers may be able to shop around for clauses).

[60] *See, e.g.*, R. POSNER, *supra* note 1, at 85.

[61] *See, e.g.*, Murray, *The Standardizing Agreement Phenomena in the* RESTATEMENT (SECOND) OF CONTRACTS, 67 CORNELL L. REV. 735, 750-51 (1982) (assuming that even businesspeople may not read printed forms they exchange); Seita, *supra* note 14, at 133.

[62] Seita, *supra* note 14, at 133.

[63] The distinction between "central" and "subordinate" terms is taken from Priest, *A Theory of the Consumer Product Warranty*, 90 YALE L.J. 1297, 1304-06 (1981). This is similar to Llewellyn's distinction between the "few dickered terms" and the remainder of the form contract's "boiler-plate clauses." K. LLEWELLYN, *supra* note 58, at 370.

[64] This is likely true in the case of a homeowner seeking a second mortgage. *But cf.* Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965) (uneducated consumer

borrowers, however, do not know the range of collection remedies available to the creditor, the myriad events that could trigger foreclosure, or that they must pay the creditor's legal fees for collection procedures, but cannot recover their own fees even if they are successful in litigation.[65]

B. The Inevitability of Imperfect Consumer Knowledge

1. Effects of High Information and Transaction Costs. The simplified classical economic model of contracts does not reflect the real world of consumers and the "special case"[66] of standard form contracts. The most important complexity that must be added to the simple classical model is the inevitable consumer ignorance of subordinate contract provisions. While information can never be perfect,[67] it is particularly inappropriate to make an assumption of perfect consumer knowledge.[68] Even though consumers may know many of the characteristics of frequently purchased products,[69] they will remain ignorant of the characteristics of contract terms which typical experience does not reveal.

Economists have divided product attributes into three categories: (1) search qualities, such as the color of a car, that can be discovered before purchase; (2) experience qualities, such as the taste of tuna fish in a can, that are discoverable only after purchase; and (3) credence qualities, such as the quality of legal services rendered, that are difficult to evaluate even after normal use.[70] The distinction between the three categories is essentially

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presumably did not know of add-on clause that provided that each item previously purchased would be security for each additional purchase).

[65] Kerr, *Mastering the Mystery of Fine Print*, N.Y. Times, Mar. 6, 1983, § 3, p. 19.

[66] *See supra* text accompanying notes 7-11. Of course, while consumer ignorance of subordinate terms is a "special case" in the world of contract law, it is the general case for consumer form contracts.

[67] *See, e.g.*, Beales, Craswell & Salop, *The Efficient Regulation of Consumer Information*, 24 J.L. & ECON. 491, 500 (1981) (stating that information is costly, and that perfect information is neither "feasible nor desirable"); Schwartz & Wilde, *supra* note 17, at 630 (stating that, because information is never perfect, task for economists is to figure out how to deal with world that lies somewhere between perfect information and perfect ignorance).

[68] A. POLINSKY, *supra* note 4, at 97-98.

[69] *See* R. POSNER, *supra* note 1, at 81-83 (implying that consumers can ascertain certain characteristics about products more easily after frequent use); Epstein, *supra* note 13, at 304-05.

[70] *See* Nelson, *Information and Consumer Behavior*, 78 J. POL. ECON. 311 (1970) (describing distinction between search and experience attributes); Darby & Karni, *supra* note 18, at

the cost of discovering relevant information. Search qualities can be discovered at relatively low cost prior to purchase, and many experience qualities can be ascertained at little or no cost soon after purchase. An experience quality that is not detectable for a long time or without great expense is essentially a credence quality, and consumers are not reasonably expected to discover these attributes.[71]

These categories typically have been used in determining when fraud and deception are most likely to occur.[72] Because a consumer will learn of any deception involving a search characteristic before purchase, sellers usually will not try to deceive consumers about such attributes.[73] Similarly, a consumer will learn quickly after purchase whether claims about most experience attributes are accurate and, if they are not, the consumer will not buy the product again. Thus, deception as to these experience attributes can be expected only by those not seeking repeat customers, such as sellers in the tourist trade or in fly-by-night operations.[74] Deception is, therefore, most likely to involve credence qualities, or experience qualities of infrequently purchased goods.[75]

The typical consumer form contract does not involve fraud or deception. Nonetheless, the above categories are useful for determining the cost to the consumer of acquiring information necessary to evaluate a purchase properly. Some central contract terms are similar to search qualities, because consumers can learn of them easily prior to purchase. The price and item being purchased are examples of this category. Most subordinate terms, on the other hand, are equivalent to credence attributes, since they will not be known to the typical consumer even after repeated purchases. Most often, these subordinate terms serve to shift risks away from the seller and on to the consumer.

Subordinate terms will not be known because the cost of acquiring the necessary information exceeds the expected gain to the

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68-69 (adding concept of credence attributes). *See generally* Craswell, *supra* note 18, at 721-22.

[71] Darby & Karni, *supra* note 18, at 69.

[72] *E.g.*, Craswell, *supra* note 18, at 720-22; Darby & Karni, *supra* note 18, at 68-69.

[73] Craswell, *supra* note 18, at 720.

[74] *Id.* at 721.

[75] *Id.* at 721-22.

consumer from that information.[76] The first cost of acquiring information concerning contract terms is the time the consumer must spend reading the document. Because of the immense number of form contracts the typical consumer encounters, the cumulative time investment would be considerable. Some sellers attempt to increase this cost through the use of fine print or obscure placement.[77] Even without these additional obstacles, the sheer number of terms to be analyzed in the typical form contract imposes too great a burden for the consumer.

The cost to the consumer is made all the more excessive by the high cost of understanding a term's legal significance.[78] Again, some sellers try to increase this cost by hiding the term's meaning in obscure "legalese." Even with so-called "plain language" contracts, costly research is generally required to understand the legal effect of a particular term.[79] Obviously, consumers will not be able to undertake such research for every form they sign.[80]

Neither is it economically viable for consumers to hire experts to interpret these documents. A consumer will only purchase the services of an attorney if the expected loss from not understanding

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[76] *See* Schwartz & Wilde, *supra* note 17, at 643. Schwartz and Wilde describe the efficient search strategy as continuing until the marginal cost of further searching exceeds the marginal gain. That is, the efficient search stops when the cost of the next step in the search process exceeds a sum that is the product of the likelihood that the next step will reveal a better price, multiplied by the amount of savings. *Id.*

[77] R. POSNER, *supra* note 1, at 85-86.

[78] Ellickson, *Of Coase and Cattle: Dispute Resolution Among Neighbors in Shasta County*, 38 STAN. L. REV. 623, 667-68 (1986) (stating that legal knowledge is imperfect because legal research is costly and human cognitive capacity is limited).

[79] Ellickson discovered that even when nonlawyers have some general understanding of their legal rights, they view the law in simplistic black and white terms with one side or the other having all the rights, rather than recognizing the coexisting rights of each party. *Id.* at 669-70.

[80] In this respect, the contract terms closely resemble a credence attribute. *See* text accompanying note 70. A consumer cannot fully evaluate the quality of repair of an automobile "since he is unfamiliar with the intricacies and peculiarities of the particular machine." Darby & Karni, *supra* note 18, at 69. Similarly, consumers are unfamiliar with "the intricacies and peculiarities" of contract law. Although some consumers will have a basic understanding of common contract terms that appear frequently, such as "warranty," Schwartz, *supra* note 25, at 372 n.36, they will not necessarily understand crucial related concepts such as limitation of remedy. *See, e.g.*, Mieske v. Bartell Drug Co., 92 Wash. 2d 40, 593 P.2d 1308 (1979). In *Mieske*, the plaintiff took film detailing the history of her family to be developed and told the camera store, "Don't lose these. They are my life." The store, of course, lost the film. The Court held that plaintiff's recovery was not limited by an undisclosed contract clause that purported to limit any recovery to the cost of the film.

the contract exceeds the cost of legal advice.[81] For most consumer purchases other than a house, the cost of legal advice will far exceed the expected value of the gain to be derived.

By contrast, it will almost always be cost-justified for the business drafting the contract to pay for legal advice. The aggregate value to the business of the potential profit from each individual transaction justifies the expense.[82] Thus, only one party in the typical consumer transaction, the business seller, will have the necessary legal knowledge to evaluate contract terms.[83]

Without legal advice, consumers cannot understand how typical contract terms shift risks away from the seller and onto the consumer. Further, consumers will also generally be at a disadvantage in determining the probability and magnitude of the loss that might result from a risk imposed by the seller. The high volume of sales by the typical business will make the risks to it reasonably predictable and, thus, insurable.[84] Because most contracts do not result in any loss to consumers, and because consumers lack knowledge about the likelihood of any particular loss, consumers tend to treat the risk as too insubstantial to protect against; therefore, they do not read the contract, let alone attempt to negotiate terms.[85]

Whatever benefit might be derived by the consumer who accurately understands a contract term must be further discounted by the high transaction costs of altering the term or finding a seller with a preferred term.[86] The informed consumer knows that the

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[81] *See* Seita, *supra* note 14, at 135. This calculation ignores the possibility that the legal experts hired may not understand the law fully. *See generally* Ellickson, *supra* note 78, at 670-71.

[82] Seita, *supra* note 14, at 138.

[83] Not only will the benefit to be obtained from correctly understanding a specific contract clause be far greater for the seller than the consumer, the seller's cost of ascertaining the information will be far less. This is because the marginal cost to the seller, above the cost for drafting the contract, will be small. The marginal cost to the consumer of hiring a lawyer, in contrast, will be considerable.

[84] Seita, *supra* note 14, at 139.

[85] *See id.* at 132-35. This lack of effort is rational: "Because the vast majority of contracts are successfully completed, a reasonable consumer should pay little attention to the terms of a contract unless he values the contract highly or is alerted to potential problems." *Id.* at 133. *See also* Murray, *supra* note 61, at 740 (stating that "the pain and suffering of attempting to read and understand every printed form would be greater than the pain [suffered] as a result of occasionally being bound by unread and uncomprehended printed terms").

[86] *See* Coase, *supra* note 18, at 15 (stating that cost of market transactions includes dis-

seller probably will refuse to bargain. First, most salespeople and clerks, the only representatives of the seller whom the buyer may find accessible, are not authorized to change a standard contract term. Second, the cost to the seller of making a special contract for one consumer will usually exceed the gain to be made by retaining that consumer as a purchaser.[87] Thus, the rational seller will prefer to risk losing a single customer to losing the cost savings of standardized forms.[88]

While a consumer theoretically could use the knowledge of the contract term to find a different seller with a preferred term, locating any new seller imposes significant additional transaction costs.[89] If most businesses are using the same form, this cost of finding a new seller with the desired terms would be even higher.[90] In either case, these transaction costs are definite and substantial, and they usually will be greater than the uncertain expected gain to the consumer from the desired contract term.

Thus, the benefit to be derived from acquiring adequate knowledge of contract terms is usually low and is likely to be far exceeded by the significant costs of acquiring that information. It is, therefore, rational for even a conscientious consumer to pay little, if any, attention to subordinate contract terms.

2. *The Failure of the Market to Protect the Uninformed.* In some instances of imperfect consumer information, generalized consumer knowledge may suffice to create a competitive market. For example, even before the Truth in Lending Act,[91] consumers knew enough about market conditions to realize that most finance companies charged more than most banks.[92] But for most terms used in typical consumer contracts, similarly useful generalized information does not exist. This is especially true of subordinate clauses involving unlikely contingencies. Moreover, without understanding each specific clause, consumers will be unable to ascertain

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covering parties with whom to deal, informing them of desire to deal, negotiating, and drawing up contract).

[87] Schwartz, *supra* note 25, at 371.

[88] Seita, *supra* note 14, at 142.

[89] *See supra* note 86.

[90] *See* Kessler, *supra* note 56, at 632 (arguing that consumers cannot shop around for preferred terms because competitors generally use similar contracts).

[91] Truth in Lending Act of 1968, Pub. L. No. 90-321, 82 Stat. 146 (codified as amended in scattered sections of 15 U.S.C.).

[92] Schwartz & Wilde, *supra* note 17, at 681.

the true cost of a product or service.

An alternate form of protecting the unknowing consumer is similarly unavailable: the influence on the market of a minority of informed consumers.[93] If a large enough group of consumers is informed, there may be a "pecuniary externality" protecting the uninformed.[94] This protection will be derived from the competition of sellers for the marginal buyers who are informed and base their purchase decisions on this information.[95] This protection-by-proxy, however, is not applicable to subordinate contract terms. While adventurous consumers may research to find the best price, the far greater costs of searching for, reading, understanding and finally comparing the aggregate value of different sets of contract terms will overwhelm any benefit from doing so.[96] Further, this benefit must be discounted by the likelihood that the risks being allocated will never materialize.[97] Thus, there generally will be too few informed consumers to produce a competitive market for contract terms.

A final way ignorant consumers may be informed is through competitive advertising.[98] In some markets, a seller injured by a

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[93] *Id.* at 638. This has been described as the "public good" property of information. Beales, Craswell & Salop, *supra* note 67, at 503.

[94] Schwartz and Wilde suggest that if one third of the consumers in a market comparison shop, the market will behave competitively. Schwartz & Wilde, *supra* note 17, at 652-55.

[95] Priest, *supra* note 63, at 1347 (recognizing that manufacturers may be forced to be responsive to small, informed group of consumers even though large majority ignore contract terms).

[96] *See supra* text accompanying notes 76-81.

[97] Schwartz and Wilde say that other researchers have presumed that if consumers price shop, they will also be term-conscious, but have cited no support for this counter-intuitive presumption. Schwartz & Wilde, *supra* note 17, at 660. In fact, Schwartz and Wilde propose that a market be considered at "monopoly equilibrium," and thus requiring government intervention, if: (a) the market is either not price competitive or fewer than one third of consumers are term conscious; *and* (b) the contracts utilize fine print or arcane terminology. *Id.* at 661. It is unclear why the terms must be obscure in order to lead to a conclusion that competition over terms will not occur. If reasonable consumers do not read the contract and would not understand the significance of the legal concepts if they did, even the terms written in the simplest English will not be subject to meaningful competition. *See also* Priest, *supra* note 63, at 1347 (suggesting that consumers influence subordinate warranty terms, such as exclusions from coverage, by indicating their preference, but admitting that there is no direct evidence as to how this preference is developed or communicated).

[98] *See, e.g.*, Coase, *The Choice of the Institutional Framework: A Comment*, 17 J.L. & ECON. 493, 495 (1974) (stating that if one firm lowers its price but reduces the value of its service more than the price savings, competitors will "have the strongest motives for informing consumers of the true state of affairs"); *see also* Schwartz & Wilde, *supra* note 17, at 651

false or misleading claim of a competitor will determine that the benefit of correcting consumer misinformation exceeds the cost of the advertising.[99] Such will not be the case with most subordinate contract terms. Most of these clauses allocate risks to the consumer, such as the consequences of defaulting on payment and the possibility of a subsequent collection suit. Since consumers are, at best, only dimly aware of these risks, sellers will not want to call attention to the risks for fear of creating a disincentive for any purchase at all.[100] It is ludicrous to imagine a bank advertising, "We have the only loan contract in town that doesn't require you to pay our attorney's fees if we successfully sue you for default," or a manufacturer proclaiming on television, "We will sell your note to a collection agency, but, don't worry, you don't have to pay them if our product doesn't live up to its warranty."

Additionally, consumers may lack the knowledge to evaluate this information even when it is given.[101] It will not be cost-effective for a firm to advertise all of its contract terms, especially when it will have to pay for educating the public as to the legal significance of each term. Moreover, comparative advertising may create free-rider problems.[102] Because negative information about one competitor's terms benefits the advertiser's other competitors, the incentive for one firm to provide this information may be limited.[103] Finally, because the expected cost of these risks to consumers is small compared to the other costs and benefits of the purchase,[104] sellers will not want to divert their limited advertising budgets to publicizing factors that will play at most a minimal role in purchasing decisions.

Thus, consumers signing standard form contracts will generally not know the value of most of the contract terms either before or after purchase. The normal competitive pressures will neither force the disclosure of these terms nor create the externality of informed

(stating that informative advertising produces competitive behavior).

[99] Craswell, *supra* note 18, at 720.

[100] *See generally* R. POSNER, *supra* note 1, at 136-37.

[101] Beales, Craswell & Salop, *supra* note 67, at 506 (stating that "consumers may underestimate the value of additional information simply because they lack other data that would tell them of their need to learn more"); *see also supra* text accompanying notes 76-81.

[102] Beales, Craswell & Salop, *supra* note 67, at 503-04 (discussing possible solutions to free-rider problem).

[103] *Id.*

[104] *See supra* text accompanying notes 76-89.

consumers protecting the uninformed majority.

C. *The Effects of Consumers' Imperfect Knowledge*

The consumer's substantial lack of information alters the assumption that free choice will inevitably lead to an efficient result.[105] When one party to a contract lacks sufficient information to determine whether a given transaction is wealth-maximizing, and the market does not supply this needed information, there can be no certainty that the transaction will increase that party's wealth.[106] In the case of consumer form contracts, there is actually a tendency towards inefficiency.

1. Consumer Preference for Inefficiency. The lack of information will produce two specific tendencies in the market, each causing a different kind of economic distortion. The first has been termed the "quantity effect" and occurs because consumers buy more than would be efficient. The second is the "quality effect" and occurs because sellers are forced by consumer ignorance to supply products of lower quality than they should be.[107]

These effects have been well-established in the analysis of product liability.[108] For example, the outcome under a negligence regimen is efficient only if consumers correctly perceive the risks involved and, thus, the true price of the product.[109] If consumers underestimate the risks associated with a product, they will undervalue its actual cost and buy too much.[110] Quality is adversely affected in these circumstances because uninformed consumers will not pay for improvements; sellers, therefore, face no inducement to

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[105] Coleman, *supra* note 15, at 541.

[106] The lack of information, in other words, undermines the simplifying assumption of utility maximization. *See supra* note 12 and accompanying text.

[107] *See* Schwartz, *supra* note 25, at 376-78 (discussing impact of consumer ignorance on achieving adequate and appropriate levels of product safety); Shavell, *Strict Liability versus Negligence*, 9 J. LEGAL STUD. 1, 5 (1980) (providing clear example of effect of consumer who incorrectly perceives risk).

[108] *See, e.g.*, Shavell, *supra* note 107, at 1; *see also* R. POSNER, *supra* note 1, at 136-37 (discussing quality effects on product safety under systems of strict liability, negligence and no liability).

[109] If consumers correctly understand the risks involved, they can ascertain the full price of an item as market price plus future accident losses. Shavell, *supra* note 107, at 4.

[110] *Id.* Conversely, if consumers overestimate the risk involved, they will overestimate the product's true cost and buy too little. *Id.* The seller, however, has an obvious incentive to correct the buyer's error if it involves overestimation of risk. There is no similar seller incentive to correct undervaluation.

exercise the appropriate level of care.[111]

For standard form contracts, the quantity effect occurs when uninformed consumers buy too much of a product or service because they have not accurately evaluated the cost of the risks involved.[112] This can be seen by returning to the example of the tractor, valued at $100 by seller *A* and $150 by buyer *B*, with a sale price of $135 and a contract containing one subordinate term, an add-on clause. If the risk represented by that clause has a value of greater than $15, the transaction does not increase *B*'s wealth and he should not make the purchase.[113] If, however, *B* has not read the contract,[114] and incorrectly assumes that *A* would not be able to repossess all of his prior purchases if he missed a payment, he will disregard the cost of the clause. Even if that clause shifts risks to the buyer so that the cost of the contract to *B* exceeds its benefits, *B* will nonetheless accept the deal.[115]

While the hypothetical tractor contract had but one subordinate clause, most consumer contracts contain numerous subordinate clauses. If these clauses are not known to the consumer and the total cost of these clauses exceeds the expected benefit from the transaction, consumers will enter into economically inefficient contracts.[116]

In some circumstances consumers may know the average or general risk of a particular product.[117] In that case, consumers would

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[111] *Id.* at 5 (illustrating that consumer who underestimates need for added safety features will not willingly pay increased cost of those features).

[112] *See, e.g.*, A. POLINSKY, *supra* note 4, at 98-99; Seita, *supra* note 14, at 129.

[113] *See supra* text accompanying note 48.

[114] For a discussion of why it would not be efficient for a consumer to read a standard form contract, see *supra* text accompanying notes 66-90.

[115] Even if the shift in risk is not so great as to cause the consumer's total contract costs to exceed the benefits, the consumer who unknowingly bears that risk transfers to the seller a portion of value the consumer expected to receive (part of the excess of value to the consumer over total price paid). *See generally* F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 17 (2d ed. 1980).

[116] A mathematical model can illustrate this situation. Let *V* be the value to the buyer of the item to be purchased, *P* the sale price and *T* the aggregate cost of the subordinate contract terms, $\{T: T = T_1 + T_2 + T_3 \ldots.\}$ where T_1, T_2, and T_3 represent the cost of each contract term. A contract will be efficient for a buyer when $V > P + T$. If, however, T_U represents the cost of unknown clauses that impose risks the buyer does not understand $\{T_U: T_U = T_2 + T_3 \ldots.\}$ an inefficient purchasing decision will result whenever the cost of the unknown terms exceeds the net benefit of the contract to the buyer, that is, whenever $T_U > V_E$, where $V_E = V - (P + T)$.

[117] *See, e.g.*, Shavell, *supra* note 107, at 5 (describing situation where customers know

purchase the correct amount. Nonetheless, the quality effect would still lead to the creation of inefficient contracts. Consumers who are unaware of risks will not seek or choose contracts that allocate those risks to the seller, even when the extra cost for shifting the risk is less than the savings to the consumer.[118] Because consumers are "price conscious" but not "term conscious," a lower price will increase demand, but better contract terms, which are not understood, will not.[119] Thus, uninformed consumers will actually prefer an inefficient contract, with a lower stated price but higher actual cost, to a contract that efficiently allocated risks to the seller.

2. *Seller Preference for Inefficiency.* Why would a seller draft an inefficient contract? Intuitively, any profit-maximizing business would prefer to shift a risk to the other party if it could do so at no additional cost.[120] Because consumers lack the knowledge to evaluate the cost of the risk, a rational seller will draft contract terms that shift risks to the consumer.[121]

The incentive for inefficient contract terms is similar to the incentive for fraud.[122] When there are substantial information costs associated with uncovering deception, fraud is more likely to occur.[123] The marginal revenue from the fraud will likely exceed the marginal loss of revenue from the loss of business of dissatisfied customers.[124]

"the risk presented by sellers as a group but do not have the ability to 'observe' the risk presented by sellers on an individual basis").

[118] *See, e.g.*, Seita, *supra* note 14, at 122 (stating that person who does not understand why premium is being charged will naturally prefer less expensive contract, even when it is cheaper to pay to avoid risk).

[119] *See, e.g.*, Beales, Craswell & Salop, *supra* note 67, at 510 (stating that "the marketplace [channels] competition toward the more easily observable product attributes"); *see also* Seita, *supra* note 14, at 145 (stating that consumers will probably fail to realize when removal of detrimental contract clause is worth increased price).

[120] *See, e.g.*, Seita, *supra* note 14, at 83, 128.

[121] If a given risk has a cost to sellers of $10 if imposed on them, a seller would pay any sum less than $10 to have a buyer assume the risk. If buyers will assume the risk without any compensation because they are unaware of it, the rational seller would obviously place the risk on the consumer.

[122] *Cf. supra* notes 72-75 and accompanying text (discussing increased chance of presence of deception in contracts for infrequently purchased goods).

[123] Darby & Karni, *supra* note 18, at 72-75.

[124] *See* Darby & Karni, *supra* note 18, at 73-75. This can be illustrated through a simplified model, adapted from Darby and Karni. *See id.* Let T_0 = present value of total profit from a customer for an honest repair shop; S_0 = the price for honestly prescribed repair service; V = the present value of future profits from the customer's return business; and C_0

Fraud is even more likely when the lack of consumer knowledge induces the consumer to purchase both an information service and the desired good or service from the same source.[125] For example, the typical consumer purchases both the diagnosis of needed automobile repair (information) and the performance of the diagnosed repairs (desired service) from the same repair shop. A business selling only diagnosis results would have no incentive to inflate the need for repairs, since it would not profit from the extra work and might lose current and future business if the fraud were to be discovered. By contrast, when the same entity provides both the information and repair services, there is a greater incentive to use the information service to increase profits from the repair service, through, for example, prescribing unnecessary work.[126]

Similarly, a consumer signing a standard form contract is purchasing both an information service (essentially paying for legal advice by having the seller's attorney draft the contract) and a "product" (the terms of the contract). As long as the marginal revenue from inserting an inefficient clause exceeds the marginal loss of business from its use, the seller will have an incentive to draft contract terms unfavorable to the consumer, even though these terms may not be efficient.[127] The marginal loss of business from

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= cost to the honest repairer of providing the service. If R_0 = the probability that a customer will refuse a properly diagnosed service and G_0 = the probability that the customer will take future business elsewhere, the expected profit from a customer is:

$$T_0 = ([S_0 - C_0] \times [1 - R_0]) + V\,[1 - G_0]. \qquad (1)$$

If S_1 = the price for the fraudulently diagnosed repairs, C_1 = the cost to the repair shop of performing those unnecessary repairs, R_1 = the likelihood that a customer will refuse the fraudulently prescribed service, and G_1 = the likelihood that a customer will not return to a fraudulent repair shop, the expected increase in profit for a fraudulent repair shop, T_1 can be described as:

$$T_1 = ([(S_1 - S_0) - (C_1 - C_0)] \times [1 - (R_1 - R_0)]) + V\,[1 - (G_1 - G_0)]. \qquad (2)$$

A business will engage in fraud when a marginal increase in S_1 (the amount of fraud) results in a marginal increase in T_1 (the profit from fraud).

Note that as $(R_1 - R_0)$ and $(G_1 - G_0)$ decrease in value, T_1 increases. That is, as the loss of present and future business from fraud decreases, the profit from such fraud increases. Therefore, when the high cost of discovery reduces the amount of fraud detected, and thus the amount of business deterred by the fraud, the profit from the fraud will be increased.

[125] Darby & Karni, *supra* note 18, at 68-70.

[126] *Id.*

[127] The analysis is similar to that for the profitability of fraud. *See supra* note 124. Let T_0 = the present value of total profit for a business using an efficient contract; P_0 = the price paid by the consumer both for the purchased goods or service and for placing risks (R_1, R_2, and R_3) on the seller; C_0 = cost to the seller of producing the goods or service, including the bearing of those risks; and V = the present value of future profits from the customer's

the discovery of an inefficient clause is probably even less than the marginal loss from the discovery of fraud, because there is not the same social opprobrium.[128] As there will be only a minimal loss of future business resulting from the use of unknown subordinate clauses, the incentive to shift risks to consumers will be high.

It has been argued that a seller with market power would not exploit customers with one-sided contracts, because a monopolist (or a group of conspiring businesses) would gain the greatest return from a contract with terms most responsive to consumer demands, but with an increased price exceeding the marginal cost of supplying the preferred terms.[129] Theoretically, such an arrangement would maximize consumer demand, thereby maximizing the seller's profit.

But there can be no consumer preference for subordinate terms

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return business. If R_0 = the probability that a customer will refuse to accept the efficient contract and G_0 = the probability that the customer will take future business elsewhere, the expected profit from the efficient placement of risks is:

$$T_0 = ([P_0 - C_0] \times [1 - R_0]) + V\,[1 - G_0]. \quad (1)$$

If P_1 = the price paid by the consumer for the purchased goods or service but without placing risks R_1, R_2, and R_3 on the seller; C_1 = the cost to the seller of producing the goods or service, without bearing those risks; R_1 = the likelihood that a customer will refuse the inefficient contract; and G_1 = the likelihood that a customer will not return to the business using the inefficient contract, then the expected increase in profit for a business using an inefficient contract, T_1, can be described as:

$$T_1 = ([(P_1 - P_0) - (C_1 - C_0)] \times [1 - (R_1 - R_0)]) + V\,[1 - (G_1 - G_0)]. \quad (2)$$

We can assume that $C_1 < C_0$, because the seller's costs are lower under the inefficient contract as risks are now being borne by the customer, and $P_1 < P_0$, reflecting the lower cost, equation (2) can be rewritten as:

$$T_1 = ([(C_0 - C_1) + (P_0 - P_1)] \times [1 - (R_1 - R_0)]) + V\,[1 - (G_1 - G_0)]. \quad (3)$$

If $P_1 = P_0$, that is, if a seller using the inefficient contract does not lower prices (either because all sellers are using the same contract or because consumers are not aware of the risks they are bearing), then profit from the inefficient contract, T_2 becomes:

$$T_2 = ((C_0 - C_1) \times [1 - (R_1 - R_0)]) + V\,[1 - (G_1 - G_0)]. \quad (4)$$

In both equations (3) and (4) the differences $(R_1 - R_0)$ and $(G_1 - G_0)$ will be either zero or very small, as consumers are unaware of the subordinate contract terms being changed. As the differences approach zero, the profits T_1 and T_2 approach:

$$T_1 = (C_0 - C_1) + (P_0 - P_1) \quad (5) \quad \textit{and} \quad T_2 = C_0 - C_1 \quad (6)$$

The profits from the inefficient contract, thus, become the savings to the seller from having risk borne by the buyer, less the decrease in sale price, if any.

[128] *See generally* Epstein, *supra* note 13, at 298.

[129] Priest, *supra* note 63, at 1321. Although the context of this analysis was a discussion of one-sided warranty terms, the reasoning would apply to all subordinate terms of a form contract. *See also* Schwartz, *supra* note 25, at 373. Professor Schwartz argues that if consumers have a noticeable preference for a particular clause, sellers will exploit this preference by providing the clause at a higher price.

that are unknown or not understood.[130] Therefore, the "preferred," presumably efficient, terms actually will have no effect on demand. Moreover, as even a monopolist must confront the reality that demand declines as price increases,[131] the efficient contract with the higher price may result in reduced profits.[132]

Similarly, if demand is not altered by a change to an inefficient contract,[133] the quantity sold by our monopolist at a given price will be the same as it would be if the contract were efficient, but the cost of producing that quantity will be less because more risks are being borne by the consumer. Thus, there is more profit for the monopolist using an inefficient contract.[134]

The lack of consumer knowledge, therefore, will cause consumers to purchase too many products and services with inefficient contracts and encourage sellers to create form contracts that are inefficient. The next section describes how courts, through common-law adjudication, can interpret these contracts to enhance the probability of obtaining efficient results.

III. The Doctrine of Reasonable Expectations

When consumers do not know or understand subsidiary form contract terms, sellers have no incentive to create efficient form

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[130] *See supra* text accompanying note 118.

[131] In other words, the monopolist, like other sellers, must deal with a demand curve that slopes downward. *See generally* F. Glahe & D. Lee, Microeconomics § 2 (2d ed. 1989).

[132] Whether any gain at all might be realized to the monopolist because of the higher price would depend on the price elasticity of the monopolist's demand curve. *See id.* § 3-2, at 72-73. In other words, whether the decrease in demand would be more than offset by the higher price charged depends on the sensitivity to price changes of the seller's particular market. *Id.* However, any gain to the monopolist realized in this fashion is irrelevant. The monopolist could have realized that same incremental increase in profit by raising his prices without ever bothering to change to an efficient contract. Moreover, the increased price combined with the inefficient contract would increase profit even more, because the monopolist would not have to bear the increased costs associated with the efficient terms.

[133] That is, if the demand curve does not shift to the left. *Id.* § 2-2, at 35-37.

[134] The monopolist's demand schedule is illustrated in the following graph, derived from Judge Posner. R. Posner, *supra* note 1, at 197-98. Let C_0 = the marginal cost for the seller using an efficient contract (for simplicity, treat marginal costs as constant and ignore fixed costs); P_0 = the price; q_0 = the quantity produced; and D_0 = the point on the demand curve when marginal revenue = marginal cost with the efficient contract. Let C_1 = the seller's marginal cost with an inefficient contract; P_1 = the price; q_1 = the quantity produced; and D_1 = the point on the demand curve when marginal revenue = marginal cost with the inefficient contract.

contracts.[135] Because there is no knowing and voluntary assent to the subsidiary terms, there can be no presumption that the exchange is wealth-maximizing.[136] The law can and should recognize that the "class" of consumers is incapable of judging the personal utility of form contract terms, because acquiring the necessary information is economically inefficient. The appropriate governmental response to excessive information search costs is to reduce those costs.[137] Once information is actually obtained by both par-

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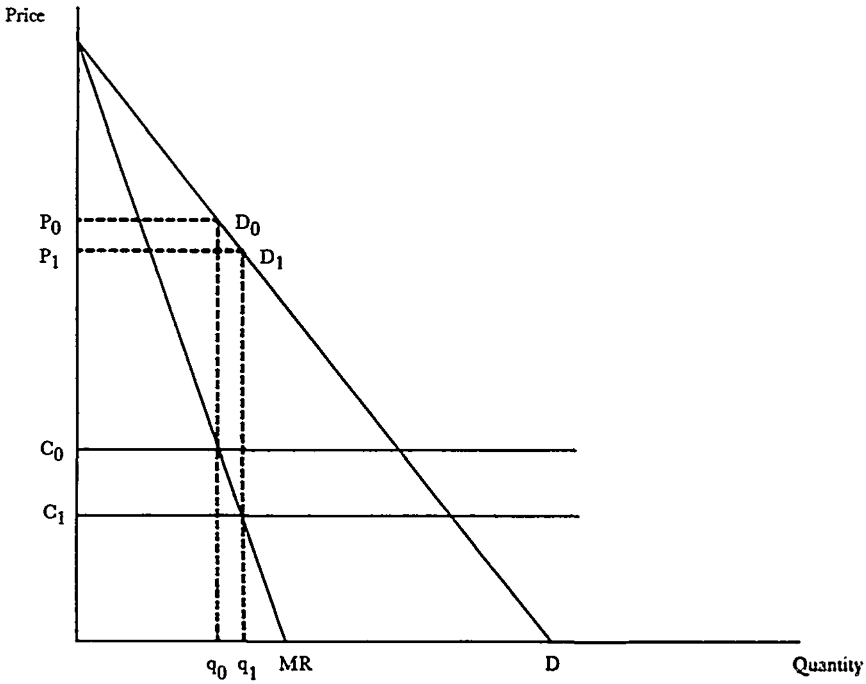

Monopoly profit can be determined by calculating the area of rectangles $P_0D_0q_0C_0 = A_0$ and $P_1D_1q_1C_1 = A_1$. If the cost savings exceed the price reduction (if any) with the inefficient contract, then C_0 - C, $\geq P_0 - P_1$. Therefore, $A_1 > A_0$ and the monopolist will earn greater profit with the inefficient contract.

[135] *See* Schwartz, *supra* note 25, at 372 (stating that "no market can work well when consumers do not know what their contracts say").

[136] *See* A. KRONMAN & R. POSNER, *supra* note 13, at 5 (noting that only contract that involves an actual meeting of the minds satisfies economist's definition of value-maximizing exchange).

[137] *See* Schwartz, *supra* note 25, at 372-74. Although Professor Schwartz concludes that courts cannot reduce high search costs, the careful selection of rules for contract construction should be able to encourage behavior by sellers that will reduce consumers' search

ties, the courts then can properly proceed on the assumption that voluntary transactions are wealth maximizing.

The concept that members of a class generally may be unable to protect their interests as contracting parties is not unknown to the law.[138] For example, contracts entered into by minors are treated differently from other contracts because children, as a class, are deemed "incapable of judging their self-interest."[139] The law creates a broad category based on an easily identifiable criterion, minority, and operates on the plausible assumptions that most of those within this category require special protection, and that most of those outside the category do not.[140] Thus, the law provides that most contracts are voidable at the minor's election.[141]

A similar argument can be made for the special treatment of consumers signing form contracts. As a class, consumers are incapable of judging whether a given form contract contains hidden costs that will injure their self-interest.[142] While there may be that rare consumer who not only reads an entire form contract but also understands its legal and economic significance, the great majority of consumers do not.

The remedy for the existing lack of consumer knowledge, however, should not be the same as for minority: making the entire contract voidable at the election of the consumer is unnecessary. With adequate knowledge, adult consumers are presumed to be able to evaluate the economic value of a transaction to them. To correct the inherent lack of consumer knowledge, an efficient scheme for interpreting and enforcing form contracts would encourage the seller, with substantially lower information costs, to share critical information with consumers.[143] Because the seller is

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costs.

[138] *See supra* notes 26-32 and accompanying text.

[139] R. POSNER, *supra* note 1, at 80; *see also* Epstein, *supra* note 13, at 300 (noting that other specially treated classes include those with diminished capacity, such as insane or intoxicated persons).

[140] A. KRONMAN &. R. POSNER, *supra* note 13, at 255.

[141] *See supra* note 26.

[142] This inability is due to the excessive information costs associated with discovering the meaning and effect of subsidiary contract terms. *See supra* notes 76-85 and accompanying text.

[143] This is similar to the proposal by Kronman that there be a duty to disclose information when such disclosure would not deter the deliberate search for information by the party with the least costly access to it. *See* Kronman, *supra* note 31, at 32-33. For example, consumers purchasing life insurance have a duty to disclose health problems, because they are

better able to control the conveying of information, sellers who give incorrect or misleading information to consumers should be held liable for the error.[144] Additionally, when information is not shared, courts should construe the contract to approximate the subsidiary contract terms to which the consumer and seller would have agreed after informed negotiations.[145]

The framework for enforcing consumer form contracts can be termed the "doctrine of reasonable expectations," with the focus on the reasonable expectations of the consumer. In some cases, the seller and buyer will have different expectations as to the subsidiary terms of the contract.[146] Sellers can discover the reasonable expectations of the consumer at far less cost than the reverse. It will likely be cost-justified for the seller, who engages in multiple similar transactions, to pay to ascertain this information, but it would not make economic sense for consumers to discover the expectations of sellers for each different purchase they make.[147] If the consumer's reasonable expectations determine the terms of the contract, the seller will be encouraged to either ascertain those expectations or alter them by providing adequate information. Once both parties are operating under the same accurate assumptions as to the meaning and value of their contract, their consent can be presumed to indicate a value-maximizing transaction.

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the cheaper information-gatherers and would want to discover information as to their health regardless of disclosure requirements. *Id.* at 26-27. Similarly, the business that is drafting the contract will need to learn about the law and its requirements even if no disclosure rules exist. Additionally, it could be argued that, because a consumer is purchasing the contract, *see supra* text accompanying notes 125-28, as well as the desired goods or services, the seller should be held to a fiduciary's obligation to share the information. *Cf.* Kronman, *supra* note 31, at 18 n.49 (describing economic rationale for fiduciary's traditionally higher standard of disclosure).

[144] *See infra* text accompanying notes 161-73.

[145] *See* A. POLINSKY, *supra* note 4, at 25. In interpreting contracts a presumption arises that parties would have bargained cooperatively. *Id.* at 25 n.16.

[146] This will be true, for example, when there is a rational buyer expecting efficient contract terms and a seller offering nonefficient terms, assuming that the buyer does not learn of the written contract provisions. It will also be true when a contract clause greatly differs from either a commonly used term or a common default rule generally utilized in similar transactions. If the consumer and seller have the same expectations, interpreting the agreement to conform to the reasonable expectations of the consumer would obviously result in a contract that conforms to the seller's expectation as well.

[147] This conclusion follows the analysis employed earlier to explain why businesses are willing to pay for legal advice in drafting form contracts, and consumers are not. *See supra* text accompanying note 81.

Although courts and commentators have used the concept of "reasonable expectations" before, usually no strict definition of how to determine what expectations are "reasonable" has been articulated.[148] The benefit of a reasonableness standard is that it implies that any expectations be objectively determinable. Because consumers are presumed to desire efficient contracts,[149] reasonableness can be determined by economic analysis, rather than, for example, by a survey of consumers.

The word "expectations" is used to encompass not only reasonable "beliefs" derived from economic analysis of a transaction, but also beliefs that were created affirmatively by a particular seller.[150] Most important, consumers' expectations can be created through accurate information. The doctrine of reasonable expectations would enforce those form contract terms that are entered into knowingly and voluntarily by consumers with adequate information.[151]

Under the doctrine of reasonable expectations, the final contract, therefore, consists of three types of terms: those explicitly agreed to by both parties; those the seller led the consumer to believe would be in the contract; and those that would have been agreed to by each party after negotiation. Such a contract comes closer to the ideal of the agreement that is voluntarily entered into by parties with perfect information than does the typical standard form contract as drafted.

A. *Explicit Consumer Assent to Known Terms*

Typically, consumers give explicit consent only to the central terms, such as price, in the standard form contract.[152] A seller wishing to ensure the enforceability of a subordinate clause should be able to do so by adequately disclosing the meaning and effect of that clause. Merely using a contract with plain language and with-

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[148] *See* Schwartz, *supra* note 25, at 385 (criticizing "consumer expectations test" as confusing, without standards and, at best, a synonym for cost/benefit analysis).

[149] *See supra* notes 12-13 and accompanying text.

[150] *See infra* notes 161-73 and accompanying text.

[151] *See* Schwartz, *supra* note 25, at 358 (stating that default rules do not contravene actual assent because they are revocable). This framework may not be appropriate for situations where monopoly power effectively precludes consumer's rejection of an inefficient contract, such as contract between consumer and utility company. *See infra* note 194.

[152] *See supra* note 63 and accompanying text.

out fine print is not sufficient, even though such a contract would somewhat decrease the consumer's information costs. Those costs would still be so high that it would not be cost-efficient for consumers to ascertain the existence, let alone value, of subordinate clauses.[153] A contract that is not read cannot indicate that a consumer knew of a risk or agreed to a particular allocation.[154]

To enforce a subsidiary clause, the seller would have to prove that the consumer was given actual knowledge of that clause. Returning to the example of the add-on clause,[155] the court should not enforce the clause unless it was adequately explained to the consumer at the time of purchase. Rather than simply including the clause in a contract that the seller knows will never be read, a seller would have to disclose the clause in such a manner that a buyer would be expected to understand its significance.[156]

The classic case of *Williams v. Walker-Thomas Furniture Co.*[157] can be understood as judicial condemnation of the disparity of information between buyer and seller. The court refused to enforce an obtusely drafted add-on clause,[158] stating that when a party "signs a commercially unreasonable contract *with little or no knowledge of its terms*, it is hardly likely that his consent, or even an objective manifestation of his consent, was ever given to all the terms."[159] In contrast, it is hard to imagine that a court would refuse to enforce the clause if the seller had actually said to the purchaser prior to the signing of the contract, "Let me make sure you understand this clause. It means that until you've paid us all the money you owe for everything you've ever bought from us, we can

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[153] *See supra* notes 76-80 and accompanying text.

[154] *See* Seita, *supra* note 14, at 132.

[155] *See supra* notes 38-49 and accompanying text.

[156] The additional cost of such disclosure should not be prohibitive for most sellers. *See infra* text accompanying note 165.

[157] 350 F.2d 445 (D.C. Cir. 1965).

[158] In *Williams*, 350 F.2d at 447, the contract stated, in part, "all payments now and hereafter made by [purchaser] shall be credited pro rata on all outstanding leases, bills and accounts due the Company by [purchaser] at the time each such payment is made." The court correctly categorized this as a "rather obscure provision." *Id.* The provision was designed to allow the seller to repossess all items previously purchased by the consumer, in the event of default. *Id.*

[159] *Id.* at 449 (emphasis added). The court also argued that the consumer was "a party of little bargaining power, and hence little real choice." *Id.* Because the subject of the transaction was a stereo set, presumably a well-informed consumer would at least have the choice of accepting or foregoing the transaction.

take back every one of those items if you miss even a single payment. Do you understand?"

With such actual notice, the consumer could decide whether the next item to be purchased was worth the risk of losing all items previously purchased from the seller.[160] Since efficiency is only concerned with informed risk taking, not with whether a given gamble pays off, the consumer should have no valid complaint if she knowingly elects to take a chance that she will be unable to pay all her debt, and thereafter defaults and loses her previous purchases.

B. Seller Statements and Advertisements

Businesses that give misleading information to consumers should be held to any promises they erroneously convey. In *C & J Fertilizer, Inc. v. Allied Mutual Insurance Co.*,[161] the written burglary insurance contract limited coverage to burglaries resulting in "visible marks . . . upon, or physical damage to the exterior of the premises at the place of entry."[162] The agent selling the insurance, however, had told the purchaser, prior to contracting, that there need only be "visible evidence of burglary."[163] The court held that the consumer's reasonable expectations, as created by the agent's statement, should supersede the written language, so that recovery was permitted even though the exterior to the building was unmarked.[164]

This decision is consistent with efficiency principles. It makes far more economic sense for the insurance company, which drafted the policy, to be required to explain it correctly to its agents than to expect the consumer, who has been told of a clause's purported meaning, to double-check the agent. The cost to the company which already has to inform its agents of the contract so as to permit them to sell the policies is minimal. The benefit to a consumer of researching a provision previously explained by an agent is too

[160] In this scenario, the informed consumer is able to evaluate the magnitude and probability of loss. *See supra* text accompanying notes 84-85. Consumers actually become better able to do so than the seller, as they can better judge the probability of defaulting.

[161] 227 N.W.2d 169 (Iowa 1975).

[162] *Id.* at 171.

[163] *Id.* The agent had the authority to bind the insurance company. *Id.*

[164] *Id.* at 177.

small to justify the cost of doing so.[165] Moreover, insurance policies are not presented to consumers until after the contract has been created. Rational consumers evaluating the wisdom of a particular policy will rely on the agent's affirmations, because they cannot read the as yet unreceived policy.

Reasonable expectations can also be created by advertisements.[166] In *Collins v. Uniroyal*,[167] tire advertisements stated that a particular tire was guaranteed against blowouts and added, "If it only saves your life once, it's a bargain."[168] The court ignored a contract clause limiting damages to replacement and permitted a suit for damages when the consumer died from an accident caused by a blowout.[169] Presuming that the buyer relied on the advertisement and was unaware of the contract clause, this result is justified.[170]

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[165] The benefit to the consumer is the value of the correct information discounted by the probability that the agent's information was correct. Because the high cost to a consumer of evaluating a contract term usually exceeds the value of correctly understanding the term, the cost here will easily exceed this discounted benefit. *See supra* notes 76-90 and accompanying text.

[166] It is not always simple to "interpret" an advertisement correctly, especially when no explicit promise is made as to the extent of the advertiser's liability for failure to perform. Nonetheless, because a false claim can inaccurately inflate the buyer's perceived value of a transaction, *see infra* text accompanying notes 171-72, advertised claims should not be ignored. If an explicit promise is made in an advertisement, it should be presumed that the parties expected the application of the traditional contract remedy: that the seller would compensate the buyer for "any injury resulting from the failure to perform." R. POSNER, *supra* note 1, at 88. An unread clause should not be permitted to overcome the presumption. Only an explicit limitation of liability to which the buyer has knowingly agreed can establish that the true value of the promise has been included in the buyer's perception of the value of the bargain.

[167] 64 N.J. 260, 315 A.2d 16 (1974).

[168] *Id.* at 262-63, 315 A.2d at 18.

[169] *Id.*

[170] *Collins* has been condemned, in part, on the basis that the plaintiff did not prove that the deceased consumer had relied upon the advertisement. *See* Epstein, *supra* note 13, at 310-11. While it may be more efficient to require consumers, generally, to prove that they knew of and relied upon advertisers' statements, it would be rational to shift the burden in the case of a deceased consumer (especially when his inability to testify is caused by the defective advertised product). Falsely advertising the safety of a tire involves a credence characteristic; safety cannot be ascertained either before purchase, or at low cost after purchase. The seller's advertisement may be the only prepurchase information about safety available to the consumer. *See* Darby & Karni, *supra* note 18, at 69 (discussing credence qualities in context of fraud); *see also supra* text accompanying notes 70-71. Additionally, the aggregate consumer injury from faulty tires far exceeds the cost of correcting the advertisement. Thus, the burden should be on the seller who conveyed misleading information to the public to prove that the advertisement did not affect the purchase decision of this par-

To illustrate, assume that the buyer had the choice of buying two brands of tires.[171] All other things being equal, if Seller *A*'s tires cost less, and only Seller *B*'s advertisements conveyed a promise that the tire would save the purchaser's life, the buyer who chose to pay extra for the advertised tire did so to receive a guaranty of safety. Since Seller *B* did not deliver the promised performance, the consumer is entitled to receive a monetary equivalent of the loss directly attributable to that failure.[172] To award the buyer only a refund on the purchase price would encourage sellers to inflate falsely the buyer's perceived value of a transaction, thereby causing inefficient transactions to occur.[173] It may well be impossible (either technologically or economically) to manufacture "blowout-proof" tires, and the damages resulting from blowouts, if not limited to purchase price, may exceed the profits derived from the sale of the tires. In that case, sellers would be encouraged to refrain from overpromising the tires' capability, and consumers would be better able to determine the value of the tires to them.

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ticular deceased consumer. *See generally* Craswell, *supra* note 18, at 724-25 (discussing suits brought by Federal Trade Commission against sellers who used false or deceptive advertising).

[171] I will ignore, for simplicity's sake, the option of not buying tires altogether and choosing an alternate means of transportation.

[172] This is similar to an award for medical malpractice against a physician who fails to treat patients with the expected level of care. *See* R. POSNER, *supra* note 1, at 126-27. Like the doctor, the tire seller should be held to the customary level of care, except for the promise of additional care made in the advertisement.

[173] To see why, assume both Seller *A* and Seller *B* offer tires for sale worth $50; further assume that all the tires offer the same level of safety. While Seller *A* sells her tires for $50 each, Seller *B* falsely advertises that her tires will definitely not cause the consumer's death and thus justifies her sales price of $65. The added $15 is the value of the promise to the consumer who buys from Seller *B*. Let V_b = the value of the consumer's life to the consumer, and R = the risk to an average driver of a fatal blowout (from either *A*'s or *B*'s tires). Therefore, $R \times V_b = \$15$. If $R = .01\%$ and Seller *B* sells 10,000 tires, one fatal accident should occur. The resulting loss from that one accident is $150,000 ($V_b = \$15 \div R = \$15 \div .01\% = \$150{,}000$). If the predicted loss is $150,000, but the seller need only pay $65 in damages, consumers will buy too much of Seller *B*'s tires.

Moreover, sellers will have an incentive to advertise falsely since the value to a seller of the false claim exceeds the cost. Let V_s be the increased profit, such that V_s = (incremental price increase) x (sales) = $15 x 10,000 = $150,000. The associated increased cost to the seller, C_s, is only $65 (the measure of liability to which the seller becomes exposed because of the false advertisement). Therefore, the profit from the deception is great: $V_s - C_s = \$150{,}000 - 65 = \$\ 149{,}935$. Because long-term safety is a credence characteristic, *see supra* note 170, and deceased customers are not a good source of repeat business anyway, sellers will be strongly motivated to sell tires for more than they are actually worth.

C. *Undisclosed Contract Terms*

1. The Efficiency-Based Default Clause. Under the doctrine of reasonable expectations, the final type of clause in a consumer form contract is essentially a default clause.[174] It encompasses the parties' obligations when the seller has not adequately conveyed to the consumer the meaning and effect of a particular contract provision.[175] The scope of these obligations can be ascertained by applying the fundamental principle that parties negotiating freely will tend to allocate risks and responsibilities in a way that maximizes the contract's joint value to the contracting parties or minimizes their joint costs.[176] This goal is generally achieved by placing the risk of a given loss on the superior risk bearer.[177] Such an allocation creates an incentive for the more efficient risk bearer to adopt cost-justified risk avoidance or risk-minimization techniques.[178]

The superior risk bearer is identified by determining which party is the superior insurer.[179] First, the party with the lower measurement costs must be identified. This requires an evaluation of the costs of estimating both the probability and magnitude of a given loss.[180] The second step is to determine who has the lower transaction costs. This is the party who would face lower costs in eliminating or reducing the risk, or in diversifying away the risk by pooling with other risks through self-insurance or market

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[174] *See supra* text accompanying notes 19-25.

[175] The economic guidelines discussed in this section obviously work equally well in developing default terms that serve the simple "gap-filling" function—addressing consequences unforeseen by both parties to the contract. *See supra* notes 19-25 and accompanying text.

[176] R. POSNER, *supra* note 1, at 179.

[177] Posner & Rosenfield, *supra* note 22, at 117. Posner and Rosenfield use this analysis to discuss contracts that become unenforceable due to impossibility and related circumstances. They emphasize that no analysis of superior risk-bearing ability should be done if the contract assigns a particular risk to one of the parties. *Id.* at 90. The authors concede, however, that a contract term will not reflect a true assignment of risk if, for example, the source or magnitude of a price change was not within the parties' contemplation. *Id.* at 94. Similarly, in the context of a standard form contract, the consumer who lacks knowledge of the risk allocated by a subsidiary term cannot be assumed to have contemplated that risk, or to have voluntarily assented to bear that risk, merely because the contract so states.

[178] Posner & Rosenfield, *supra* note 22, at 113.

[179] R. POSNER, *supra* note 1, at 77; *see also* Posner & Rosenfield, *supra* note 22, at 91-92 (discussing various factors relevant to evaluating which party is the cheaper insurer).

[180] Posner & Rosenfield, *supra* note 22, at 91.

insurance.[181]

In the typical transaction involving a consumer form contract, sellers have the lower measurement costs because of their greater experience with the product or service gained through their high volume of sales.[182] Just as a well-driller will be better able than the customer to estimate the probability of hitting a boulder,[183] the experienced business person will be better able than the typical consumer to estimate the probability that a product will fail to perform. Of course, if there are special needs associated with a particular consumer, such as a purchaser who intends to use his family washing machine for commercial use eight hours a day, that consumer will likely have lower measurement costs.[184]

The typical business will also have the lower transaction costs. Obviously, the business that drafted the agreement faces substantially lower information costs in learning who is to bear a specific risk than the consumer. Therefore, the business seller will be better able to act to reduce the risk at less cost.[185] Furthermore, as producer of the goods or supplier of the service, the business frequently will be better able to prevent harms caused by poor quality goods or services, and to do so more cheaply than could the purchaser.[186]

The business seller, therefore, is the superior insurer for most consumer goods and services. Moreover, the seller's high volume of transactions makes a given risk reasonably certain; with high enough sales, a manufacturer can predict the total number of defects.[187] The seller can then eliminate many risks through self-in-

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[181] *Id.* at 91-92.

[182] *See supra* notes 84-85 and accompanying text.

[183] *See* Posner & Rosenfield, *supra* note 22, at 101 (discussing Hein v. Fox, 126 Mont. 514, 254 P.2d 1076 (1953)).

[184] *Cf.* Priest, *supra* note 63, at 1333 (noting that warranty protection may be denied when consumer does not use product in customary way; further, dominant group of consumers, who do expect to use the product in usual way, may accept reduced warranty protection in exchange for lower price).

[185] *See, e.g.*, Kronman, *supra* note 31, at 4-5 (noting that court concerned with economic efficiency would impose risk on superior information gatherer to reduce transaction costs of contract process); *see also* Seita, *supra* note 14, at 120-21.

[186] *Cf.* Posner & Rosenfield, *supra* note 22, at 110-11 (stating that producing party is generally superior risk bearer because it is better able to estimate likelihood of an unfavorable event and to prevent its occurrence).

[187] Seita, *supra* note 14, at 139-40.

surance, simply by charging all customers a higher price.[188]

Risks should be borne by the consumer, however, when the consumer is better able than the seller to avoid the loss. For example, the damage caused to a car by high-speed racing is a risk that the consumer could avoid more easily than could the seller of mass-produced automobiles.[189] In the typical consumer transaction, however, the seller is the superior bearer of many risks, and the efficient default clause should place those risks on the seller.

2. *The Traditional Default Clause.* An alternate, but perhaps equivalent, means for determining the consumer's reasonable expectations of undisclosed risk allocation is to apply traditional contract default terms.[190] Many of these default clauses are efficient, as they have been created by common law to approximate the result of cooperative bargaining.[191] One example of an efficient default clause is the rule that any contract that requires a seller's performance to be "satisfactory" to the buyer is presumed to require that the buyer's rejection be objectively reasonable.[192] In the words of Judge Posner, "The requirement of reasonableness is read into a contract not to protect the weaker party but to approximate what the parties would have expressly provided with respect to a contingency that they did not foresee, if they had foreseen it."[193]

In addition, reliance on traditional default terms reduces the uncertainty of judicial involvement in contract interpretation. When courts begin to interpret form contracts other than explicitly as

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[188] Posner & Rosenfield, *supra* note 22, at 93; Seita, *supra* note 14, at 130. The seller self-insures by charging a price high enough to offset any losses caused by defects.

[189] Priest, *supra* note 63, at 1333. Many of the warranty exclusions discussed by Professor Priest can be categorized as risks that should be borne by consumers because, in the posited situations, they are better able than the sellers to avoid the harm (such as damage to the enamel finish on an appliance or damage to automobiles caused by weather). *Id.* at 1329, 1334.

[190] *See* Rakoff, *Contracts of Adhesion: An Essay in Reconstruction*, 96 HARV. L. REV. 1173, 1258-60 (1983) (stating that courts should presume that subsidiary or "invisible" clauses are unenforceable and, therefore, that "background law" of implied gap-fillers should be applied); *see also* Seita, *supra* note 14, at 122-32 (stating that "strong" default rules, based on strong justifications such as efficiency, should not be negated without explicit approval, while "weak" default rules, which make an essentially arbitrary risk allocation, should be easily negated by the writing).

[191] *See* A. POLINSKY, *supra* note 4, at 25.

[192] E. FARNSWORTH, CONTRACTS 556-59 (1982).

[193] Morin Bldg. Prods. Co. v. Baystone Constr., Inc., 717 F.2d 413, 415 (7th Cir. 1983) (Posner, J.).

written, sellers become uncertain about the scope of obligations to which they are already committed. If courts are free to ignore any clause they consider "inefficient," a seller cannot be confident that a court will always agree with its assessment of contract efficiency. A relatively simple principle, applying traditional default rules, gives a court fewer questions to resolve. This reduces the risk of judicial error and increases the seller's ability to predict eventual judicial outcomes.

It is essential to remember that the contracting parties must always be permitted to agree upon an allocation of risk that a court might find to be inefficient. To enforce a particular clause, the seller should have to show only that the consumer was given actual knowledge of the allocation in such a way as to be able to evaluate the costs of that risk allocation.[194] Consumers who are adequately informed about proposed contract terms can decide whether they wish to receive additional compensation for assuming a particular risk. Absent knowledge adequate for decisionmaking, consumers are deprived of return for the value they confer to the seller by "agreeing" to bear a risk.

D. *Reasonable Expectations and the Efficient Form Contract*

Despite the economic rationale for the doctrine of reasonable expectations, no claim can be made that the resulting system would ensure one hundred percent efficient results. It is axiomatic that government involvement in the marketplace is a second-best solution.[195] All governmental regulation of contracts imposes costs and risks of inefficiency and error and can only be justified when the gains from a regulation exceed its costs.[196] Nonetheless, not all governmental limits on absolute "freedom to contract" violate economic principles. The Statute of Frauds, which bars enforcement

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[194] This enforcement scheme should not apply when consumers have no choice about entering the contract, for that presents a "special case" not addressed by the model as offered here. *See supra* text accompanying notes 7-11. For example, assume that an electric company contract states that consumers must pay all of the company's legal fees in an action against the consumer, even if the consumer wins the case. Such a clause should not be enforced regardless of the "consent" of the consumer. *Cf.* D. v. Educational Testing Serv., 87 Misc. 2d 657, 386 N.Y.S.2d 747 (N.Y. Sup. Ct. 1976) (finding that applicant to law school has no choice but to accept contract provided by those operating Law School Admissions Test).

[195] Schwartz & Wilde, *supra* note 17, at 679.

[196] Craswell, *supra* note 18, at 726; Darby & Karni, *supra* note 18, at 83.

of certain oral contracts, promotes efficiency by reducing the risks of oral transactions and thereby reducing the cost of contracting.[197] Similarly, the doctrine of reasonable expectations promotes efficiency by reducing the costs associated with inadequate understanding of contractual risks and obligations.[198] The alternative to the doctrine of reasonable expectations is not a system of market decisions based on perfect information but, rather, one of transactions in which one party is ignorant of most of the contract terms.

If standard form contracts are only enforced precisely as written, drafters would be able to insert inefficient clauses that they know consumers do not expect, desire or learn about prior to signing. Just as a contract containing a unilateral error known to one party should not be enforced against the other,[199] it is economically irrational to enforce against the uninformed consumer standard contract clauses known only to the seller. In both instances, courts should not encourage the reliance of the informed party on the known misunderstanding of the other, especially if that misunderstanding can be easily rectified before the contract is signed.[200]

Undoubtedly, some subsidiary contract terms will be more costly to explain than others, in terms of time and the training of employees. Such explanation, though, is only required for inefficient terms; written contract terms that allocate risks efficiently need not be specifically disclosed to be enforced.[201] Even assuming occa-

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[197] A. KRONMAN & R. POSNER, *supra* note 13, at 253.

[198] The doctrine, therefore, compensates for the excessive information and transaction costs faced by consumers. *Cf.* Posner & Rosenfield, *supra* note 22, at 98 (stating that economics-based contract discharge rules should be limited to contingencies not provided for in contract, since choice in contract must be the more efficient one, "subject to information and transaction costs").

[199] *E.g.*, RESTATEMENT (SECOND) OF CONTRACTS § 153(b) (1979).

[200] *Cf.* Kronman, *supra* note 31, at 7 n.18 (stating that when one party has no reason to know of error in contract, that party may usually enforce contract or recover damages based on reliance).

[201] Theoretically, if the seller wanted to use a term that was actually more efficient than a default term, but the cost of disclosing the information exceeded the gain in efficiency from the term, the seller would be forced to use the less efficient term. Let C_d = the cost of disclosure, B_1 = the benefit of the term the seller wants to use, and B_2 = the benefit of the default term. Thus, if $B_1 > B_2$ and $C_d > B_1 - B_2$, the seller would choose to avoid the extra cost and elect to use the default term. The loss in efficiency will equal $B_1 - B_2$.

Because default terms are presumed to be generally efficient, *see supra* text accompanying notes 190-93, in most cases the default term will be at least as efficient as the seller's desired terms. Even when the seller's term is more efficient, the default term will not be excessively inefficient. In other words, generally, $B_2 > B_1$. Thus, it can be expected that, in sional judicial error, requiring only inefficient terms to be struck would tend to lead to more efficient form contract risk allocation.

The doctrine of reasonable expectations also is more economically efficient than an alternate regimen relying on ambiguous or covert standards, such as unconscionability or the principle of interpreting contracts against drafters.[202] The explicit standard puts parties on notice of the relevant issues which would be considered by a court and permits the parties to adjust their actions accordingly.[203] Even if the first case brought under the standard were expensive, once the rule is announced it is available to guide future contracting parties and reduce contract transaction costs.[204]

Some have argued that banning or restricting various subsidiary terms will harm poor consumers by raising the prices they must pay for goods and credit.[205] This contention, however, is based only on considering sales price, without factoring in the added cost of subsidiary terms which shift risks to consumers.[206] Thus, it is not at all self-evident that poor consumers ultimately will pay a higher total price. Moreover, enforcing all standard contract terms as drafted merely to lower sales prices for poor consumers falls into the category of paternalism: a nonefficient regimen whose sole justification is the protection of the welfare of certain individuals.[207] By contrast, the doctrine of reasonable expectations, which reduces information costs and decreases the likelihood of one party's unknowing assumption of risk, is easily justified on nonpaternalistic,

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most cases, $C_d < B_1 - B_2$, and the more efficient term will be utilized, despite the cost of disclosure. Even when $B_1 > B_2$, it is assumed that the default term is not irrational, and, therefore, the efficiency loss represented by $B_1 - B_2$ will not be great. When the loss is great, it will likely exceed the cost of disclosure, $C_d < B_1 - B_2$, and the more efficient term will be used.

[202] In the words of Karl Llewellyn, "Covert tools are never reliable tools." Llewellyn, *Book Review*, 52 HARV. L. REV. 700, 702 (1939). It may still be necessary, however, to resort to unconscionability to interpret and to enforce contracts where there is truly no alternative for the consumer. *See supra* note 194.

[203] Craswell, *supra* note 18, at 728.

[204] Posner & Rosenfield, *supra* note 22, at 114.

[205] *E.g.*, Epstein, *supra* note 13, at 306-08; Schwartz, *A Reexamination of Nonsubstantive Unconscionability*, 63 VA. L. REV. 1053, 1058-59 (1977).

[206] *See supra* text accompanying notes 40-41.

[207] A. KRONMAN & R. POSNER, *supra* note 13, at 254. While the discussion of paternalism by Kronman and Posner focuses on the rationale for limitations on freedom of contract, the "conflict between paternalism and economic theory," *id.* at 257, is also encountered in choosing a framework for analyzing form contracts.

economic grounds.

CONCLUSION

The principle of consumer sovereignty must be adapted to the realities of the consumer form contract. The inevitability that consumers will be ignorant of most form contract terms negates the presumption that these contracts are efficient. Efficiency requires voluntary, knowing assent. To create efficient results, the seller, as the drafter of the contract, must be motivated to disclose the existence and effect of subsidiary terms. By enforcing these terms only if they have been assented to by a knowledgeable consumer, courts will encourage disclosure by sellers. If form contracts are interpreted to include terms that the seller has led the consumer to believe were in the contract, sellers will be encouraged to avoid misleading consumers, and consumers will receive what they rationally assumed they were purchasing. Finally, if subordinate written terms to which the consumer has not knowingly assented are replaced by presumptively efficient terms, consumer form contracts will more likely approach an efficient bargain.

By applying an economics-based principle of reasonable expectations, courts can create true consumer sovereignty. Both parties to a consumer form contract will then be able to ascertain whether a proposed transaction increases their individual, and thus societal, wealth.

APPENDIX: AN EFFICIENCY PRIMER

The term "efficiency" has a meaning to the economist that differs from its plain English usage. In general, a situation is considered economically efficient if it maximizes aggregate benefits less aggregate costs.[208] Economists often use the word "utility" to describe the level of satisfaction derived from the consumption of particular goods and services.[209] Judge Posner has evaluated utility by a "wealth-maximizing" criterion, one that measures utility by consumers' "willingness to pay for goods and services."[210]

There are two main ways to evaluate whether one situation is more efficient than another. The first, called "Pareto superiority,"[211] exists when at least one person is better off after some change and none is worse off. A particular situation is "Pareto optimal" if any alteration in the allocation of benefits would lead to at least one person being worse off. It has been argued that Pareto superiority is an ethical way of allocating resources and that rational, self-interested people will consent to its use because at least one person's situation has improved but no one else has suffered.[212]

In the real world, however, it is difficult to create changes that do not injure somebody. Therefore, economists have created a second basis for evaluating efficiency, the Kaldor-Hicks criterion.[213] This criterion, also called Potential Pareto Superiority, does not require that no one be injured by a change, but merely that the aggregate gain be larger than the aggregate loss.[214] Although in

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[208] A. POLINSKY, *supra* note 4, at 7.

[209] *See* P. SAMUELSON, ECONOMICS 447 (13th ed. 1989); Schwartz & Wilde, *supra* note 17, at 633 n.5.

[210] R. POSNER, *supra* note 1, at 10-12.

[211] The standard was first proposed in V. PARETO, MANUAL OF POLITICAL ECONOMY 369-75, 451-62 (A. Schwier trans. 1971).

[212] *Id. See generally* Coleman, *supra* note 15, at 516-18 (elaborating on efficiency of Pareto judgments); Tullock, *Two Kinds of Legal Efficiency*, 8 HOFSTRA L. REV. 659, 663-64 (1980). Judge Posner states that this consent can be implied from the "absence of systematic distributive effects." Posner, *Common Law Adjudication*, *supra* note 12, at 506. It could be argued, however, that in a situation of greatly skewed income distribution, a Pareto superior move that only increased the wealth of the rich would injure the poorest by making them worse off comparatively, even though they suffered no monetary loss.

[213] This standard is derived from Kaldor, *Welfare Propositions of Economics and Interpersonal Comparisons of Utility*, 49 ECON. J. 549 (1939) and Hicks, *The Foundation of Welfare Economics*, 49 ECON. J. 696 (1939).

[214] Posner, *Common Law Adjudication*, *supra* note 12, at 491.

theory this would permit compensation to injured parties,[215] actual compensation is not required for a situation to be superior under Kaldor-Hicks.[216] Therefore, some people may well be worse off under such a regimen. Nonetheless, its use has been defended as having the implied consent of society because *ex ante* all would agree to a system whereby each change creates a net benefit to society.[217]

The Kaldor-Hicks criterion has been vigorously challenged. Because, unlike Pareto superiority, there are actual losers, evaluating the efficiency of a new situation requires comparing one party's losses with another's gains. Such "interpersonal comparisons of utility" are difficult, if not impossible.[218] Additionally, since Kaldor-Hicks would permit a situation in which a few suffer catastrophic loss to create a small benefit for many, it is not self-evident that, even *ex ante* when the losers were unknown, all would consent simply because the total gain was greater than the total loss.[219]

Similar questions are raised about whether efficiency is at all a proper goal for the legal system. A chief complaint is that the focus on an individual's "willingness to pay" to achieve some perceived gain or to avoid some perceived risk underestimates the effects of the initial distribution of wealth. For example, the poor, with less money to pay, may be willing to pay all that they have, but they will still appear to value something less than wealthy people who are willing to pay a larger sum that represents only a tiny portion

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[215] Thus, the Kaldor-Hicks criterion is essentially the same as wealth-maximization. *See id.*; *see also supra* notes 12-16 and accompanying text. Accordingly, some have argued that the discussion of efficiency and the law would be clearer if the noneconomic sounding term "efficiency" were replaced with the more intuitively definable "wealth-maximization." Michelman, *A Comment on* SOME USES AND ABUSES OF ECONOMICS IN LAW, 46 U. CHI. L. REV. 307, 309 n.9 (1979).

[216] Coleman, *supra* note 15, at 513.

[217] Posner, *Common Law Adjudication*, *supra* note 12, at 491-94.

[218] Dworkin, *Why Efficiency?*, 8 HOFSTRA L. REV. 563, 582-83 (1980); *see also* Coleman, *supra* note 15, at 519 (stating that process of determining whether one group's aggregate gain exceeds another's aggregate loss may reveal inconsistent preferences regarding social states and thus render Kaldor-Hicks "paradoxical as a standard of utility").

[219] *See* Dworkin, *supra* note 218, at 578 (terming such consent "counterfactual"). There are two reasons a rational person might object to such a system. First, a risk-averse person would rather avoid the chance of suffering the large loss, even though it is more likely he would realize a small gain. Second, one might reject as unfair the catastrophic loss to innocent parties, particularly where the benefit to others is small.

of their wealth.[220] Thus, basing a system on willingness to pay ("offer price"), rather than the price at which one would be willing to sell ("asking price"), biases the analysis against the poor.[221] Similarly, when only net societal gain or loss is considered, the starting points of societal members are disregarded.[222] In other words, a change that would lift many out of poverty while causing monetary loss to the wealthy may be rejected solely because the poor would not gain as much as the rich would lose, even though more people might be helped than hurt and even though the percentage increase in wealth for the poor people would far exceed the percentage of wealth lost by the rich.[223]

Others have criticized reliance on efficiency because it fails to consider factors that are not monetary in nature. If a moral precept does not have a monetary value, it is not included in the equation.[224] One proposed solution is to consider concepts such as justice or fairness as "veto points," so as to require that legal rules not only be efficient but also just.[225]

Many proponents of the economic analysis of the law respond that considerations such as distributive justice or fairness are inherently subjective and uncertain.[226] By contrast, economic efficiency is defended as not only an "ethically attractive" goal, but,

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[220] Economists use the phrase "wealth effects" to describe the impact of initial wealth on value estimations as reflected in the amount an individual is willing to pay to achieve some desired result. Thus, while a poor person may not be able to afford to pay much to avoid a loss, he might demand a substantially higher sum before he would willingly consent to bear the loss. A. POLINSKY, *supra* note 4, at 124-25; Bebchuk, *The Pursuit of a Bigger Pie: Can Everyone Expect A Bigger Slice?*, 8 HOFSTRA L. REV. 671, 679-80 (1980).

[221] Bebchuck, *supra* note 220, at 680.

[222] It has been argued, however, that the proper application of principles of law and economics does not require acceptance of the current societal distribution of wealth and property. For an insightful discussion of the "reformist law and economics," see Rose-Ackerman, *Progressive Law and Economics—And the New Administrative Law*, 98 YALE L.J. 341 (1988).

[223] *See* Michelman, *supra* note 215, at 311 (describing wealth-maximization as "oblivious to distributive justice").

[224] Rizzo, *supra* note 9, at 641-46. Rizzo adds that if one includes noneconomic "moralism" by assigning it a hypothetical monetary value, then the resulting economic analysis will be "nonfalsifiable," and, thus, meaningless. *Id.* at 646-67.

[225] Calabresi, *About Law and Economics: A Letter to Ronald Dworkin*, 8 HOFSTRA L. REV. 553, 557-78 (1980).

[226] Posner, *Uses and Abuses*, *supra* note 5, at 292; *see also* Posner & Rosenfield, *supra* note 22, at 87 (criticizing judicial decisions based on "amorphous, ad hoc concepts [such] as fairness, equity and justice").

perhaps more important, "objective" as well.[227]

One need not resolve the debate over the ethical basis for an economic analysis of law to find it useful to evaluate legal rules in terms of their economic efficiency. Even if efficiency should not be the only goal of law, it represents an "important, if not necessarily paramount, value."[228]

Additionally, there is strong evidence that economic theory can help explain the development of the common law.[229] Thus, a positive, as opposed to normative, use of economic analysis exists to explain what the law is, even if one chooses not to use economics to explore what the law should be.[230]

Finally, economic analysis of the law can provide valuable insights for the lawyer. Areas of the law previously perceived as unrelated sometimes prove to be quite similar when they relate to certain economic principles in a similar manner.[231] Indeed, this "unifying perspective,"[232] which helps the lawyer see new analogies and garner solutions from a wider variety of legal situations, may prove to be a use for the economic analysis of law that is beyond ideological contention.

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[227] Posner, *Common Law Adjudication, supra* note 12, at 487. According to one commentator, this argument implies that wealth maximization may be the only "socially uncontested" value. Michelman, *supra* note 215, at 313.

[228] R. POSNER, *supra* note 1, at 17. Indeed, as Judge Posner has argued, even if it cannot be proved that economics is the best source of legal analysis, once one accepts that economics helps measure costs relevant to policy decisions, it follows that economic analysis has some role in the debate on legal issues. Posner, *Uses and Abuses, supra* note 5, at 287.

[229] R. POSNER, *supra* note 1, at 404-07. The tendency of common law to reach efficient solutions has been attributed not to a conscious preference by judges but to the greater likelihood of litigation arising from inefficient rules. *See id.* at 439-40; Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65, 67-75 (1977); Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977). Professor Rubin contends, however, that in situations where only one party has a long-term interest in the resolution of a dispute, that party will be likely to prevail eventually, even if the resolution is inefficient. *Id.* at 56. Because the costs of litigation are certain while the outcome is frequently in doubt, only the party with a long-term interest will have an economic incentive to keep litigating an issue until a favorable precedent is established. *Id.*

Unlike the development of common law, the development of legislation is presumed to tend towards inefficiency, in part because compact interest groups can usually outbid diffuse ones for governmental benefits and assistance. Posner, *Common Law Adjudication, supra* note 12, at 503.

[230] Posner, *Uses and Abuses, supra* note 5, at 285. The purpose of positive analysis is to understand the world as it is, not improve it. *Id.* at 287.

[231] *See, e.g.*, Kornhauser, *supra* note 9, at 637 (stating that economics permits lawyers to see things like automobile accidents as "externalities," and thus similar, for example, to problems like pollution); Posner & Rosenfield, *supra* note 22, at 118 (stating that same economics framework can be used to clarify many different areas of contract law).

[232] Kornhauser, *supra* note 9, at 638.