

Standard Form Contracts

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To appear in the *New Palgrave Dictionary of Economics and the Law* (The MacMillan Press, forthcoming 1998), Peter Newman, ed.

Preliminary draft, March 5, 1997
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Abstract: Among legal commentators, standard form contracts have long been received with distrust, and the rules governing their interpretation have engendered considerable controversy. While economic analysis has little to say regarding the libertarian objection to standard form contracts or their relationship to personal autonomy, it can help evaluate their effects on efficiency and the distribution of the gains from trade. From such a perspective, standard forms should be analyzed like any other productive input, comparable to design, marketing, and technical support. Whether their use raises any special regulatory or policy concerns, therefore, depends on their implications for the standard litany of market failures: scale economies, monopoly, externalities, imperfect information, and the like. This essay surveys and discusses such implications, concluding that a measure of special legal treatment for form contracts is appropriate on economic grounds.

I. INTRODUCTION

Standard form contracts are an inevitable by-product of a mass production economy. Just as fixed costs and scale economies in production lead manufacturers to develop standardized goods, those regularly engaged in business find it advantageous to standardize the terms on which they conduct exchange, because this saves the expense of negotiating arrangements for each individual transaction. Among legal commentators, however, form contracts have long been received with distrust, and the rules governing their interpretation have engendered considerable controversy.

The main reasons for such distrust are twofold. First, most persons presented with standardized forms do not bother to familiarize themselves with the specific contents, relying instead on the drafter's reputation and on the knowledge that other contracting parties regularly do business on like terms; this reaction is reinforced by the fact that form contracts typically contain abstruse language and are printed in small type. None of these observations fits well with traditional justifications for legal enforcement of contracts based on voluntary and knowing consent. Second, because the advantages of form contracts would be lost if bargains were open to routine renegotiation, their users are often unwilling to do business on other than standard terms. This take-it-or-leave-it aspect of standard forms has seemed to many lawyers to give the drafting party an inequitable degree of control over the bargaining process. Indeed, since Kessler (1943), standard forms have commonly been disparaged as "contracts of adhesion," and associated by both courts (e.g., *Henningsen v. Bloomfield Motors*) and legal commentators (e.g., Kessler 1943, Rakoff 1983) with monopoly and market power.

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II. MONOPOLY AND ECONOMIES OF SCALE

The popular association of standard form contracts with market power in legal circles and the related claim that they are thus likely to contain suboptimal terms are not well founded. Such arguments are based on two misconceptions. First, the use of standard forms need not indicate market power. Because standardization, like other types of mass production, lowers the per-unit cost of contracting, competitive firms as well as monopolists have an incentive to use it. Indeed, standardized contracts are widely used in many industries conservative and liberal economists would agree are workably competitive. Even the fact that competing firms offer similar terms is no evidence of collusion (contrary to the supposition of the *Henningsen* court), since such a congruence would be also observed in perfectly competitive markets.

Second and more importantly, the suggestion that a monopolist would want to offer lower-quality contract terms than a competitive firm depends upon a mistaken analogy between quantity and quality. The reason a monopolist finds it profitable to produce an inefficiently low quantity of goods is that by doing so, it forces consumers to compete against each other for the reduced supply, bidding up the price. If the monopolist tries to reduce quality, in contrast, whether of contract terms or of the underlying goods, it lowers the amount consumers are willing to pay. As Spence (1975) has demonstrated (see Comanor 1985, Craswell 1991 for legally oriented expositions) a profit-seeking monopolist will thus want to choose the level of product quality that best suits the preferences of the marginal consumer, for this maximizes the markup he can charge. If all consumers have the same willingness to pay for quality, the monopolist will do best to provide a product with socially optimal quality and to extract available profits through a high price. Only if the tastes of the marginal consumer are unrepresentative of others who buy will suboptimal quality be offered. Indeed, if willingness to pay for quality is positively correlated with willingness to pay for the underlying good (as will be the case when quality and the good itself are both normal goods), the quality of monopolistically supplied goods will be too high from the viewpoint of efficiency, not too low.

Similarly, while critics of form contracts have expressed concern that oligopolists might use standard forms to collude on non-price terms, cartel profits are ordinarily maximized by choosing optimal quality. The proper question to ask in the oligopoly setting, rather, is whether standard forms hinder price competition. Antitrust lawyers are appropriately wary of agreements among competitors not to compete on non-price terms, since such agreements and the institutions set up to enforce them can make it easier secretly to engage in price-fixing. Since standard forms do not require substantial ongoing communication among their users, however, and since price is typically one of the few terms they leave open for bargaining, they do not raise the same risks as do explicit non-competition agreements. Furthermore, to the extent that standard forms facilitate comparison shopping on consumers' part, they may increase the intensity of price competition (though the inability to disguise price cuts by making them under non-price cover could strengthen cartels by making it more difficult for individual members to defect without detection.)

A potentially more serious antitrust problem is that incumbent firms may have an incentive to

distort standard contract terms in order to raise barriers to potential competition. This could result in provisions that provide too much quality from a short-run perspective, such as generous return or repair policies that require entrants to maintain a vast inventory and expensive service department in order to break into the market. The danger here is analogous to that arising from product tying (Adams and Yellen 1976, Whinston 1990). Alternatively, it could result in too little quality as measured by the parties' formal legal rights, as in the case of liability disclaimers that increase buyers' reliance on seller reputation, which a newcomer cannot match. This is also a form of tying, since it effectively brings dispute resolution services in-house, forcing buyers to purchase them from the seller. Its success in deterring entry will depend on entrants' abilities to develop and market contracts of their own, and to get those contracts enforced in the public legal system.

A more fundamental link between market structure and form contracts arises from the scale economies that motivate standard forms in the first place. Because of the fixed costs associated with developing and marketing new forms, not all contractual terms will be offered in an unregulated market. The same is true of the underlying goods being sold, of course, since some market niches are too small to be profitably served. Thus, at least some consumers with different tastes for quality (and for contractual terms) will find themselves buying a single undifferentiated product from the same seller. In such a context, the proper regulatory question is whether the market provides the right number and selection of contractual products.

From an efficiency standpoint, a new product should be introduced if and only if the additional consumer surplus it generates justifies the extra costs of production, which include both the costs of the new product itself and any additional costs incurred by reducing the market for existing products. A monopolist able to engage in perfect price discrimination and having control over all possible substitutes, accordingly, would always provide an optimal selection of products, but firms unable to capture the full increment of consumer surplus may not. As Spence (1976) and Dixit and Stiglitz (1977) demonstrated, how close actual markets come to the optimum depends on the curvature of demand and cost curves, the degree of substitutability among competing brands, the feasibility of nonlinear pricing, and market structure.

In principle, then, government regulation of form contracts, by influencing the variety of terms offered, could improve market efficiency or redistribute welfare between marginal and inframarginal consumers. In order for the state to do a better job than the market in choosing products, however, it would either have to have access to superior information regarding inframarginal consumer preferences or be better able to bring purchasing power to bear on their behalf. The former possibility seems unlikely, and the latter would probably be best effectuated not by regulation, but by a direct subsidy to whatever product lines or terms are deemed to be underprovided. Such a subsidy would also be the most direct way to redistribute in favor of whatever inframarginal or distinct consumer groups were considered worthy of state support (for example, those with special needs due to physical disability).

III. EXTERNALITIES AND PUBLIC GOODS

A second and related reason why unregulated markets might produce a suboptimal variety of contract terms is externality. Indeed, the product selection problem discussed in the previous section

can be recast as an externality, in that competitors' sales are reduced when a firm introduces a new product. Because monopolistic competitors set price above marginal cost, this is a real and not just a pecuniary externality; the amount that consumers would pay to switch from one product to another does not properly reflect marginal social benefit.

Additionally, standard form contracts generate a classic network externality, in that the value of a particular contractual form tends to vary directly with the number of its users. As Klausner (1995) has argued in the context of corporate charters, the less familiar a contractual term, the harder it is to predict how courts and third parties will interpret and react to it, not to mention how the contracting parties themselves will understand it. Accordingly, rational contractors have an incentive to adopt customary forms in order to save on costs of legal advice, accounting services, and third-party financing. Anyone who chooses a familiar form, or who invests in expertise relating to its use, thus confers a positive benefit on others who use that form and a negative externality on those who use other forms.

These externalities are exacerbated by the fact that contractual innovations are public goods. Like information generally, they are nonrival in use and largely nonexcludable from those who wish to copy them without payment. Prevailing regimes of intellectual property, furthermore, do not accord them much legal protection; while the particular form in which a contract term is expressed can be copyrighted under U.S. law, for instance, the underlying substance cannot. As a result, innovation in form contracts is likely to be inefficiently undersupplied.

Such factors suggest a legitimate role for the state in encouraging the creation and development of contractual forms. One way to do this would be to lessen doctrinal barriers that currently raise the costs of writing and enforcing forms, but these rules are also needed to cope with problems of fraud and asymmetric information in contracting (see the next section, *infra*). Another approach would be to grant form contracts stronger intellectual property protection, though the proper scope of such protection in the presence of network externalities is currently a matter of controversy. And a third would be for the government to supply such forms itself, through the promulgation of default rules of interpretation and legal terms of art. This last approach has substantially influenced the U.S. drafters of the Uniform Commercial Code. For instance, UCC § 2-205 provides a formal method for merchants to make irrevocable offers to buy or sell goods without consideration; §§ 1-201(3), 1-205 and 2-208 provide that the parties' agreement is to be read as incorporating course of dealing, course of performance, and usage of trade; and §§ 2-316 and 2-319 establish explicit verbal formulas for disclaiming warranties and allocating the risk of loss for goods in transit.

Whether judicial or statutory provision of contractual forms actually increases the variety of terms available on the market, however, is an open empirical question. As Goetz and Scott (1985) have argued, the availability of the U.C.C.'s "off-the-rack" default terms may deter private parties from trying to formulate terms of their own; and if the goods produced by private parties are better suited to their needs than those supplied by the state, the net effect could be to reduce efficiency. Such an effect, if it exists, would be a special case of the more general phenomenon (Bergstrom et al. 1986, Andreoni 1988) whereby government provision of public goods can crowd out private provision of those same goods. Indeed, such crowding out could, in the limit, entirely neutralize the effects of government action, though this is a polar case depending on special assumptions. It seems likely, rather, that there is at least some room for state-supplied contract terms to improve market efficiency,

since the public-good nature of authoritative legal pronouncements is presumably the chief justification for government enforcement of contracts in the first place.

IV. ASYMMETRIC INFORMATION

Perhaps the most plausible rationale for government regulation of standard form contracts, and the one most closely corresponding to traditional legal objections to their use, is asymmetric information. As is well known, market equilibrium is inefficient when transacting parties are differentially informed regarding the value of the good being exchanged. In the “lemons” model of Akerlof (1970), for instance, where sellers know the precise quality of their product and buyers know only the average quality of all goods being sold, low-quality goods tend to drive high-quality goods off the market. This is because in the absence of special information, a typical buyer will assume she is dealing with an average-quality seller and will pay no more than her reservation price for average-quality goods. Sellers of high-quality goods, therefore, will be unable to recover their costs. The lemons model applies quite straightforwardly to the case of form contracts, since such contracts vary substantially in their terms and the drafting party (effectively, the “seller” of the contract) knows much more about those terms than the nondrafting party.

Actual markets have developed a variety of methods for addressing the lemons problem, including most prominently the contractual warranty (Grossman 1981), under which a seller undertakes to reimburse losses resulting from low quality. But warranties and analogous promises only work to the extent the parties communicate about them; and in the form contract setting the effective cost of communication is often high. One approach to this problem is to reduce the degree of asymmetric information by making it harder for drafters to include self-serving terms; the doctrine of unconscionability and the maxim that contracts are to be construed against the drafter take this tack. Another is to deny enforcement of certain terms thought problematic unless the drafter has incurred the cost of calling such terms to the other party’s attention. For instance, Article 2 of the U.C.C. requires that warranty disclaimers be “conspicuous” (§ 2–316) and that form-contract terms barring oral modifications be “separately signed” (§ 2–209). Such rules can be thought of as “penalty defaults” (Ayres and Gertner 1989, 1992), putting the burden of communication on the party who can undertake it most cheaply.

So long as buyers of form contracts face any communication costs whatsoever, however (and even when a strange term is called to one’s attention it is usually still necessary to spend time and effort assessing its import), such penalty default rules will be less than fully effective. The reason is that the buyer’s investigation expenditure is a relation-specific investment subject to expropriation by the seller (Katz 1990a, 1990b). Specifically, the buyer must decide whether to invest resources evaluating a standardized form before she knows its terms. Because her costs of becoming informed are sunk once incurred, she can wind up in a situation where she just barely wants to accept, but wishes she had not bothered to become informed. The seller’s optimal course of action, furthermore, is to choose terms that place the buyer in precisely this situation. Since the buyer can anticipate this turn of events, she prefers not to read in the first place. (The argument extends to situations in which buyers attach different levels of importance to quality, as buyers who value quality the highest will find that it is not worthwhile to read, but then the seller will want to reduce quality to the reservation level of the next-most-sensitive buyers, and so on.) In equilibrium, therefore, buyers will not read,

sellers will offer the lowest possible quality terms, and buyers will refuse to pay more than fly-by-night prices. While the last two results may be moderated in actual markets by sellers' concerns for reputation (Klein and Leffler 1981, Baird and Weisberg 1982), the first is consistent with empirical behavior.

A legal rule that imposes a duty to read on the buyer makes no difference to this logic. While sellers might wish to offer higher quality contracts at higher prices, they have no means to commit themselves to doing so, since they can always act opportunistically by sneaking disclaimers into the fine print. Rules providing implied warranties and refusing to give effect to fine-print terms, however, can improve the efficiency of exchange by restricting the scope for such opportunism.

Such a conclusion of course depends on regulators' ability to set the implied and unenforceable terms correctly; if warranties are set too high, the result could be worse than *laissez-faire*. So long as state-set terms are on average more efficient than the quality levels that would be set in an unregulated market, however, and so long as there is a cheap way to contract around the legal default, implied warranties will likely improve the functioning of the market. U.S. warranty law under the U.C.C. arguably approximates such a policy in non-consumer settings, combining an implied warranty of merchantability defined by ordinary market expectations with reasonably straightforward requirements for disclaimer. The practical difficulties of predicting when courts will find a breach of warranty in specific cases and the substantial quantity of litigation arising as a result, however, leaves this conclusion open to objection. In the consumer area, in contrast, public policy has been for the most part less controversial, even though under federal law (e.g., the Magnuson-Moss Warranty Act and regulations promulgated under its authority) most consumer warranties are not disclaimable. This is due to the fact that the lemons problem is worsened in consumer markets by the higher degree of asymmetric information and by consumers' relatively lesser sophistication and access to legal assistance.

V. CONCLUSION

Standard form contracts arise from technological features of the world that depart from the neoclassical model of perfect competition as well as from the classical model of contract. Thus, one should expect some inefficiencies to arise from their use, at least in the first-best sense that the price of goods or of particular contract terms diverges from marginal cost. Whether standard forms benefit contracting parties overall, however, is a problem of the second best, depending upon whether these inefficiencies are outweighed by the savings they bring to the process of exchange. And as with product standardization more generally, they almost certainly are. No modern commentator proposes a return to a classical regime based on individualized bargaining. Rather, the relevant policy question is whether state regulation of form contracts can improve on the unregulated market.

The empirical factor most relevant to answering this question is the extent and effectiveness of reputation. If reputational concerns lead drafters of forms to moderate their opportunism, regulation may be largely unnecessary. But in markets where reputation is insufficient to address the lemons problem—where purchase is infrequent, parties are isolated, and sellers can easily discriminate between sophisticated and unsophisticated buyers—state intervention can lower the efficiency costs

of form contracts, making them more useful to sellers and buyers alike. Thus, a measure of special legal treatment for standard form contracts is appropriate on economic grounds.

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