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"Contracting" for Credit

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INTRODUCTION

On a recent day, I used my credit cards in connection with a number of minor transactions. I made eight purchases, and I paid two credit card bills. I also discarded (without opening) three solicitations for new cards, balance transfer programs, or other similar offers to extend credit via a credit card. Statistics suggest that I am not atypical. U.S. consumers last year used credit cards in about 100 purchasing transactions per capita, with an average value of about $70. At the end of the year, Americans owed nearly $500 billion dollars, in the range of $1,800 for every man, woman, and child in the population.[1] Although the individual credit card transaction is small and routine, the transactions collectively have a significant effect on the overall stability of many American families, leading to a rise in consumer borrowing and an

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1. *See* THE NILSON REPORT No. 828, at 9 (Feb. 2005).

increase in bankruptcy filing rates.[2] The crux of the borrowing problem is the relationship between the cardholder and the issuer, which the law relegates almost entirely to the private contractual relationships between those groups. Yet the existing literature has done little to assess the unique contracting problems that those transactions present.

That is not to say that scholars have overlooked credit cards. On the contrary, some scholars have noticed the lengthy fine-print agreements that issuers tender to their cardholders. Thus, credit cards have become a common topic in the boilerplate literature that culminates in the symposium for which this Article is prepared.[3] The branch of that literature focused on consumer contracts explores the extent to which voluminous terms in adhesion contracts become enforceable without the type of voluntary and informed assent on which the paradigm of contract law rests.[4] At the same time, other scholars have become increasingly concerned about the likelihood that cognitive and behavioral limitations restrict the ability of consumers to evaluate borrowing transactions effectively.[5]

Credit card contracts directly implicate both of those literatures because the contracts are complex both in their literal form and in their economic substance. Two features of the context make credit card contracting more problematic than other consumer credit transactions. The first—suggested by the description of my account activity—is that credit cards have their effect in a large number of small transactions, each of which is so insignificant as to make careful consideration and calculating reflection impractical. Second, and more fundamentally, the transactions occur over an extended period, during which the business conditions that confront the issuer are likely to change. What that means is that the terms on which the issuer extends credit and seeks repayment will need to change over time. Because it is not cost-effective to engage in a separate contracting ritual for each purchase, the result in practice is a set of terms that are defined by the issuer and changed with surprising frequency (often without meaningful notice to the user). To understand the difference, consider a home mortgage transaction. If a consumer makes a mistake in a home mortgage transaction, the

2. *See* RONALD J. MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS AROUND THE WORLD chs. 4–5 (forthcoming 2006).

3. *See, e.g.*, Clayton P. Gillette, *Rolling Contracts as an Agency Problem*, 2004 WIS. L. REV. 679, 716–17; James J. White, *Autistic Contracts*, 45 WAYNE L. REV. 1693, 1700–01 (2000).

4. *See* Gillette, *supra* note 3, at 688; Robert A. Hillman & Jeffrey J. Rachlinski, *Standard-Form Contracting in the Electronic Age*, 77 N.Y.U. L. REV. 429 (2002).

5. *See* Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373 (2004); Susan Block-Lieb & Edward Janger, *The Myth of the Rational Borrower: Rationality, Behaviorism, and the Misguided "Reform" of Bankruptcy Law*, 84 TEX. L. REV. (forthcoming 2006), *available at* http://ssrn.com/abstract=786427; Ron Harris & Adu Einat Albin, *Bankruptcy Policy in Light of Persuasion in Credit Advertisement*, 7 J. THEORETICAL INQUIRIES IN L. (forthcoming 2006); Cass R. Sunstein, *Boundedly Rational Borrowing: A Consumer's Guide*, 73 U. CHI. L. REV. (forthcoming 2006), *available at* http://ssrn.com/abstract=772186; Lauren E. Willis, *Decisionmaking & The Limits of Disclosure: The Problem of Predatory Lending* (Loyola-LA Legal Studies Research Paper No. 2005-14, 2005), *available at* http://ssrn.com/abstract=748286.

consumer does so when she signs the documents, a point on which all of the financial considerations of the relation turn.

A striking aspect of credit card contracts, however, is the comparative lack of regulation. Other similarly important consumer financial transactions—like the home mortgage transaction and even the purchase of insurance—display a common historical pattern, in which regulators or intermediaries have stepped in to standardize terms in a way that focuses competition on the attributes of products that are most readily comprehensible to consumers. Those different regulatory approaches are provocative.

The Essay begins in Part I with a summary of the problems presented by standardized terms in consumer transactions. Part II describes the contracting practices that dominate the modern credit card industry. I argue that sophisticated card issuers have learned to exploit the boilerplate features of their agreements to produce a set of dynamic contracting obligations that even sophisticated cardholders could not understand. Finally, Part III analyzes several potential responses. First, I briefly explain my thoughts on several proposals mentioned in the literature. In general, those proposals are designed to improve consumer decisionmaking without limiting consumer choice. I generally conclude that those proposals are not likely to be effective. Then, I discuss choice-limiting responses that have been used effectively in other consumer finance contexts. I argue in favor of prohibiting terms that alter the consequences of borrowing *after the fact*. Those terms make it very difficult for consumers to take account of the borrowing costs at the time of their purchasing and borrowing decisions. More broadly, I propose a centrally promulgated set of standardized terms that would leave businesses free to compete on the key financial terms that consumers are most likely to understand.

I. PROBLEMS WITH BOILERPLATE

Standardized contracts challenge the notion of informed consent upon which a market economy depends. Yet all seem to agree that they are inevitable, because of the lower transaction costs associated with drafting, bargaining, and allocating risks in a uniform way[6] and because standardized contracts allow large organizations to control the contracts to which their agents bind them.[7]

I begin by detailing a familiar litany of problems attributed to standardized contracts. Because those problems rest on debatable empirical or experimental premises, it is difficult to generalize about their effect on actual contracting

6. *See* Richard Craswell, *Property Rules and Liability Rules in Unconscionability and Related Doctrines*, 60 U. CHI. L. REV. 1, 50–51 (1993); Todd D. Rakoff, *Contracts of Adhesion: An Essay In Reconstruction*, 96 HARV. L. REV. 1174 (1983); W. David Slawson, *Standard Form Contracts and Democratic Control of Lawmaking Power*, 84 HARV. L. REV. 529, 531 (1971).

7. *See* Arthur Allen Leff, *Contract as Thing*, 19 AM. U. L. REV. 131, 144 (1970); Stewart Macaulay, *Private Legislation and the Duty to Read—Business Run by IBM Machine, the Law of Contracts and Credit Cards*, 19 VAND. L. REV. 1051, 1058–60 (1966); Rakoff, *supra* note 6, at 1220–25.

practices. Nevertheless, most would agree that some of these problems are likely to affect some people at least some of the time.

A. *Assent*

Some of the most prominent questions in recent case law relate to the contracting process, with a general focus on the robustness of the consumer's assent. With standardized contracts, it often is hard to know which documents compose the contract or when the contract is formed. A written contract might refer to or incorporate other policies that may or may not be presented at the same time,[8] but are likely to have been written by a different person at a different time. The terms might be presented in such a way that the consumer does not necessarily have to see them to enter the contract. For example, with the so-called browsewrap contracts that are used for website terms of use, a website user might be held to accept the terms by using the site even if the user does not actually locate and read the terms.[9] There is a similar problem with terms presented by hyperlink, or perhaps in a scrollable screen or pop-up screen.[10] Another possibility is that the terms are presented after the consumer has invested time or money in the transaction,[11] as is often the case with "pay-now terms-later" contracts that are common for insurance policies,[12] tickets,[13] and packaged consumer products.[14]

8. An obvious example is the airline ticket, which might incorporate by reference provisions on limitation on liability, claim restrictions, rights of the carrier to change terms, rules about reservations, and covenants regarding the air carrier's schedule. The full text of the terms must be available at the airport and city ticket office of the airline, and provided by mail or other delivery service. *See* 49 U.S.C. § 41707 (2000); 14 C.F.R. § 253.5 (2005).

9. Consider the website for Amazon.com. Scrolling to the bottom of the entry screen, you see hyperlinks for "Conditions of Use" (a 70-paragraph, 2400-word document) and "Privacy Notice" (a 5-paragraph, 2400-word document). Although those policies purport to bind anyone who visits the site, someone who orders a product will eventually come to a "Place Order" screen that states that "[b]y placing your order, you agree to Amazon.com's privacy notice and conditions of use." The contract of purchase is not complete until Amazon.com sends an e-mail verifying shipment.

10. *E.g.*, Hubbert v. Dell Corp., No. 5-03-0643, 2005 WL 1968774 (Ill. App. Ct. Aug. 12, 2005).

11. Credit card account agreements raise this concern to the extent that consumers cannot choose an issuer based on the issuer's card agreement without investing the time to open an account. If those agreements were readily available over the Internet (something I advocate below), this might change, because cardholders would be better able to select credit card issuers based on comparing information available to them on the Internet. Of course, credit card agreements then might raise the other presentation problems that presently plague e-commerce transactions.

12. *See* Edwin W. Patterson, *The Delivery of a Life-Insurance Policy*, 33 HARV. L. REV. 198 (1917) (noting that policies are often delivered after the customer has spent time to complete and file an application); W. David Slawson, *The New Meaning of Contract: The Transformation of Contracts Law by Standard Forms*, 46 U. PITT. L. REV. 21, 39 (1984) (same).

13. Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 600 (1991) (Stevens, J., dissenting) (decrying the Court's enforcement of exculpatory boilerplate language in a cruise ticket provided after the ticket was purchased, at which point the average passenger would accept the risk of injury rather than risk cancelling a planned vacation at the last minute).

14. Brower v. Gateway 2000, Inc., 676 N.Y.S.2d 569 (App. Div. 1998) (computer equipment shipped with terms in box, at which point customer has incurred shipping costs and search costs); Rogers v. Dell Computer Corp., No. 99,991, 2005 WL 1519233 (Okla. June 28, 2005) (same).

Finally, and of particular import for my project, the contract may be subject to unilateral modification by the drafter. Even where bilateral modification is required due to regulatory constraint or the drafter's failure to reserve the unfettered right to amend, acceptance may be established by notice and continued performance.[15] For continuing contracts, the notion of assent can be illusory. If the notice is not readable or is presented in a way that does not reach the consumer in an effective way, the consumer might not be aware of the modified terms. Similarly, even a consumer that reads the notice might be unable or disinclined to comply with an available opt-out right.

B. *Readability*

A second set of concerns, assuming that the consumer in fact has seen the relevant documents, falls under the heading of readability. Is the font size too small? Is the agreement too long? Is it written in a language that the consumer can understand? Does it use jargon that obscures the plain meaning of the words? Does the lack of tailoring to the transaction mean that large parts of the agreement do not apply? Does the agreement fit the actual transaction?

The severity of readability problems depends on the nature of the transaction. The example often used to illustrate this point is the rental car contract. Consider the eight-page, foldout rental car agreement, with very small print and loaded with complex terminology, many of the terms of which would apply only to subsets of customers selecting particular service packages. This document is likely to be functionally unreadable, especially when it is presented for the first time at the counter, to a customer who has just completed a lengthy plane flight, perhaps accompanied by a number of small children, often late at night, and generally with numerous other people waiting in line in the same tiny office space. Aside from the circumstances of presentation, the reality is that the typical consumer contract requires a level of literacy and reading comprehension that is far beyond the grasp of the normal American.[16]

Yet, would it be more readable if it were twelve pages of larger print or if it were sixteen pages of twelve-point type with clearer definitions? Would it make more sense if the counterperson had a higher level of education or training and were able to choose one of several different contracts that more accurately described the circumstances of the transaction? As Macaulay teaches us, a decision to enforce such contracts as written cannot rest on the idea that a man is bound to a written contract because he has chosen to accept

15. *See* Boomer v. AT&T Corp., 309 F.3d 404 (7th Cir. 2002) (holding that there was acceptance of contract with long distance carrier established by customer's continued use of services after receiving customer agreement).

16. See Alan M. White & Cathy Lesser Mansfield, *Literacy and Contract*, 13 STAN. L. & POL'Y REV. 233, 235–41 (2002) (discussing incomprehensibility of financial disclosures).

its terms.[17] Yet, if we would not enforce a contract written in lemon juice (legible to the sophisticate with a candle),[18] where do we draw the line to permit enforcement of a contract where the type is legible? Is six-point type big enough? What about three-point type? Surely, the answer must have something to do with the substance of the form and the business conditions that motivate the way in which it is presented.

Readability problems are not traditionally within the purview of the basic doctrinal tools of contract law, except to the extent that they render the contract unconscionable.[19] Rather, responses have come from a variety of ad hoc quasi-regulatory consumer protection initiatives. For example, font-size requirements apply in certain types of transactions.[20] A number of states have plain-language initiatives that require approval of forms by some centralized agency.[21] In addition, there are often requirements that certain types of contracts be written in the language in which the transaction proceeded.[22] Only occasionally is there any comprehensive effort to respond to readability concerns.[23]

C. *Fragmentary Contracts*

Another basic aspect of the standardized form is that the written document need not contain all, or even most of, the terms of the transaction. Thus, in many of the most common examples of standardized terms, the document captures only a few of the relevant terms. For example, an event ticket might include only the date and time of the event and (on the back in smaller type) a detailed exculpatory clause protecting the exhibitor. A warranty typically will describe the product features (and perhaps what the manufacturer does not promise in regards to the product) but omit the terms of the sales transaction. Similarly, a typical sales receipt might note the date

17. *See* Macaulay, *supra* note 7, at 1051, 1080–81. Rakoff makes the same point: "The traditional treatment requires that adherents to form contracts be treated as if they had read and understood the document presented to them, even if that conclusion is false and known by the other party to be so." Rakoff, *supra* note 6, at 1187.

18. The example is Macaulay's. Macaulay, *supra* note 7, at 1056.

19. *See* Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 600 (1991) (Stevens, J., dissenting) (criticizing the Court's enforcement of choice-of-forum clause in the fine print on the back of a ticket that only the "most meticulous passenger" would have seen).

20. *E.g.*, 16 C.F.R. § 433.2(a) (2005) (holder-in-due-course notice in consumer credit transactions).

21. *See* 7 TEX. ADMIN. CODE §§ 1.1201–1.1247 (2005) ("Plain Language Contract Provisions" for Texas consumer credit transactions); TEX. FIN. CODE § 341.502 (2004) (requiring specified types of consumer loans, "whether in English or Spanish, [to] be written in plain language designed to be easily understood by the average consumer" and requiring creditors to use either administratively drafted models or contracts previously approved by the finance commission); White & Mansfield, *supra* note 16, at 260.

22. *See, e.g.*, 7 TEX. ADMIN. CODE § 5.1(c)(5) (2005) (requiring Spanish translation of home loan notices "if the transaction is conducted primarily in Spanish").

23. *See* N.J. LAW REVISION COMM'N, FINAL REPORT RELATING TO STANDARD FORM CONTRACTS (1998), *available at* http://www.lawrev.state.nj.us/rpts/contract.pdf.

and time of the transaction and the price and tax paid, but omit any discussion of the return policy.

Fragmentation often occurs in areas in which the law might require a specific term to be included in a contract. Thus, for example, we might see a fine-print document that includes little more than rules purporting to limit the consumer's right to sue, either substantively (through disclaimers of warranties) or procedurally (through choice-of-law, choice-of-forum, or arbitration provisions).[24] Still, fragmentation occurs even in lengthy boilerplate agreements. For example, consider a case in which the drafter might benefit from including some terms in writing, such as an arbitration clause or a choice-of-forum clause. If the drafter has little incentive to define other relevant terms in writing, even a lengthy standardized agreement might not memorialize all of the terms of the transaction.[25]

D. *Choice*

The preceding sections deal with how readily the consumer can learn the terms of the arrangement before the consumer chooses to enter a transaction with the drafter. From an economic perspective, it is that point—the moment of choice—that is significant. We value contracts in a free market economy largely because they facilitate decentralized and informed decisionmaking about the allocation of resources in the economy.[26] However, that judgment only makes sense when the parties not only are aware of the risks and opportunities of their transactions, but also evaluate those risks in a rational way in making the choice to transact.[27]

In the world of standardized terms and contracts, the range of choice is quite narrow. Negotiation is typically not an option. The consumer's only substantial options are to accept the terms presented, continue shopping for other potential providers, or abandon the purchase altogether. If the document is likely to be hard to read and even harder to revise, a rational consumer might not expend the effort to review the terms.[28] Likewise, the consumer's willingness to read the document certainly will be affected by

24. *See* James v. McDonald's Corp., 417 F.3d 672 (7th Cir. 2005) (enforcing arbitration provision incorporated by reference in language affixed to french-fry carton); *see also* John J.A. Burke, *Contract as Commodity: A Nonfiction Approach*, 24 SETON HALL LEGIS. J. 285, 292 (2000) (presenting results of empirical study finding that "[m]ost short contracts were printed on a written receipt and addressed two issues: scope of warranty and limitation of liability").

25. Thus, in the credit card context, the issuer has little incentive to explain the limited implications of paying an "annual" fee or obtaining a card with an expiration date.

26. *See* Macaulay, *supra* note 7, at 1058.

27. *See* Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471 (1998).

28. *See* Robert D. Cooter & Edward L. Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEX. L. REV. 63 (1987); Gillette, *supra* note 3; Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203 (2003); *see also* RESTATEMENT (SECOND) OF CONTRACTS § 211 cmt. b (1979) ("A party who makes regular use of a standardized form of agreement does not ordinarily expect his customers to understand or even to read the standard terms.").

the social setting in which it is proffered—something that often is entirely within the control of the merchant.[29]

In the case in which the consumer does read the document, attention is likely to focus on a few of the more significant terms rather than the document as a whole.[30] If much of the document addresses legal risks and conditions that are not within the everyday experience of the typical consumer, the consumer might err in assessing the likelihood that those conditions will occur. The consumer might not weigh the severity of the ensuing consequences accurately.[31] Moreover, the consumer's own preferences may shift over time. Finally, consumers may have bounded willpower, meaning that they may take actions that conflict with their own long-term interest.[32]

The significance of those defects is open to debate. For example, in markets in which segmentation is difficult and in which errors are random, a relatively small number of heroically rational customers might drive contracting markets to competitive terms.[33] In other markets, in which merchants easily can segment their customers, or in which those that err in assessing risk will do so in a predictable and systematic way, these defects may cause consumers in the market to make choices that are systematically suboptimal.[34]

II. Credit Card Account Agreements

A. *Context*

The first point to make about the issuer–cardholder relationship is that it begins in a way that satisfies traditional doctrinal concerns about assent. The card agreement is typically the product of a solicitation that contains the terms expected to matter most to the cardholder and on which the card issuer competes. Issuers sent more than five billion direct mail solicitations in 2004, for an average of more than five offers per month to more than seventy percent of U.S. households.[35] Although the response rate typically is

29. *See* Macaulay, *supra* note 7, at 1061.

30. I amplify this point below, discussing literature that emphasizes the limited number of attributes (typically no more than 3–5) that a typical individual can compare in making market choices.

31. This could be true because of simple (and presumably random) error, or because of a systematic bias related to optimism or availability.

32. The most obvious example here is hyperbolic discounting (which I discuss in more detail below).

33. *See* Gillette, *supra* note 3, at 691–93; Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387 (1983).

34. *See* Steven P. Croley & Jon D. Hanson, *Rescuing the Revolution: The Revived Case for Enterprise Liability*, 91 MICH. L. REV. 683, 772–79 (1993); Gillette, *supra* note 3, at 691–93; Jon D. Hanson & Kyle D. Logue, *The First Party Insurance Externality: An Economic Justification for Enterprise Liability*, 76 CORNELL L. REV. 129, 154–58 (1990); *see also* Rakoff, *supra* note 6, at 1231 (arguing that results of competition say nothing about consumer preferences when contracts are not in fact understood by consumers).

35. FEDERAL RESERVE SYSTEM, BOARD OF GOVERNORS, THE PROFITABILITY OF CREDIT CARD OPERATIONS OF DEPOSITARY INSTITUTIONS 5 (2005) [hereinafter FEDERAL RESERVE, 2005 REPORT],

quite low,[36] tens of millions responded last year by submitting a credit card application. The solicitation is followed by the submission of an application by a cardholder, which is followed upon acceptance by the issuance of a card and a cardholder agreement.[37] Typically, that process is followed by the requirement that the card be validated over the telephone—the telephone validation occurs after the cardholder has received the agreement and before the card is used. Thus, to generalize, the contracting process is still primarily paper-based, and the assent is more robust than in the electronic contracting practices challenged so often in recent litigation.

It is less clear, however, that a cardholder of reasonable care and intellectual capability can be expected to read or understand the agreement. Credit card contracts share many of the features of other standardized agreements. Thus, they are relatively complex. A typical credit card agreement, for example, might have about eight single-spaced pages of small (seven-point) type, including about eighty separately numbered provisions. Many of the terms in the agreement are comprehensible only for cardholders with specialized knowledge. For example, financial terms such as "annual percentage rate" or "APR" assume proficiency with interest calculations, and legal terms such as arbitration, forum, and default assume an advanced understanding of the legal process. Further, a single account may have multiple APRs that apply to different types of credit extensions or different periods.

The likelihood that the cardholder will have cards from multiple issuers only exacerbates the complexity of the relationships. Although most consumers have only one deposit account, the typical cardholder, and especially the frequent borrower, is likely to have several different cardholder agreements.[38] They also are likely to contain choice-of-law provisions that select the laws of different states. Moreover, unlike the issuers of home mortgages[39] or insurance policies,[40] to take the closest parallels, each credit card

available at http://www.federalreserve.gov/boarddocs/rptcongress/creditcard/2005/ccprofit.pdf (discussing industry study that shows that an estimated 5.23 billion direct mail solicitations were sent by issuers during 2004, up 22% from 4.29 billion in 2003, with 71% of U.S. households receiving an average of 5.7 offers per month).

36. *Id.* (noting that the response rate on credit card solicitations in 2004 was estimated to be 0.4 %).

37. I am not aware of any issuers that make their standard forms available to consumers either online or with solicitation materials so that consumers can compare terms before submitting an application.

38. As of the end of 2004, there were more than two credit card accounts for every man, woman, and child in the United States, including about 430 million credit card accounts from Visa and MasterCard, THE NILSON REPORT, No. 828, at 6 (Feb. 2005), 50 million from Discover, THE NILSON REPORT, No. 831, at 9 (Apr. 2005), 115 million from in-house store card programs, THE NILSON REPORT, No. 838, at 8 (July 2005), and 30 million from American Express, THE NILSON REPORT, No. 826, at 7 (Jan. 2005).

39. *See* Arthur R. Gaudio, *Electronic Real Estate Records: A Model for Action*, 24 W. NEW ENG. L. REV. 271, 284–85 (2002) (discussing the development of the standard residential real estate mortgage by the Federal National Mortgage Association (Fannie Mae)); Ronald J. Mann, *Searching for Negotiability in Payment and Credit Systems*, 44 UCLA L. REV. 951, 971 (1997) (same).

40. *See, e.g.*, KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 32 (3d ed. 2000) ("[S]tandardization in insurance . . . involves . . . an offer of the same policy, to all customers, by all

issuer is likely to use a standardized agreement that is in form (if not substance) different in several respects from the forms of other major issuers. Thus, the cardholder who wants to maintain a comprehensive understanding of the status of cardholder agreements will need to understand the relevant legal rules in the applicable states, will need to study a different agreement for each card, and will need to remember as cards are pulled from the wallet which agreement corresponds to each card. This in a world in which few consumers are likely even to notice, much less retain, the relevant agreements as they arrive in their stack of daily junk mail.

Another point is that it is not always easy for a layperson to determine which papers constitute the agreement for each card. The current Bank of America agreement, for example, consists of a separately printed eight-page standardized form, together with a set of "Additional Disclosures" that appear in the billing statement at the bottom of a sheet labeled "Important Summary of Changes to Your Account." The cardholder who skips the summary after reading the agreement would fail to notice such additional terms as a default provision that permits Bank of America to impose a penalty APR of about ten percent per annum more than the standard APR.

Finally, a cardholder also would need to monitor the frequent amendments of each of the agreements. It is typical for major issuers to amend their agreements in important respects with remarkable frequency. Amendments are not the typical bargained-for modifications of contract theory. Rather, the typical agreement reserves to the issuer the right to amend the agreement at any time, with the issuer promising at best that it will provide notice of the amendments. When it does provide notice, the notice typically is in the form of a new agreement included in a billing statement together with a variety of other promotional materials. The cardholder who uses a rule of thumb[41] to discard all marketing information that comes with bills is likely to fail to notice such amendments.[42]

To be sure, issuers obtain consent before applying some new financial terms, but consent is inferred from such actions as continuing to use the card after notice of the amendment or failure to close the account and send a prompt written objection to the amendment.[43] Importantly, amendments

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companies. Competition in insurance markets, therefore, often tends to be over price, quality of service, or reliability, but rarely over the terms of coverage itself.").

41. *See* Robert E. Scott, *Error and Rationality in Individual Decisionmaking: An Essay on the Relationship Between Cognitive Illusions and the Management of Choices*, 59 S. CAL. L. REV. 329 (1986) (discussing the prevalence of such rules as techniques for managing complex choices).

42. As a matter of traditional contract doctrine, it is not plain that such amendments are enforceable. *See* Badie v. Bank of America, 79 Cal. Rptr. 2d 273 (Ct. App. 1998) (declining to enforce "bill-stuffer" amendment that added arbitration term even though cardholder did not close or stop using account upon receipt of amendment with bill). However, several key states explicitly permit amendments based on notices enclosed with billing statements followed by subsequent card use. *E.g.*, DEL. CODE ANN. tit. 5, § 952 (2001); GA. CODE ANN. § 7-5-4(c) (2004); *see also* Strand v. U.S. Bank Nat'l Ass'n, 693 N.W.2d 918 (N.D. 2005) (holding that bill-stuffer amendment waiving the right to file a class action was procedurally unconscionable, but enforceable because the term was not substantively unconscionable).

43. Issuers have used a variety of different opt-out provisions in "change in terms" clauses. Some require that a consumer opt out of the modified terms in ways that might not be feasible or

typically apply to funds already borrowed. For example, a change in the terms of default[44] might substantially increase the interest rate the cardholder will pay on balances outstanding at the time of the amendment.

In evaluating the contracting problems that the card presents, it is important to remember the unusual nature of the reciprocal obligations on which the relationship rests. On the cardholder's side, there is no commitment to use the card. Moreover, even if the card is used, timely payments often obviate any obligation to pay interest or fees. Nor is the lack of a commitment illusory. In many (perhaps most) cases, the cardholder can switch credit sources easily. Viewed on a purchase-by-purchase basis, the typical cardholder makes a different decision for each transaction when deciding which card to present at the checkout counter.

On the issuer's side, there is a similar evanescence of obligation inherent in the business of card issuance. As with most lending transactions, the lender is not in any practical sense obligated to lend until the moment at which the lender actually extends funds to the borrower. Rather, the parties proceed on the useful rule of thumb that absent an unforeseen change of circumstances it normally will be profitable for the lender to extend the credit for which the lender has expended time and energy to structure a transaction. Issuers deal with the possibility of such changes by reserving the right to refuse to extend credit on a transaction-by-transaction basis.[45] If this were not permitted, issuers would be deprived of the ability to terminate accounts based on deterioration of the borrower's credit over time. It would also make it difficult to respond to concerns about unauthorized use.

More broadly, because interest rates and the competitive landscape change rapidly, credit card issuers require a great deal of flexibility to operate. Forcing an issuing bank to adhere to credit terms in a dynamic economic environment would not promote an efficient credit relationship.

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desirable for all accountholders. Those ways include notice and immediate repayment of the entire outstanding balance, *see* Shea v. Household Bank (SB), Nat'l Ass'n, 129 Cal. Rptr. 2d 387 (2003) (holding that failure to repay outstanding balance not sufficient "use" to support bilateral modification), or notice and deferred repayment of the outstanding balance at a penalty rate, *see* Rossman v. Fleet Bank R.I. Nat'l Ass'n, 280 F.3d 384, 388, 398 (3d Cir. 2002) (noting that interest rate would increase from 7.99% to 24.99% upon closure of account). Others more generously permit opt out based on notice and discontinuation of use of the card or, even easier, notice with the right to continue using the card under the current terms until the end of the membership year or expiration date on the card.

44. To give context, one major issuer recently amended its agreement to provide that it can charge its default rate to any cardholder who is late or overlimit twice in a single year. Thus, a cardholder with a $12,000 annual limit that makes two $50 overlimit transactions on a single day might be exposed to a default rate on the existing $12,000 of debt, even if that type of conduct would not have been an event of default at the time the funds were borrowed. This could reflect, for example, a shift from a model in which issuers welcome overlimit transactions as an identifier of illiquid borrowers likely to pay interest, to a model in which issuers rely on cognitive difficulties that cardholders face in tracking their outstanding balances to collect fees on accidental overlimit transactions by liquid borrowers.

45. Some courts have rejected the argument that payment of an annual fee precludes the issuer from modifying or terminating the agreement for that period. *E.g.*, Gaynoe v. First Union Direct Bank, No. 97 CVS 16536, 2001 WL 34000142, at *10 (N.C. Super. Ct. Jan. 18, 2001) (holding that annual fees are not fees paid for services to be performed over time, but rather in consideration of issuing a card).

That is not to say that lenders cannot commit at one time to provide credit at some specified future date. It is to say, however, that lenders typically charge for such a commitment and that the absence of a commitment (and related fee) from the credit card market should surprise nobody. Thus, market conditions require that issuers retain *some* ability to modify the terms of their agreements.[46]

As suggested above, the difficulty of obtaining individual consents from large numbers of cardholders has led issuers generally to reserve the right to change the terms of their agreements when cardholders use their cards after receiving notice of the change.[47] In the context of the business model, however, that provision is less onerous than it might seem at first glance. Given the lack of obligation—on either side—it makes more sense to view each separate purchase transaction as a separate agreement between the cardholder and card issuer that is completed when the card issuer agrees to extend credit for a particular transaction that the cardholder wishes to enter.[48] When the cardholder decides to borrow funds from the lender, it borrows them on the terms available from the issuer at that point, just as we purchase a CD from a bank at the interest rate available on the day we contact the bank to purchase it.

B. *Ramifications*

The key question is whether consumers on the ground are making choices with sufficient care and rationality to drive the market to a competitive and optimal set of products and prices. These are complex relationships. It is unlikely that the typical consumer will be able to evaluate all of the attributes of the transaction that have economic significance.

I draw here on a long-standing body of experimental literature indicating that the ability of a typical consumer to evaluate separate attributes declines rapidly after the number of relevant attributes exceeds three.[49] Applied to this particular context, Jeffrey Davis has conducted an empirical study of

46. Regulation Z, 12 C.F.R. §§ 226.1–226.36, requires a credit card issuer to give fifteen days written notice of a change in terms if the term was required to be disclosed initially under 12 C.F.R. § 226.6 or the required minimum payment is increased. 12 C.F.R. § 226.9(c)(1) (2005). The fifteen-day advance notice requirement does not apply if a rate or fee is increased due to the customer's default, and the notice requirement does not apply at all if the change involves late payment charges, over-the-limit charges or other specified occurrences.

47. *See* White, *supra* note 3, at 1700–01 (asserting that modification of credit card agreements following notice and use is consistent with the objective theory of contracts and practical necessity).

48. *See* Garber v. Harris Trust & Savings Bank, 432 N.E.2d 1309 (Ill. App. Ct. 1982) (holding that a separate contract was created each time the card was used according to the terms of the cardholder agreement at the time of such use).

49. *See* JAMES R. BETTMAN, AN INFORMATION PROCESSING THEORY OF CONSUMER CHOICE (1979); David M. Grether et al., *The Irrelevance of Information Overload: An Analysis of Search and Disclosure*, 59 S. CAL. L. REV. 277, 296–97 (1986); Herbert A. Simon, *Rationality as Process and as Product of Thought*, 68 AM. ECON. REV. 1, 13 (1978); *see also* Block-Lieb & Janger, *supra* note 5, § III(A)(1) (reviewing the literature).

consumer comprehension of consumer finance agreements,[50] using an agreement much less complicated than a modern credit card agreement.[51] Davis found that most consumers that read the agreement could not understand most of its terms. Davis's findings emphasize in particular the difficulty that consumers face in understanding terms that involve complex concepts that are not common in daily experience.[52] Although the study is relatively informal, its findings do dovetail with the reality of the modern credit card agreement. In particular, a consumer must account for costs and fees that differ from card to card and shift over time (often after the purchase in question), as well as complex concepts of default and a litany of fees payable as a consequence of specified actions.[53] In reality, we cannot think it likely that consumers understand most of the terms even when they do review the agreements.

Rather, decision theory suggests, the rational approach for the typical cardholder will be to select a product based on a small number of price and service attributes that are of obvious relevance, recognizing that the remaining terms of the agreement are nonnegotiable. For example, a consumer would be likely to select a bank based solely on the cost of writing checks, the minimum balance required to avoid a monthly fee, and the location and fees for using automated teller machines to withdraw cash. In the case of a credit card contract, empirical research suggests a typical consumer selects a card based on the brand, annual fee, grace period, affinity or rewards benefits, and the stated interest rate if the consumer expects to pay interest in the immediate future.[54] Because those terms are contained in the advertising materials, consumers in most cases are unlikely even to look at the contract. Thus, a consumer of typical decisionmaking capacity would not rationally consider the terms defining or explaining the consequences of late payment or excessive borrowing, even though they generate a substantial share of issuer revenue (in the form of fees and default APRs). If consumers do not consider those terms, there is a concern that issuers will not draft them in a competitive way.[55]

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50. Jeffrey Davis, *Protecting Consumers from Overdisclosure and Gobbledygook: An Empirical Look at the Simplification of Consumer-Credit Contracts*, 63 VA. L. REV. 841 (1977).

51. The agreement is set forth in an appendix to Davis's article. *Id.* app. A at 908–11. It is perhaps one-quarter the length of a modern credit cardholder agreement.

52. *See id.* at 854–56.

53. *See* Philip Shuchman, *Consumer Credit by Adhesion Contracts*, 35 TEMP. L.Q. 125, 134–35 (1962) (discussing some of the detailed legal acumen required for understanding consumer credit contracts).

54. Jinkook Lee & Jeanne M. Hogarth, *Relationships Among Information Search Activities When Shopping for a Credit Card*, 34 J. CONSUMER AFFAIRS 330 (2000) (documenting rarity with which consumers evaluate anything other than the most basic financial terms).

55. *See* Hanson & Logue, *supra* note 34, at 154–58 (discussing lack of competitive pressure on terms not examined by consumers); Korobkin, *supra* note 28 (explaining why—when contract terms are not within the limited number of attributes that consumers are expected to price—drafting parties will have an incentive to include terms that favor themselves regardless of whether the terms are efficient).

A second concern, one to which legal academics have paid considerably more attention, is the likelihood that consumers would not price the risks of card agreements accurately even if they did invest the time and attention necessary to understand and evaluate the relevant financial terms. Tom Jackson has suggested that systematic failures in the cognitive process cause individuals to underestimate the risks that their current consumption imposes on their future well-being.[56] Building on that point, recent behavioral economics literature suggests that consumers give excessive weight to the conspicuous "up-front" aspects of a relationship and inadequate weight to less conspicuous "back-end" terms.[57]

The pricing problem is associated with several related cognitive tendencies. One is a so-called "optimistic" bias, which leads people to underestimate the likelihood of adverse events—in this case, to underestimate both the likelihood that they would suffer financial distress and the costs that the distress would impose on them.[58] Another is an "availability" bias, which leads people to overweigh the probability of common occurrences (which are readily available to their decisionmaking faculties) and underweigh the probability of uncommon occurrences. If financial distress is an uncommon event, that bias might cause consumers to underweigh the likelihood and consequences of financial distress.[59] Another concern is hyperbolic discounting. Generally, this causes consumers to make intertemporal comparisons that are unstable over time—so that future behavior will be systematically inconsistent with present predictions of that behavior.[60] In this context, it can lead to excessive borrowing.[61]

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56. *See* Thomas H. Jackson, *The Fresh-Start Policy in Bankruptcy Law*, 98 HARV. L. REV. 1393, 1410–14 (1985).

57. *See* Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets* (Mass. Inst. of Tech. Dep't of Econ. Working Paper Series, Paper No. 05-18, 2005), *available at* http://papers.ssrn.com/abstract_id=728545 (summarizing literature).

58. *See, e.g.*, James R. Bettman et al., *Cognitive Considerations in Presenting Risk Information*, *in* W. KIP VISCUSI & WESLEY A. MAGAT, LEARNING ABOUT RISK: CONSUMER AND WORKER RESPONSES TO HAZARD INFORMATION 13, 17 (1987); Jon D. Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 654–58 (1999); Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 809–12 (1980).

59. *See, e.g.*, Jon Hanson & David Yosifon, *The Situational Character: A Critical Realist Perspective on the Human Animal*, 93 GEO. L.J. 1, 40 (2004); Amos Tversky & Daniel Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 5 COGNITIVE PSYCHOL. 207, 208 (1973); Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124 (1974); Cass R. Sunstein, *Group Judgments: Statistical Means, Deliberation, and Information Markets*, 80 N.Y.U. L. REV. 962, 991 (2005).

60. *See* George Ainslie & Nick Haslam, *Hyperbolic Discounting*, *in* CHOICE OVER TIME 57, 69 (George Loewenstein & Jon Elster eds., 1992); Stefano DellaVigna & Ulrike Malmendier, *Contract Design and Self Control: Theory and Evidence*, 119 Q.J. ECON. 353 (2004); Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1539–40 (1998); David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q.J. ECON. 443 (1997).

61. Bar-Gill, *supra* note 5, at 1375–76; DellaVigna & Malmendier, *supra* note 60.

The concerns those tendencies justify are exacerbated if card issuers are in a position to exploit them.[62] David Laibson and his co-author have identified a strategy that they call "shrouding," in which merchants identify a myopic or satisficing class of customers and exploit the lack of rationality by systematically backloading the less attractive terms into a less prominent time and place in the relationship.[63] Stewart Macaulay's work on credit cards before the Truth in Lending Act ("TILA") suggests that card issuers used similar techniques to make cardholders responsible for the losses from stolen cards. At that time, the strategy was to omit any language about lost cards from the application and then include a fine-print clause on the back of the card indicating that the cardholder was responsible for all transactions in which the card was presented (even if the transaction was conducted by a thief with a stolen card).[64] Similarly, Oren Bar-Gill's article on credit card contracting argues specifically that credit card companies use pricing features such as teaser rates to take advantage of a quasi-rationally elevated concern for near-term costs as opposed to long-term costs for market products that depend on systematic underestimation of borrowing costs.[65]

Those strategies are less successful where competition can "debias" markets. Consider, for example, how the entry of Netflix has trumped the earlier shrouding strategy on which Blockbuster relied.[66] Generally, Blockbuster's profit model in the early years of this decade coupled low rental fees with high late fees. If consumers underestimated the amount of late fees or the probability that they would pay them, they would underestimate the costs of renting from Blockbuster. By designing a product that exploited that error, Blockbuster increased its short-term profits. Netflix responded with a two-pronged approach: a pricing model that does not involve late fees and an education strategy designed to create an aversion to late fees. It is too soon to tell whether the Netflix approach will result in a long-term market position for Netflix,[67] but it did disrupt Blockbuster's profit model.

62. *See* Hanson & Kysar, *supra* note 58; Rakoff, *supra* note 6, at 1231 (noting that "intense competition will, if anything, make the situation worse, for it tends toward degradation of any [consumer]-protective provisions of the contract").

63. *See* Gabaix & Laibson, *supra* note 57 (presenting model that explains why firms shroud the negative attributes of their products, particularly high prices for complementary add-ons, and shows why competition will not induce firms to reveal information that would improve market efficiency).

64. Macaulay, *supra* note 7, at 1069–74.

65. *See* Bar-Gill, *supra* note 5; *see also* Lawrence M. Ausubel, Adverse Selection in the Credit Card Market (June 1999) (unpublished manuscript, on file with *Michigan Law Review*). The suspicion that credit card issuers try to hide the terms that are harmful to consumers is not a new one. Macaulay's work on credit cards before the Truth in Lending Act (TILA), 15 U.S.C.A. § 1642 (West 2004), suggests that card issuers used similar techniques to make cardholders responsible for the losses from stolen cards. Macaulay, *supra* note 7, at 1069–74.

66. *See* David Leonhardt, *All Consuming; Why That Doggie in the Window Costs More Than You Think*, N.Y. TIMES, May 16, 2005, at C5.

67. *See* Gabaix & Laibson, *supra* note 57 (pointing out that it is difficult for any single firm to capture the profits from debiasing consumers).

As the Blockbuster–Netflix example suggests, educating consumers of both front-end and back-end costs can disrupt a profit model that relies on back-end costs. In the credit card context, issuers at one time might have been vulnerable to sophisticated cardholders who avoid the payment of interest and fees by using a card with no annual fee and making timely monthly payments.[68] Thus, as the number of sophisticated users grew, it became increasingly difficult for card issuers to profit by hiding expensive back-end interest payments.

The complexity of the modern credit card transactional structure minimizes the likelihood that issuers will be forced to use transparent pricing models without regulatory intervention. The Blockbuster–Netflix example describes a single market segment with a shrouding technique that was destabilized when consumers were encouraged to develop accurate perceptions of their future behavior. Modern credit card issuers, however, have used at least two tactics to prevent increased customer sophistication from destabilizing their profit models.[69]

The first tactic has been to develop product features that segment the market into smaller niches. The discussion above describes a single credit-card product, offered to all customers. That product was attractive to the sophisticated because it was free and to the unsophisticated because they failed to understand either the costs of the product or their likely use of it. Responding to the growth of card users that do not borrow, issuers in recent years have developed a number of different products that prevent increased sophistication. For example, the sophisticated cardholder who wishes not to pay interest and fees is likely to be attracted to an affinity or rewards card issued by MBNA. For that product, the cardholder is likely to pay an annual fee,[70] which the sophisticated user will rationalize as costing less than the value of the rewards (frequent flyer miles or the like). There is every reason to expect that the cardholder's calculation often will be incorrect.[71] Moreover, those calculations accord no weight to the value of the information MBNA obtains from the relationship.[72] Even if that calculation is correct, the new product certainly has made the relationship more profitable on a cardholder-by-cardholder basis than it was in years past, when there might have been a direct cross-subsidization between convenience users and borrowers.

68. *See id.* at 5 (noting that sophisticated credit card users take advantage of "free miles" and avoid interest rate charges and late payment fees).

69. *See id.* (noting that innovation creates new opportunities for shrouding and undermines the effects of education).

70. The card issuer also may receive a higher interchange fee for these cards, which might be passed back to consumers at the point of sale in the form of higher prices.

71. The emphasis here is on rationalization, not rational calculation. Macaulay's early study compared contracts for gasoline cards (issued primarily to less wealthy individuals) and travel and entertainment ("T&E") cards issued to more wealthy individuals. He provides some interesting empirical evidence suggesting that the wealthy are no more likely to "debias" than the impecunious—perhaps because their sense that their time is more valuable decreases the likelihood that they will pay attention to details of small transactions. *See* Macaulay, *supra* note 7, at 1086–1107.

72. MBNA's annual reports explain in detail the valuable uses it makes of that information.

The concept of segmentation is not a new one. As Lizabeth Cohen explains in *A Consumer's Republic*, the strategy of segmenting consumers into ever more finely delineated classes has been a dominant strategy for a half century. It was identified in the 1950s in academic writings by people like Wendell Smith and Pierre Martineau, and swiftly transformed the business models of all U.S. businesses aiming at consumers.[73]

The second tactic is to take advantage of the fact that consumers are likely to have multiple account agreements, all of which are likely subject to frequent unilateral modifications, both of which work together to hinder consumer understanding. If each issuer has a different set of rules, and if the pitfalls hidden in the rules differ for each issuer and from time to time, only the most careful cardholder will avoid *any* level of interest or fees. The point of this tactic is that within each of the market segments described above, even for the cardholders that attempt to position themselves as non-borrowing convenience users, it will require an increasing level of attention to detail to successfully avoid paying fees to the issuer.

If I am right, those strategies make the card industry more resistant to debiasing than parallel industries. That leaves us with a basic policy question: how to regulate a contracting market in which a seller faces a heterogeneous set of purchasers, some but not all of whom are sufficiently careful and sophisticated to respond rationally to the terms offered by the seller. As discussed above, we know that if purchasers are homogeneous in their preferences, a relatively small number of sophisticated customers can produce competition in the market that will drive the seller to offer an efficient product. Alternatively, if purchasers are heterogeneous in their preferences but are always sophisticated, then each purchaser will respond rationally to the terms offered by the seller. We would expect this to be the case, for example, in relatively high-dollar markets. We are left here, however, with the case that falls between those simple cases: a market in which only some customers understand the offered terms, and in which the choices of those customers do not produce competition that alters the terms available to the other customers. The existing theoretical literature, I think it is fair to say, has not worked out how to analyze potential regulatory responses in that context.

III. RESPONDING TO PROBLEMS WITH CREDIT CARD AGREEMENTS

If the allocation of risks in existing cardholder agreements is not the result of effective competition or rational choice by cardholders, the natural question is whether and, if so, how the law should respond. Lawrence Friedman describes a common pattern of consumer regulation. After an industry develops to a point where a stable set of products and transactions has developed, the typical response is for the legislature to step in and transfer those areas "from the realm of abstract contract law" to the realm of

73. *See* LIZABETH COHEN, A CONSUMERS' REPUBLIC: THE POLITICS OF MASS CONSUMPTION IN POSTWAR AMERICA 292–309 (2003).

economic regulation.[74] As Stewart Macaulay explains, we can view this as a process by which commercial areas "spin off" for special treatment.[75]

For example, as the mail order industry grew in size, the FTC adopted a set of standardized contract terms, eliminating competition on terms that consumers are unlikely to notice. The FTC Mail Order Rule establishes a set of procedures that retailers must follow if they are unable to ship goods within the time they estimate at the time they take the order. If the delay is moderate, they must give the customer an opportunity to cancel the order. If the delay is extreme, they must cancel the order unless the customer explicitly consents to the extension.[76] We can imagine that in the absence of such a rule, retailers might have different terms in their contracts to deal with the possibility of delayed shipments. We also can be sure that few consumers would examine and analyze those terms. Therefore, even if the FTC delay term is not optimal, it does serve to focus competition in that industry on the price, selection, and quality of delivered products, terms customers are most likely to notice.

Viewing the regulatory framework within that paradigm, it is striking how little the existing law does to regulate the credit card agreement. Most of the rules that govern credit card transactions are found in the Truth in Lending Act ("TILA") and Regulation Z.[77] The legal regime defined by those rules is primarily a disclosure-based system,[78] but it does impose several substantive constraints on the practices of card issuers. Specifically, TILA prohibits banks from issuing unsolicited credit cards to consumers.[79] TILA also has several provisions relating to unauthorized use and merchant

74. LAWRENCE FRIEDMAN, CONTRACT LAW IN AMERICA 140–83 (1965). I write consciously in a line of recent scholarship that analyzes how responses to social problems that traditionally are characterized as "public" and "private" in fact are closely intertwined and interdependent. *E.g.*, JACOB S. HACKER, THE DIVIDED WELFARE STATE: THE BATTLE OVER PUBLIC AND PRIVATE SOCIAL BENEFITS IN THE UNITED STATES (2002); DAVID A. MOSS, WHEN ALL ELSE FAILS: THE GOVERNMENT AS ULTIMATE RISK MANAGER (2002).

75. Macaulay, *supra* note 7, at 1056.

76. FTC Mail or Telephone Order Merchandise Rule, 16 C.F.R. § 435 (2005).

77. Truth in Lending Act (TILA) § 132, 15 U.S.C.A. § 1642 (West 2004); Regulation Z, 12 C.F.R. §§ 225, 226 (2005). The Uniform Commercial Code does not cover payment cards. *See* U.C.C. § 4-104(a)(9) (2002) ("'Item' . . . does not include . . . a credit or debit card slip."). *But see* Broadway Nat'l Bank v. Barton-Russell Corp., 585 N.Y.S.2d 933, 938 (Sup. Ct. 1992) (reaching a contrary conclusion under pre-revision Article 4). Although some states have enacted statutes that govern certain aspects of the issuer/cardholder relationship, it seems fair to say that none of those statutes has any significant impact, largely because the National Bank Act would preempt any substantial regulation. *See* Mark Furletti, *The Debate over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards*, 77 TEMP. L. REV. 425 (2004). To the extent there is any substantive regulation by the states, it tends to be very specific statutes authorizing specific business practices, like the Delaware bill-stuffer statute discussed above. *See supra* note 42.

78. Regulation Z requires that a bank issuing a credit card provide the consumer a written disclosure that summarizes the applicable legal rules. Regulation Z, §§ 226.5, 226.6. Appendix G to Regulation Z contains model disclosures. *Id.* app. G.

79. TILA, § 1642; Regulation Z, § 226.12(a).

disputes that give consumers a right to cancel payment that is broader than the consumers' rights in any of the competing payment systems.[80]

Still, the existing framework assumes, at least if the card issuer makes the required disclosures, that cardholders are best situated to decide with which entities and on which terms to enter card agreements.[81] That framework reflects an almost complete acceptance of the concern that terms established by government fiat will be less flexible, less innovative, and less likely to allocate risks sensibly than the terms selected by parties to a freely negotiated commercial arrangement.[82]

The question is whether there is some reason to think that credit card contracts are sufficiently afflicted by contracting inefficiencies or externalities to warrant spinning them off from the general hands-off realm of contract enforcement to the realm of interventionist social planning. On the first of the two points—whether market obstacles prevent efficient contracting—the preceding section of this essay summarizes a number of reasons to think that the process by which cardholders enter into card agreements does not function well. On the second one, there also is good reason to think that the results of that process not only have adverse effects for the cardholders, but also impose costs on society more broadly. The concern is that the credit card is so easy to use that borrowers fail to give adequate attention to the financial distress attendant on their borrowings. Thus, in related work I show that increased credit card borrowing is uniquely associated with an increase in personal bankruptcy filings—even when we hold constant the total level of borrowing and account for general conditions in the economy.[83] Following on that point, the increased financial distress associated with rising card use can cause harms that the borrower might not adequately consider when the borrower makes contracting decisions.[84]

Assuming that some form of economic regulation is called for, it is less clear precisely what type of intervention makes the most sense. If the existing literature makes anything clear, it is that a sensible intervention must pay attention to the situation on the ground, lest it end up doing more harm than

80. TILA, §§ 1643, 1666, 1666i. Oddly enough, those provisions might be counterproductive if they encourage consumers to use credit cards instead of debit cards.

81. That is not to say that I think the existing disclosure regime is sensible, *see* White & Mansfield, *supra* note 16, at 260–62 (arguing that the disclosures are too complex to be comprehensible to typical consumers), or that it could not be improved. I argue in related work that the existing disclosure regime should focus much more on disclosure at the point of purchase (where consumption and borrowing decisions are made) than the existing regime. *See* MANN, *supra* note 2, ch. 13. One of the leading reasons for that recommendation is the view that a shift from credit card usage to debit card usage would decrease imprudent borrowing.

82. *See* Craswell, *supra* note 6, at 49–50 (explaining that problems in market competition for contract terms do not justify administrative promulgation of terms if the administrative terms will not be better than the market terms).

83. *See* MANN, *supra* note 2, chs. 4–5.

84. *See, e.g.*, Jackson, *supra* note 56, at 1419–22; Eric Posner, *Contract Law in the Welfare State: A Defense of the Unconscionability Doctrine, Usury Laws, and Related Limitations on the Freedom to Contract*, 24 J. LEGAL STUD. 283 (1995). For a more detailed discussion, see MANN, *supra* note 2, ch. 4.

good.[85] The biggest concern is that a regulatory intervention viewed as a minor and plainly benign intervention by regulators might in fact undermine the business models prevalent in the industry in ways that harm competition. That is a major problem in this context, because the credit card is an especially efficient payment and borrowing device.[86] Working from that perspective, the remainder of this essay considers a series of possible responses.

A. *Running in Place*

To understand the feasibility and effectiveness of interventions in the credit card market, it is important to understand not only the contracting problems discussed above, but also some more general difficulties with consumer behavior in that market. Generally, the borrowing problem associated with credit cards arises from two related consumer errors.[87] The first is what I call the instrument-induced risk. This risk occurs when consumers use a credit card as a payment device and do not intend to borrow. Because some evidence suggests that the credit card encourages consumers to spend more than they otherwise would, and perhaps more than they can repay out of monthly incomes, credit card use can lead to unanticipated debt. The second is the convenience risk. Because the transaction costs of credit card lending are so low, borrowers are more likely to underestimate the risks associated with future revenue streams than they would be in another type of consumer credit transaction. Both of those risks arise against a trifurcated framework that makes the contracting decision less important to most consumers than the spending and borrowing decisions. Thus, both types of mistakes occur after the contracting decision has been made. Because existing analyses have failed to understand that trifurcated framework and its effect on consumer decisionmaking, neither the current regulatory framework nor the leading proposals in the existing literature respond adequately.

1. *Invalidate Unconscionable Terms Ex Post*

For example, the simplest possibility is the response of the common law: ex post judicial invalidation of terms as unconscionable. There is nothing new about this idea, which dates (at least) to work by Friedrich Kessler in the early 1940s.[88] A similar idea appears in section 211 of the *Restatement (Second) of Contracts*. But several considerations limit the effectiveness of that doctrine as a general tool to police contracting problems. For example, judicial decisionmaking under a vague rubric of "unconscionability" often

85. *See* Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism"*, 151 U. PA. L. REV. 1211 (2003); Macaulay, *supra* note 7.

86. *See* MANN, *supra* note 2, ch. 3.

87. I discuss these two classes or errors in more detail in *id.* pt. IV.

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

leads to the disparate readjustment of terms in ways that the parties did not contemplate in their pricing decisions. Moreover, courts that apply such an approach with sufficient vigor to have a substantial effect on contracting practices are likely to do a poor job of sorting provisions that make economic sense from those that reflect overreaching.[89]

This is not to say that the unconscionability doctrine can serve no useful purpose. For example, the unconscionability doctrine might encourage businesses to think more carefully about the enforceability of the clauses that they write, leading them to use larger print, simpler language, and the like. However, the doctrine probably does not substantially constrain the major industry actors, who easily can obtain legislative redress in areas where questionable practices are important to their business models.[90]

In the credit card context, the use of unconscionability as a tool to police contracting excesses also must overcome the widespread use of arbitration clauses in cardholder agreements.[91] When courts enforce those provisions, they have no serious opportunity to assess the substantive provisions of credit card agreements or to consider whether issuers have complied with those provisions.[92] Still, I doubt that judicial or regulatory invalidation of those provisions will have any substantial impact. For one thing, arbitration clauses might not contribute to business models that permit excessive cardholder borrowing. Arbitration clauses are at most a detail in the history of the credit card industry. It is quite clear that most issuers did not use arbitration clauses in the United States until the late 1990s,[93] and they are used rarely overseas. Yet the rise in borrowing—and attendant rise in consumer bankruptcy—that troubles policymakers was well on its way even before those clauses came into common use. To be sure, arbitration clauses probably deter at least some class actions. But, the class actions that would be available if the clauses were not enforced would only buttress the weak

89. Jim White has an excellent discussion of the cases interpreting Section 211. James J. White, *Form Contracts Under Revised Article 2*, 75 WASH. U. L.Q. 315 (1997); *see also* Gillette, *supra* note 3, at 712–14.

90. *See, e.g.*, DEL. CODE ANN. tit. 5, § 952 (2001); GA. CODE ANN. § 7-5-4(c) (2004).

91. Attempts to invalidate arbitration clauses as unconscionable are hampered by the bluntness of unconscionability, discussed above. The unconscionability doctrine works best with a limited set of problems. Thus, it might be able to respond to procedural defects with the provisions: lack of mutuality, inconvenient forum, high cost, and the like. *See, e.g.*, Comb v. PayPal, Inc., 218 F. Supp. 2d 1165 (N.D. Cal. 2002) (relying on those kinds of defects to invalidate PayPal's arbitration clause as unconscionable). Courts also arguably can grapple with arbitration clauses that limit substantive rights (i.e., shorten statutes of limitation, bar punitive damages or class actions, or shift attorney fees). *See, e.g.*, Discover Bank v. Boehr, 113 P.3d 1100 (Cal. 2005). It is more difficult, though, for courts to address problems with the way arbitration works in practice under seemingly neutral arbitration provisions (i.e., concerns with secrecy, lack of accountability, and bias). *See* Jean R. Sternlight, *Creeping Mandatory Arbitration: Is It Just?*, 57 STAN. L. REV. 1631 (2005).

92. Samuel Issacharoff & Erin F. Delaney, *Credit Card Accountability*, 73 U. CHI. L. REV. (forthcoming 2006), *available at* http://ssrn.com/abstract=789704 (arguing that functional judicial review of arbitration clauses would curtail unscrupulous behavior by card issuers by allowing the class action lawyer to be an agent for myopic consumers).

93. I rely here on the pleadings in *Ross v. Bank of America*. Class Action Complaint, Ross v. Bank of America, No. 05 CV 7116 (S.D.N.Y. filed Aug. 11, 2005) [hereinafter Class Action Complaint].

TILA disclosure regime discussed above[94] and increase the ability of cardholders to hold issuers to the terms of the agreements the issuers have drafted. Thus, for the reasons discussed in the preceding paragraph, they would have little effect on the substance of the relationship.

This is not to say that there are not serious problems with arbitration clauses in credit card contracting. For example, there is at least some evidence to support the view that issuers have colluded to adopt the clauses broadly because of concerns that customers care enough to shop for issuers that do not force arbitration.[95] There also is some reason to think that the problems of bias have a serious effect in this industry, where the major issuers have gravitated to a single provider (the National Arbitration Forum) that seems to be competing for business (at least in part) on a reputation for providing results that are satisfying to card issuers.[96]

At bottom, the discussion in Part II suggests that arbitration clauses are not the result of competitive contracting. It is at least possible, however, that the cost savings of arbitration are sufficiently valuable that inclusion of the clauses is efficient.[97] Moreover, arbitration proceedings probably could be constructed in a cost-effective and neutral way if the card networks were encouraged to intervene. Regardless of the outcome of that debate, it does not seem likely that prohibiting the use of arbitration provisions or regulating their content will solve the problem of excessive borrowing.

2. *Regulating Information*

If the existing regulatory regime is inadequate to inform consumers, even with the buttress of unconscionability doctrine to invalidate egregious excesses in contracting, the natural question is whether some other information-based initiative could work. The goal would be to solve the borrowing problem that afflicts card markets without limiting the ability of market participants to design and select products, through the provision of information

94. Issuers might benefit by using arbitration offensively to avoid the ability of cardholders to raise defenses TILA grants them. For example, arbitrators might be more willing to enforce strict pleading deadlines, award attorney fees, and the like. Because so much of the collection litigation revolves around unauthorized use defenses, truncated procedures might dispose of those claims more expeditiously than litigation.

95. This is the core allegation, as yet unproven, in *Ross v. Bank of America*. Class Action Complaint, *supra* note 87.

96. *Id.* Again, this has been alleged, not proven.

97. Arbitration clauses arguably are no worse in the credit card industry than they are in the many other contexts in which they are common. To be sure, it is easy to think of some contexts in which it is hard to object to truncated remedies—the terms on which McDonald's offers prizes to its customers, for example. The aggregate effect of credit card borrowing makes it hard to put credit card agreements in that category. Yet, I doubt that credit card transactions are uniquely ill suited to resolution by arbitration. *See* James J. White, *Contracting Under Amended 2-207*, 2004 WIS. L. REV. 723, 742 ("For a nickel or a dime, almost all of us would . . . agree to arbitrate."); *cf.* Carnival Cruise Lines, Inc. v. Shute, 499 U.S. 585, 594 (1991) ("[I]t stands to reason that passengers who purchase tickets containing a forum clause like that at issue in this case benefit in the form of reduced fares reflecting the savings that the cruise line enjoys by limiting the fora in which it may be sued.").

that might "debias" consumers and thus overcome the cognitive defects emphasized in Part II of this essay. This is a specific example of the approach of using information to warn consumers about systematic cognitive errors. Gabaix and Laibson, for example, talk of required "warning labels" like those we see on cigarettes.[98] As applied to this context, the basic idea is that warnings of some sort might limit improvident and impulsive spending.

One approach would rely on information campaigns designed to respond to the availability-heuristic, making consumers more cognizant of the effects of excessive borrowing by telling consumers about them.[99] Yet the parallel to smoking campaigns illustrates how difficult such a campaign would be. It has taken decades of concerted effort at all levels of the government to bring the growth of smoking among young people to something of a standstill—this for a product without redeeming social value, plainly addictive and associated with the most catastrophic health consequences. Consumer expenditure and credit, on the other hand, are more ambiguous in their effects on our economy: we can hardly expect the government to urge consumers not to spend.[100] In addition, we certainly cannot expect the government to ban advertisements urging consumers to spend as we have banned most cigarette advertising. Finally, as Juliet Schor shows so well, discretionary consumer spending is such an integral part of U.S. culture that it would be even harder to eradicate it than it has been to slow the growth of smoking.[101] Collectively, those concerns make investment in information campaigns a poor option.

Another possibility—the focus of existing statutory responses like TILA—is additional disclosures at the time of contracting. Yet there is little reason to think that government-drafted summaries of the terms on which issuers do not compete will make those terms any more important to consumers than they currently are. If, as Part II suggests, consumers choose a credit card based on a small group of salient characteristics on which card issuers compete, then disclosures at the point of agreement will do little to alter consumer decisionmaking.

That is not to say that nothing can be done to improve consumer decisionmaking. For example, if the point of contracting is not a salient point in the psyche of the consumer, a regime altering the information available at the points of purchase or repayment could be productive.[102] I also think it is plausible that policymakers could reduce impulsive consumption by efforts to foster greater segmentation of payment systems (so that fewer people are using a credit card for everyday purchasing transactions) and by removing

98. *See* Gabaix & Laibson, *supra* note 57, at 24.

99. *See* Sunstein, *supra* note 5 (recommending a campaign that would disseminate "vivid narratives of possible harm").

100. *See* COHEN, *supra* note 73 (discussing longstanding federal campaign to foster consumer spending to resuscitate the American economy after World War II).

101. *See* JULIET B. SCHOR, THE OVERSPENT AMERICAN (1998).

102. I discuss such a regime in MANN, *supra* note 2, ch. 13.

and reducing the current monetary incentives to use credit cards.[103] For present purposes, however, the relevant point is that I see no cost-effective way to use information-based responses to improve the rationality of cardholder behavior at the point of contracting.

B. *Moving Forward*

I turn now to the possibilities of direct regulation of the terms of credit card agreements. Here, I consider two approaches: prohibiting unpriceable terms and promulgating agreements that provide a standard contractual template for the relationship.

1. *Prohibit Specific Terms Ex Ante*

The first solution would be to prohibit the use of certain terms. That approach is common in other jurisdictions. Consider, for example, the European Union's Unfair Terms Directive,[104] which generally prohibits the inclusion of certain types of unfair terms in consumer contracts unless they are the result of individual negotiation.[105] By U.S. standards, the list is intrusive, prohibiting, among other things, unilateral modification clauses and arbitration clauses.[106]

Such a broad regime might seem almost unthinkable to U.S. businesses. Yet it is not that different from the regulatory approach in other consumer financial transactions in which a small number of important issues dominate the forms. For example, consider the residential lease contract, in which the most important term for consumer protection purposes is likely to be a warranty of habitability. After a period during which courts struggled with lessor efforts to waive such a warranty, it is in many jurisdictions now settled by statute or regulation that the lessor of a residence provides such a warranty.[107] Similarly, in the home mortgage context, it is now quite uncommon to see a provision providing for mandatory arbitration.[108]

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103. *See id.* chs. 11, 14.

104. Council Directive 93/13/EEC, Unfair Terms in Consumer Contracts, 1993 O.J. (L 95) 29.

105. As Larry Bates has shown, several other countries have developed administrative approaches under which bureaucrats generally approve form contracts. *See* Larry Bates, *Administrative Regulation of Terms in Form Contracts: A Comparative Analysis of Consumer Protection*, 16 EMORY INT'L L. REV. 1 (2002). For example, consider Israel's Standard Contract Law of 1964, which allows users of form contracts to obtain government approval of "restrictive terms." Approval immunizes the terms from court challenge for five years. Standard Contracts Law, 5724-1964, 18 LSI 51 (1963–64) (Isr.).

106. *See* Council Directive 93/13/EEC, Unfair Terms in Consumer Contracts, Annex, 1993 O.J. (L 95) 33 ¶¶ 1(j), 1(q).

107. *See, e.g.*, TEX. PROP. CODE ANN. §§ 92.006, 92.052 (Vernon 1995) (establishing a nonwaivable warranty of habitability); Slawson, *supra* note 12, at 49–50.

108. The most obvious reason is that the Federal National Mortgage Association ("FNMA" or "Fannie Mae") will not purchase a mortgage that includes such a provision. *E.g.*, FANNIE MAE, ANNOUNCEMENT 04-06, at 4–5 (2004), *available at* http://www.mortgagebankers.org/resident/2004/fannie-04-06.pdf.

In this context, there are price terms that consumers might assess more rationally if the contracting process were improved. Provisions that permit retroactive price adjustments interfere with the ability of consumers to assess the risks of default and nonpayment, because they allow price adjustments that come into effect after the time of the purchasing decision to which they apply.[109] I call those "unpriceable" terms, not because consumers can *never* evaluate them, but because few consumers can be expected to evaluate their significance accurately.[110] That impulse would follow naturally from the idea that it is appropriate to ban terms whenever it is likely that all or almost all consumers will not be able to respond accurately to the terms.[111]

Thus, for example, regulators could ban unilateral amendments that apply to prior transactions without allowing consumers a feasible opportunity to opt out. The fifteen-day notice requirement mandated by Regulation Z[112] gives consumers little time to find alternate credit sources. Depending on the requirements of the particular opt-out provision, the absence of another credit source might make compliance with opt-out requirements impractical. For example, a provision stating that the consumer must repay the entire balance immediately will not provide a realistic option to a liquidity-constrained customer.

One possible response that might enhance consumer decisionmaking without significantly restricting the drafting practices of issuers would be to lengthen notice requirements so that consumers would have additional time to find alternate credit sources. Going farther, regulators could explore ways to improve the readability and presentation of change-in-terms notices, broaden consumer opt-out rights, or even ban post hoc application of unilateral amendments entirely.

A similar example is the "universal default" provisions that are the focus of current regulatory initiatives. Essentially, universal default terms in credit card agreements permit an issuer to raise the rate it charges one of its borrowers substantially if that borrower commits a default on an unrelated debt to a different lender, even if the borrower has not missed a payment to the credit card issuer in question. It is one thing for an issuer to stop (or raise the rate on) new extensions of credit based on adverse credit information—we expect (and hope) that issuers will do that routinely. It is quite another,

109. As I discuss in *Optimizing Consumer Credit Markets and Bankruptcy Policy*, one might think that this problem poses an objection to the entirety of the consumer bankruptcy provisions in the Bankruptcy Abuse and Consumer Protection Act of 2005. Ronald J. Mann, *Optimizing Consumer Credit Markets and Bankruptcy Policy*, 7 J. THEORETICAL INQUIRIES IN L. (forthcoming 2006).

110. Todd Rakoff refers more elegantly to "invisible" terms—terms the consumer does not notice. *See* Rakoff, *supra* note 6, at 1250–55. I have in mind here a narrower category—terms that not only are invisible in practice, but that are impossible for a consumer to assess because they operate ex post facto.

111. *See* Schwartz & Wilde, *supra* note 33, at 1456–59; *see also* Camerer et al., *supra* note 85.

112. Truth in Lending Act, 12 C.F.R. § 226.9(c)(1) (2005).

however, for creditors to increase the interest rate on debts already incurred, solely because of a late payment to a different creditor. Regulators, upset by the application of universal default provisions, have responded by insisting that credit card issuers provide better disclosure of the provisions in their agreements with customers.[113]

The discussion above suggests that a disclosure regime is not the appropriate response. For one thing, it rests on the premise that consumers that receive the disclosures will alter their behavior, which is improbable for the reasons emphasized above. More fundamentally, an emphasis on disclosure misses the point. My sense is that the underlying complaint of consumers is that the provisions are fundamentally unfair: "We shouldn't have to pay more to Bank One simply because we were late on a payment to Providian." Policymakers for the most part have retreated to a disclosure-based response because of their unwillingness to press that fairness argument.[114]

In my view, the discussion above shows how the fairness argument conceals a powerful economic argument for barring universal default provisions. Universal default rules are one of the attributes consumers are least likely to "price" in their contracting and product-selection decisions. This is true because they are a "boilerplate" attribute that will not be of great significance for most consumers selecting products. It also is true because the cost of the provision is quite difficult to assess up front (depending, as it does, on the interaction between future defaults by the borrower to other lenders and the other lenders' reactions to those defaults). It is difficult when I make a purchase today to factor in the likelihood that the interest rate on that purchase at some distant time in the future will increase by some unspecified amount because of a default I make in a payment to some other creditor. If an omnicompetent consumer could not take account of the rate differentiation, then the differentiation is not effectively altering borrowing behavior. Because consumers are not pricing this term, there is no reason to rely on its existence in contracts as evidence of its optimality.

The absence of contracting competition does not prove, however, that the term is not optimal. It is possible that the provisions operate to shift the net burden of charges by credit card issuers to some extent toward the most distressed borrowers, the ones most likely to default, and away from those least likely to default. The increased collections from those customers might support lower charges for "convenience" users that do not borrow or default. Thus, it is at least possible that a rational and fully informed cardholder would think the benefits of such a clause exceed its costs.[115]

113. *See* Linda Punch, *Getting Tough?*, CREDIT CARD MGMT., Feb. 2005, at 42, 43–44 (discussing proposals made by the Comptroller of the Currency).

114. There is, however, a bill pending that would ban these provisions entirely, by prohibiting any alteration of interest rates "for reasons other than actions or omissions of the consumer that are directly related to [the consumer's credit card] account." Consumer Credit Card Protection Act of 2005, H.R. 3492, 109th Cong., § 2 (2005).

115. I discount the possibility that the clause provides signaling benefits by sorting customers that do not expect to default (who would not be concerned about such a clause) from those that do

More broadly, universal default provisions are part of the developments in the credit card market that have fostered segmentation, which has led in turn to a marked differentiation of rates among cardholders with different risk profiles.[116] As a general matter, that trend is positive, because it permits more accurate pricing. The role of universal default terms in that market segmentation depends on the odd ramifications of "default" in the credit card market. In conventional commercial markets, an act of default by a borrower is a data point that indicates to the lender that the transaction has become riskier than previously anticipated and thus more likely to produce a loss. Typically, lenders respond proactively by managing the transaction in a way that responds to the increased risk of loss.[117] In the credit card context, however, an event of default (such as a late payment to another creditor or even a late payment to the card issuer) is a signal that the cardholder is financially constrained. To the issuer, such an occurrence is a signal of two cardholder attributes that collectively make the cardholder a profit center for the issuer. First, the cardholder is likely to borrow more in the immediately ensuing months. Second, the cardholder's switching costs have increased because of the difficulty the cardholder will face in repaying the entire outstanding balance in a time of financial distress. Thus, the issuer can respond by substantially increasing the fees charged to the cardholder with a diminished concern that the cardholder will shift the borrowing to a different lender. Indeed, one might imagine that a cardholder's anticipated value as a customer rises almost to the point of a bankruptcy filing.

The issue, then, is whether it matters that cardholders in fact do not understand the clauses (or their consequences) when they enter the agreements. Should we prevent this choice on that basis? If we think of this as tantamount to a unilateral alteration of terms after the fact, we might be inclined to ban such clauses. On the other hand, if we want to protect the ability of convenience users to choose a card that might be cheaper for them because of the increased revenues issuers receive when they exercise unilateral default provisions, we might want to allow them.

An intermediate approach, parallel to the analysis of opt-out clauses above, would focus on providing cardholders a practical opportunity to respond before adverse action. For example, regulators might forbid issuers to raise interest rates based on application of a universal default clause without providing cardholders a substantial notice period, coupled with an opportunity to challenge the relevant information and an opportunity to shift their outstanding debt to a different issuer.

For me, in the end, the most sensible approach is to ban the clauses entirely. I am driven primarily by my view that convenience users as a class

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expect to default (who would be concerned). Tolerance of a clause that goes unread can send no signal.

116. *See* MARK FURLETTI, PAYMENT CARDS CTR., FED. RES. BANK OF PHILA., CREDIT CARD PRICING DEVELOPMENTS AND THEIR DISCLOSURE (2003).

117. *See* Ronald J. Mann, *Strategy and Force in the Liquidation of Secured Debt*, 96 MICH. L. REV. 159 (1997).

should be shifted to debit cards and newer payment systems.[118] I recognize that one likely effect of such a rule would be more extensive and detailed default clauses, focusing on events internal to the cardholder-issuer relationship.[119] That seems positive, at least in part because of the likelihood that it would lessen reliance on external sources of information (with questionable reliability) such as credit reports. Moreover, it might be that cardholders eventually could come to understand and react to those terms.

Another likely effect would be a contraction of credit (or increase in price) to the affected borrowers. Again, that response would be beneficial if financial distress by cardholders imposes costs on society and if current business models encourage borrowers to wait too long before filing for bankruptcy. A system that induces issuers to terminate lending earlier might lower the social costs of financial distress by pressing risky borrowers into an earlier resolution of their financial affairs.

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This discussion is not intended to suggest that universal default provisions are the only—or even the most important—provisions in credit card agreements that do not advance the social value of the relationship. Rather, within the brief scope of this essay, the discussion is intended to be exemplary, to illustrate the kinds of provisions that such an approach would ban.

Presumably, the most sensible way to implement such an approach would be for a relatively well-informed regulator (such as the Federal Reserve or the Office of the Comptroller of the Currency ("OCC"),[120] or, less plausibly in our current environment, the Federal Trade Commission) to engage in a cooperative examination, with participation by the affected parties, of the relevant terms. The point here is that a regulator that bans a particular term that commonly is part of the product is likely to affect the market for the product in some cognizable way—by either increasing the cost or lowering the amount or quality of the product in some way.[121] The

118. I discuss that view in more detail in MANN, *supra* note 2, pt. IV.

119. Of course, in some sense *all* clauses that define events of default operate to alter the terms of the relationship after the fact: whenever a borrower fails to make a payment in a timely manner, the lender is likely to have the right to increase the interest rate that applies to debt that is outstanding at that time. Universal default clauses are more problematic than the standard clauses, however, because they extend the definition of default to include events outside the relationship. My point is not that a creditor reacts irrationally (or unfairly) in concluding that cardholders that are in default to other creditors are more risky than those that are not in default to any creditor. Rather, the concern is that most cardholders, most of the time, will not accurately account for this in ordering their financial affairs. Moreover, few if any of them will price it accurately when they enter into their cardholder agreements. To that extent, the actual effect of the clause is quite different from the typical default clause, which in consumer lending agreements focuses almost entirely on a failure to make timely payment to the creditor.

120. National banks dominate the major card issuers, because only national banks are entitled to the preemptive provisions of the National Bank Act. Because the OCC regulates all national banks, the OCC would be in a position to regulate major credit card issuers if it chose to do so. *See* Furletti, *supra* note 77. To date, however, the OCC for the most part has limited itself to safety and soundness regulation—criticizing practices that might undermine the solvency of the institution (such as unduly risky lending practices).

121. *See* White & Mansfield, *supra* note 16, at 258–59.

justification for regulation is the idea that contracting is inherently lawmaking,[122] and that standardized adhesion contracts in practice operate as "unilateral codes," by which the parties that promulgate them "usurp the law-making function," effectively providing "government by private law."[123]

The idea is not a new one. Indeed, it is at least as old as the work of Arthur Leff, who viewed defective contracts as analogous to defective automobiles.[124] As he explains, the decision a regulator should be making when it makes such a decision is that consumers are better off with the higher price (or lower quantity or quality) of the product that comes in a market without the choice to accept the prohibited term.[125] Thus, the discussion above suggests banning universal default terms based on the idea that the most likely effect would be a contraction of credit in a market that is both functioning quite poorly and also generating substantial externalities. The analysis is comparable to the decision of the Department of Transportation to require all cars to have airbags—some of us would buy cars without airbags, but the government has determined that we all are better off if we cannot make that choice.

There are obvious problems with such an approach.[126] Among other things, it is not clear that regulators *will do* a better job than courts in identifying terms to be invalidated. Still, there is at least some reason to believe that an ex ante approach—that can be applied evenly across contracts and be incorporated into the price—is preferable, because of the likelihood that the opportunity for input from affected businesses will lead regulators to avoid (or quickly repair) truly egregious errors.

2. *Standardized Terms*

Term invalidation is probably an incomplete response. Another response would be to standardize card agreements.[127] At first glance, that approach seems more intrusive, because it abandons reliance on the market to develop the optimal terms. The use of pre-approved terms, however, is the conventional approach for remedying contracting problems in other consumer finance markets. Indeed, credit card agreements stand out as one of the rare types of consumer financial transactions that do not proceed on some set of pre-approved terms.[128] Home mortgages are executed almost entirely on the

122. *See* Slawson, *supra* note 6, at 530.

123. *See* Schuchman, *supra* note 53, at 130.

124. *See* Leff, *supra* note 7, at 144–55.

125. Jean Braucher argues that the Federal Trade Commission has been doing something much like this, and that it did it reasonably well, at least during the 1980s. *See* Jean Braucher, *Defining Unfairness: Empathy and Economic Analysis at the Federal Trade Commission*, 68 B.U. L. REV. 349 (1988).

126. *See* Gillette, *supra* note 3, at 717–19; Leff, *supra* note 7, at 152.

127. Jeffrey Davis made a similar proposal two decades ago. *See* Jeffrey Davis, *Revamping Consumer-Credit Contract Law*, 68 VA. L. REV. 1333 (1982).

128. The phenomenon is not new. For early discussion, see Nathan Isaacs, *The Standardizing of Contracts*, 27 YALE L.J. 34, 37–40 (1917); Rakoff, *supra* note 6, at 1182.

standard FNMA form. A glance at the form would convince most of us that—although it suffers from many of the readability problems discussed in Part I—it is not a form drafted to exploit consumer myopia or cognitive weakness.[129] Similarly, state regulators largely determine the major terms of insurance policies.[130] Major real estate transactions—such as the sale of a home—typically proceed on forms that are standardized by a government agency[131] or some intermediary that at least in part represents the interests of consumers.[132]

Presumably, a standard account agreement would include mandatory provisions for the legal aspects of the relationship, with specific options on issues where there are substantial business reasons for product differentiation. Thus, we might expect two or three variations on the method for calculating the outstanding balance—one without any grace period, one with a full grace period, and a moderate provision in between. There also would be options for the financial terms on which issuers compete, including the interest rate and the amount of annual, late, and overlimit fees.

Such a proposal would respond directly to the problem of multiplicity of terms and agreements summarized above. Thus, like the FTC Mail-Order Rule, it would funnel competition among card issuers directly into the attributes for which variation is permitted, predominantly price-related attributes as to which consumer understanding is heightened and for which competition is easier to imagine.

To be sure, this solution would do little to decrease complexity. Yet the relationship necessarily is a complex one. Even if standardization substantially lowered the number of terms that a typical cardholder would need to understand, it is doubtful that it would simplify the relationship sufficiently to make a fully competitive cardholder reaction a realistic possibility. The number of attributes of relevance to a fair assessment of a modern credit card product, even putting the agreement aside, is sufficiently large as to make it implausible to think that most cardholders can aggregate and assess the attributes rationally.[133]

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129. It is not the point of this essay to argue that those markets function well or that cognitive problems do not contribute to excessive borrowing in those markets. I do think, however, that much of the recent controversy in these markets focuses on home equity products, which are less standardized than the first-lien home mortgage markets I discuss in the text. In my view, the greatest cause of excessive borrowing in the first-lien home mortgage market is likely to be federal intervention (in the form of loan guarantee programs) that encourages homeowners to borrow funds that private lenders would not lend.

130. *See* ABRAHAM, *supra* note 40, at 32–33; Macaulay, *supra* note 7, at 1062; Slawson, *supra* note 12, at 50–52.

131. *See, e.g.*, TEX. PROP. CODE ANN. § 5 (Vernon 2003) (articulating various provisions and notices that must be used in residential real estate transactions).

132. In many geographic areas, a residential real estate transaction proceeds on a form prepared by a group of real estate brokers. That group might not be biased in favor of consumers—their primary interest doubtless is to prod the transaction toward consummation (so that a brokerage commission is due)—but that interest typically results in a reasonably balanced form.

133. *See* Grether et al., *supra* note 49, at 296–97.

Still, standardization should over time advance cardholder understanding considerably. I think, for example, of the typical apartment lease, a document of comparable complexity, read directly by few consumers. However, most of us have a reasonable understanding of the typical aspects of that business relationship, predominantly because the terms are relatively standardized and stable over time. If the terms of credit cardholder agreements were uniform, we would expect that through experience many cardholders would come to understand the basic terms that define the events that lead to late payments, overlimit fees, events of default, and the like. Given the ways in which multiplicity of terms and term cycling exacerbate the role of complexity in the existing market, there is good reason to think that standardization would be helpful.

Further, the oft-cited objections to using mandatory terms are less compelling in this context. The first is the one discussed above, that standardization will narrow the range of product attributes that issuers can use to attract and satisfy customers. As suggested in the previous section, standardization decreases consumer welfare to the extent that it drives attractive products out of the market.[134] In this context, however, firms do not currently compete to attract customers based on the non-price terms of these agreements. Indeed, the root of the problem is that there are terms that have a substantial economic effect that are ignored. A regime that eliminates differentiation on those terms would not make the products less attractive to most customers. The dominant effect would be a long-term one, in which customers eventually might come to understand those terms sufficiently to consider them in assessing the risks and appropriate pricing of their purchasing and borrowing behavior. To the extent that opportunities for delivering products to particular classes of cardholders are limited, I expect that the benefits to the cardholders in the mainstream would far exceed the harms.[135]

A more difficult problem is the likelihood that regulators will draft the terms less capably than card issuers will. The terms will be more obscure, will not improve over time, will include more unintentional ambiguities, or will not produce the optimal allocations of risks among the parties. In many contexts, such concerns would be serious, and the record of obscure drafting of disclosures by the Federal Reserve should give us pause before seeking uniform governmental drafting. In this case, however, against the background of existing contract practices, the problems might be less troubling. For one thing, the discussion above suggests little reason to think that existing terms are drafted with care to be clear and unambiguous or to create an optimal allocation of risks. Rather, the market currently seems to drive competitive issuers to obscure their terms to escape the notice of their

134. *See id.* at 298–99.

135. *See* Camerer et al., *supra* note 85. The most obvious potential harm to consumers would be a contraction of the credit markets in response to limitations on ex post facto terms. My analysis here assumes that the likely contraction will affect for the most part consumers that are already in serious financial distress. To the extent lenders stop or limit credit to those people sooner, contraction in fact is likely to be desirable. MANN, *supra* note 2, ch. 17.

customers. Moreover, as long as the terms are standardized and within some broad range of reasonableness, differences in their impact can be treated by alterations in the price terms that would be left to card issuer discretion (grace periods, interest rates, amounts of the various fees, and the like).

Still, the problems of government drafting suggest an alternate approach that might be useful: pressure from federal regulators on the networks to promulgate uniform terms. Many of the examples to which I refer at the beginning of this Section do not involve direct government regulation. Rather, they involve drafting by intermediaries in a framework that motivates the intermediaries to consider the interests of consumers.

In this context, the obvious candidates for standardized drafting would be Visa and MasterCard. If Visa and MasterCard could be motivated to perceive that the issuance of uniform (and stable) terms on a network-by-network basis was a prudent course to avoid federal intervention and government standardization, we might reach the best of all possible outcomes: a well-drafted and sophisticated allocation of risks, with sufficient stability that customers could adapt to it. For example, if networks were motivated to allocate risks efficiently, they might include a low-cost dispute resolution process like the one used for consumer-merchant disputes governed by TILA. As Andy Morriss and Jason Korosec illustrate, a side effect of the provisions of TILA shifting the costs of dispute resolution to card issuers has been the creation of a highly efficient and technology-driven system for resolving claims of inappropriate charges.[136] A system in which an individual network committed that its issuers could be held to the terms of their agreements at least theoretically could be a powerful marketplace tool. Imagine, for example, if MasterCard advertised that consumers who are troubled by "unfair late fees" and "unresponsive card issuers" should use their MasterCard, knowing that they could rely on MasterCard's consumer protection guarantee.

At first glance, it might seem difficult to motivate Visa and MasterCard to implement such a scheme. The history of federal regulation of payment intermediaries, however, suggests a more optimistic perspective. For example, Stewart Macaulay shows how bitterly card issuers opposed the provisions of TILA that make them responsible for unauthorized use.[137] Today, however, the leading card networks advertise their willingness to accept responsibility for unauthorized use even more broadly than TILA requires. Similarly, banks strongly opposed the Expedited Funds Availability Act, but now offer funds availability schedules far more generous than that statute requires.[138] More generally, a familiar pattern of policy development on the

136. Andrew P. Morriss & Jason Korosec, *Private Dispute Resolution in the Card Context: Structure, Reputation, and Incentives* (Case Research Paper Series in Legal Studies, Working Paper No. 05-12, 2005), *available at* http://ssrn.com/abstract=735283.

137. *See* Macaulay, *supra* note 7.

138. *See* RONALD J. MANN, PAYMENT SYSTEMS AND OTHER FINANCIAL TRANSACTIONS 23–29 (3d ed. 2006) (discussing the Expedited Funds Availability Act, 12 U.S.C.A. §§ 4001–4010 (West 2005)).

Internet has involved extensive initiatives by private intermediaries acting in the shadow of threatened regulation.[139] Thus, just as eBay and the card networks have been persuaded by state regulators to limit their involvement in activities in ways existing law probably does not require, there is some reason to think that regulatory authorities could persuade Visa and MasterCard that voluntary "Fair Contracting" initiatives might be a prudent course to forestall formal regulatory intervention.

Finally, a still narrower solution might avoid the risks of centralized drafting, but still force the production of terms in a way that makes them amenable to evaluation by intermediaries. There is some reason to think that public scrutiny of the terms of cardholder agreements is more effective than person-by-person negotiation with cardholders. For example, a review of cardholder agreements used by major issuers indicates that the flurry of public attention to universal default terms (discussed below) has led at least one major issuer to agree to provide advance notice before declaring universal default.[140] The current public attention led to standardization of the time by which consumers must send payments to avoid late fees—a bright-line rule, for example, that lenders must treat payments received by mail at 3 p.m. or 5 p.m. as made on the date of actual receipt.[141]

The Internet makes broad dissemination of standard terms easier than it would have been when TILA was enacted. Thus, credit card issuers could be required to post the major nonprice terms of their agreements in a uniform format on either their own sites or publicly available Internet sites (such as a site hosted by the FTC, the Federal Reserve, or the OCC).[142] The simplest approach probably would be to post them on the FTC's user-friendly website, so that intermediaries reliably could find all of the terms in a single place. Issuers that wished to do so also of course could post their terms on their own sites. Indeed, if the FTC required issuers to provide a URL for an address at which the issuer had posted the terms, it would not matter where the terms technically were posted, because the FTC site could provide a catalog of links to the individual postings. The benefit of requiring the terms to be posted directly at the FTC, however, is that it would facilitate downloading the terms in a readily analyzable format such as a spreadsheet.

139. *See* Ronald J. Mann & Seth R. Belzley, *The Promise of Internet Intermediary Liability*, 47 WM. & MARY L. REV. 239 (2005).

140. *See Universal Default*, CARDFLASH: DAILY PAYMENT CARD NEWS, May 18, 2005, at 2, http://cardweb.com/cardflash (discussing change in Citibank policy). I find it most unlikely that all (or even most) issuers will remove these clauses. In the current environment, in which cardholder agreements—even those used by publicly traded regulated financial institutions—are not available online, it is difficult to collect specific information on that point.

141. *See id.* at 1 (discussing Federal Reserve consideration of such a proposal). Any reader that thinks it is impractical for mail to be processed as quickly as that proposal suggests should become familiar with Netflix's mail processing routines. *See* Netflix.com, How It Works, http://www.netflix.com/HowItWorks?lnkctr=nmhhiw (last visited Jan. 7, 2006).

142. *See* Robert A. Hillman, *On-Line Consumer Standard-Form Contracting Practices: A Survey and Discussion of Legal Implications* (Cornell Law School Legal Studies Research Paper Series, Paper No. 05-012, 2005), *available at* http://ssrn.com/abstract=686817 (making similar proposal for electronic contracts).

Regulators also could require that any set of terms remain in effect for a certain minimum period (such as 90 days) to facilitate the activity of intermediaries that might examine the postings and provide public assessments of the various terms. In the current environment, terms are not publicly available, so consumers do not see them until they have responded positively to a solicitation and received a card, at which point their credit rating already reflects the extension of credit. Initiatives to educate consumers about the meaning of unpriceable terms or to persuade responsible issuers to avoid unpriceable terms can have a positive effect only if it is possible for consumers to pick among issuers based on the terms. Public disclosure of the terms is perhaps the simplest way to jump-start such a regime.

CONCLUSION

Compared to other consumer financial contracts, credit card agreements are not subject to significant regulatory constraints. Yet, credit card contracts arguably are the most perilous for consumers, because credit cards are associated with increased consumer spending and financial distress. The risk is exacerbated by the ability and incentives of sophisticated card issuers, admittedly driven by the business necessities of a continuing credit relationship, to exploit cardholder relationships. Thus, the realities of credit card transactions produce a set of dynamic contracting obligations that even sophisticated cardholders cannot master.

I argue that the juxtaposition of financial peril, market dysfunction, and lack of regulation should not continue. Thus, I propose the prospective invalidation of terms in cardholder agreements that apply to debts incurred in connection with previous transactions. A more effective response, however, would parallel the approach that already exists in most other substantial consumer financial transactions—a regulatory (or self-regulatory) standardization of cardholder agreements.